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Division of Swap Dealer and Intermediary Oversight

Gary Barnett
Director

CFTC Letter No. 14-67
No-Action
April 8, 2014
Division of Swap Dealer and Intermediary Oversight

RE: Request for No-Action Relief for Certain Subsidiaries of "A"

Dear :

This letter is in response to your letter, dated March 6, 2014 (the "Correspondence") with staff of the Division of Swap Dealer and Intermediary Oversight ("Division") of the Commodity Futures Trading Commission ("Commission"). In the Correspondence, you request no-action relief with regard to specific activities known as Interposed Longevity Reinsurance Transactions on behalf of "B" and "C" (collectively, "D"). Specifically, you request that based on the facts and assumptions described below in connection with "D's" execution and delivery of its Reinsurance Agreements (as defined below) in Interposed Longevity Reinsurance Transactions (as defined below), (1) the Division will not recommend that the Commission take any enforcement action against "D" based upon the view that the Reinsurance Agreements are "swaps" as defined under the Act (and the regulations thereunder) or should be characterized as swaps, (2) the Division will not recommend that the Commission characterize the Reinsurance Agreements as insurance of swaps or guarantees of swaps, and (3) further, in connection with clauses (1) and (2) above, the Division will not recommend that the Commission take any enforcement action against "D" based upon the view that "D" is a provider of, a party to, guarantor of, or insurer of, a swap.

I. Facts and Assumptions as Presented by "D"

The facts and assumptions described below are the facts that you have presented to us in the Correspondence:

A. Subsidiaries of "A"

"B" is a life insurance company domiciled in the State of New Jersey duly authorized under the insurance laws of that state to issue annuities and other life insurance products. "C" is a life insurance company domiciled in the State of Connecticut duly authorized under the insurance laws of that state to issue annuities and other life insurance products, and "C" is also a wholly-owned subsidiary of "B". Both "B" and "C" are wholly-owned subsidiaries of "A". Currently, longevity reinsurance is written by "C", but in the future it may be written by "B". "C's" and "B's" transactions are regulated by the insurance departments of their respective states and are subject to state regulatory capital and reserving requirements.

"C" and "B" are each licensed under applicable state law to conduct life insurance and annuity business and are authorized to reinsure such business. Under applicable state insurance law, the coverage of longevity risk, defined as the risk that beneficiaries in a pension plan live longer than expected, constitutes an annuity risk and therefore, "C" and "B" are authorized to reinsure such annuity risk. "C" and "B" treat the reinsurance of such annuity risk as reinsurance for regulatory purposes.

B. Longevity Risk Coverage and the Interposed Longevity Reinsurance Transactions

Many foreign companies sponsor defined benefit pension plans ("Pension Plans") that are obligated to pay retirement benefits ("Retirement Benefits") (whether fixed or including adjustments for inflation) to employees, eligible spouses, and eligible dependents ("Plan Beneficiaries"). Such Pension Plans often purchase longevity risk coverage to protect themselves against the risk that the Plan Beneficiaries, in the aggregate, live longer than actuarially expected, and thus are entitled to retirement benefits for a longer period of time.

In jurisdictions outside of the United States, longevity risk coverage may be initially provided in the form of a derivative. The provider of such derivative is herein referred to as the "Longevity Risk Assuming Party" or "LRAP." The Longevity Risk Assuming Party will be a non-U.S. financial institution that is not regulated as an insurance company and that in each case, provides the longevity risk coverage in the form of a derivative because it is not authorized to issue insurance contracts. The non-U.S. regulator of such Longevity Risk Assuming Party does not disapprove of the provision of such longevity risk coverage being done in the form of a derivative.

The derivative provides longevity risk coverage to the Pension Plan in exchange for the payment of premiums through a stop-loss arrangement in which the LRAP makes payments to the applicable Pension Plan over the lifetimes of the Plan Beneficiaries in an amount, if any, equal to the excess of actual Retirement Benefits paid over the retirement benefits expected to be paid at the time the longevity risk coverage is purchased. Aside from the premiums the Pension Plan pays for this coverage, no Pension Plan assets are transferred to the Longevity Risk Assuming Party.

The Correspondence describes the process and circumstances of reinsuring Pension Plans' longevity risks as follows. Under each of "D's" Reinsurance Agreements, "D" assumes

100% (or some lesser percentage) of the actual longevity risk borne by the Pension Plan – that is the risk that the Retirement Benefits payable to each actual Plan Beneficiary will in the aggregate exceed the actuarially expected payments agreed to by the parties at the time the Reinsurance Agreement was entered into. Such excess payments would be caused by such Plan Beneficiaries living longer than actuarially expected. "D's" obligations under each Reinsurance Agreement reference the lives of the actual Plan Beneficiaries. "D's" obligations are tied directly to (1) whether the actual Plan Beneficiaries live, in the aggregate, longer than expected and (2) the obligations of the Pension Plan to pay such Plan Beneficiaries. During the term of the Reinsurance Agreement, "D's" payment obligations are not tied to, dependent upon, or otherwise affected by, any other obligations that the Longevity Risk Assuming Party may assume under such LRAP's derivative with the Pension Plan.

Prior to "D" entering into a Reinsurance Agreement, the longevity risk is initially assumed by the Longevity Risk Assuming Party in the form of a derivative contract, as described above. The longevity risk is then ultimately transferred to "D" in the following process known as an "Interposed Longevity Reinsurance Transaction":

1. The longevity risk is transferred by the Longevity Risk Assuming Party to a non-U.S. company, such as a Bermuda cell insurance company (the "Interposed Longevity Risk Transferee"), under a mirror derivative contract, with the payment obligations substantially similar to those under the derivative contract (or the transferred portion thereof) between the LRAP and the Pension Plan. Bermuda insurance companies, or similarly situated companies, are authorized under the laws of their respective jurisdictions to assume insurance risks through derivative contracts.

2. The longevity risk is assumed from the Interposed Longevity Risk Transferee under an insurance policy issued by a non-U.S. insurance company (which may be a different cell of the same Bermuda insurance company or another insurance company affiliated with the Interposed Longevity Risk Transferee) (the "Cedant").

3. Finally, the longevity risk is reinsured by "D" to the Cedant pursuant to a reinsurance agreement (each, a "Reinsurance Agreement").

At the time any such Reinsurance Agreement is entered into, "D" will not be, and will not contemplate becoming, an "affiliate" (as such term is defined in Rule 405 under the Securities Act of 1933) of either the Longevity Risk Assuming Party, the Interposed Longevity Risk Transferee, the Cedant, or any of their respective affiliates.

Regarding inflation and how it affects longevity risk and the transferal or reinsurance thereof, the Correspondence makes the following representations. Many Pension Plans also provide inflation-adjusted payments to their Plan Beneficiaries to cover cost of living increases.

In such situations, the Pension Plan's longevity risk includes the risk that the Plan Beneficiaries living longer than expected are entitled to inflation-adjusted Retirement Benefits.[1] "D" can assume this aspect of the longevity risk in a number of ways. "D" could agree with the Cedant to increase the baseline Retirement Benefits by a fixed annual percentage. "D" could also provide longevity risk coverage based on the actual inflation rate set forth in the Pension Plan for the benefit of Plan Beneficiaries. Alternatively, "D's" payment obligations could be subject to a cap on the aggregate amounts paid as a result of adjusting for inflation. In cases where the inflation-adjusted payments to the Cedant do not exactly match the actual inflation adjustments owed by the Pension Plan to the Plan Beneficiaries, such mismatch is expected to be small. Any resulting mismatch is not structured to, or intended to, achieve tax treatment for the Reinsurance Agreement as a notional principal contract as opposed to as a reinsurance contract. Whether and to what extent "D" makes inflation-adjusted payments is based upon contractual negotiations with the Cedant and the scope of coverage the Cedant is looking to reinsure, and is solely correlated to the obligations of the Pension Plan. "D's" decision to make inflation-adjusted payments is not in any case based upon "D" speculating on the inflation rates, and "D's" exposure will often be covered by its own investment in index-linked government bonds.

C. The Terms and Mechanics of "D's" Reinsurance Agreements

For each Reinsurance Agreement, the reinsurance premium is fixed on the inception date of the Reinsurance Agreement, subject to being subsequently adjusted in connection with periodic data reviews to adjust for data entry errors and to reflect actual lump-sum payments to Plan Beneficiaries under the Pension Plan. The reinsurance premium charged for the Reinsurance Agreement is not different from the premium that an insurer would charge if it were providing longevity risk coverage directly to the Pension Plan rather than in an Interposed Longevity Reinsurance Transaction. Such reinsurance premium is divided under the terms of the Reinsurance Agreement into payments designated as premium and payments designated as fees.[2]

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[1] Generally, a Pension Plan or a Longevity Risk Assuming Party may seek coverage of inflation risk that does not exactly match the actual inflation adjustments owed by the Pension Plan to the Plan Beneficiaries for at least three commercial reasons: (1) they may have a more economically efficient way of managing inflation risk other than buying reinsurance coverage (*e.g.*, some Pension Plans manage inflation risk by purchasing assets that adjust for inflation and so they manage their inflation risk in a physical assets portfolio); (2) the price for full reinsurance coverage of inflation risk may be too high, so the Pension Plan or LRAP may decide to keep a portion of the risk; or (3) the Pension Plan or LRAP may purchase longevity coverage that covers only an average inflation rate that is based on the inflation rate covered by the Pension Plan in order to reduce complexity and administrative burdens associated with the use of multiple inflation rates.

[2] In an Interposed Longevity Reinsurance Transaction, the premium component of the total reinsurance premium is an amount equal to "D's" best estimate of the future longevity risk, while the fee component of the total reinsurance premium is an amount that is charged by "D" to cover the risk that the Plan Beneficiaries live longer than such estimate. This dichotomy occurs in order to simplify calculations upon the termination of the Reinsurance Agreement. Namely, if "D" defaults, the industry standard is that "D" is not entitled to the fee component, but is

"D" nevertheless records both components as reinsurance premium on its statutory financial statements. Reinsurance benefits are also paid on a periodic basis. Such benefits are based on actual Retirement Benefits paid compared to those expected to be paid at the inception of the Reinsurance Agreement, and therefore, "D" assumes the risk that actual Plan Beneficiaries live, in the aggregate, longer than expected. As is typical, reinsurance premium and reinsurance benefits are netted and only the net amount is paid by one party to the other party on any given periodic payment date. "D" accounts for the Reinsurance Agreements on its statutory financial statements as the reinsurance of annuity contracts and subjects the risks assumed under the Reinsurance Agreements to periodic actuarial analyses as it would with respect to any annuity contracts.

Under the Reinsurance Agreements, the Cedant and "D" agree to provide collateral to each other from time to time based on the amount of future reinsurance premium to be paid over the remaining term of the Reinsurance Agreement and the amount of expected reinsurance benefits to be paid over the remaining term of the reinsurance agreement. The expected reinsurance benefits are recalculated periodically over the term of the Reinsurance Agreement. Typically, if the present value of future reinsurance premiums (excluding its fee component) exceeds the present value of expected reinsurance benefits, collateral must be posted by the Cedant. As is customary in Interposed Longevity Reinsurance Transactions for the protection of the Cedant and given the relatively large potential payment obligations, if the present value of future reinsurance benefits exceeds the present value of future premiums (excluding its fee component), collateral must be posted by "D". In such case, the Cedant must concurrently counter-post an equivalent amount of collateral to "D" up to the full amount of the present value of the fee component of the future reinsurance premiums. The present value determinations of each of the future premium payments (excluding fee component), the fee component of future premium payments, and the payment stream of future reinsurance benefits are calculated from the date of determination through the date on which the last such payment would be owed. The posting of collateral by a reinsurer for the benefit of a cedant is not unusual in large reinsurance transactions outside of the longevity market.

Upon any termination of a Reinsurance Agreement, the parties are obligated to make a final settlement. In addition, in the event of an early termination of the Reinsurance Agreement due to an insolvency of "D", the safe harbors provided in the U.S. Bankruptcy Code for terminating derivatives contracts would not apply and the applicable state insurer insolvency laws would govern. The final settlement is based on the present value of the future reinsurance premium (including its fee component), the present value of expected future reinsurance benefits and, in some instances, the expected cost to the Cedant of securing replacement reinsurance protection. Among the termination events, the Reinsurance Agreement will automatically

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entitled to any excess of the present value of the premium component (excluding the fee component) over the present value of expected reinsurance benefits at the time of such default.

terminate upon the termination of the underlying annuity or other insurance contract or derivative contract, as the case may be.

Typically, the Reinsurance Agreement is expected to remain in effect for so long as the Plan Beneficiaries are alive and the coverage provided by the Longevity Risk Assuming Party to the Pension Plan remains in effect (although it may provide coverage for a shorter specified period of time). When the last reinsured Plan Beneficiary dies (or on an earlier scheduled termination date), the Reinsurance Agreement terminates, unless it is terminated pursuant to its early termination provision.[3] As with annuity contracts issued in the United States, the contract issued by the Longevity Risk Assuming Party is assignable. "D" anticipates that any assignment of such contract by the Pension Plan would be to an insurance company entering into a buy-out transaction with the Pension Plan.

Each "D" entity that issues a Reinsurance Agreement will be licensed under applicable state law to conduct life and annuity business at the time that it issues the Reinsurance Agreement, and therefore, will be authorized to reinsure such business. Under applicable state insurance law, the underlying longevity risks being transferred to the Longevity Risk Assuming Party and reinsured by "D" under the Reinsurance Agreements will constitute annuity risks. Because each "D" entity will be licensed under applicable state law to directly issue annuities, you state that such entities are authorized to reinsure such annuity risk. Accordingly, with respect to each Interposed Longevity Reinsurance Transaction, you represent that the applicable "D" entity will be authorized under applicable state law to reinsure the longevity risk being assumed in such transactions. In addition, each Reinsurance Agreement is, and will be, treated by "D" as reinsurance for state insurance regulatory purposes. Each Reinsurance Agreement is, and will be, subject to state insurance regulatory capital and reserving requirements. For applicable tax and accounting purposes, each Reinsurance Agreement is, and will be, treated as an annuity product.

The Correspondence asks that the Division further assume, in evaluating the request for relief, that (1) the insurance contract issued by the Cedant to the Interposed Longevity Risk Transferee constitutes an "annuity" within the use of such term in the *Federal Register* release[4] in which the Commission finalized the swap definition; and (2) the Reinsurance Agreement issued by "D" to the Cedant constitutes "reinsurance" of an annuity within the use of such term in the Release.[5] The Correspondence also explains that in adopting the definition of swap, the Commission stated that it "views a guarantee of a swap to be a collateral promise by a guarantor

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[3] The early termination provisions of the Reinsurance Agreement are typically limited to a party's bankruptcy event, failure of a payment obligation or collateral posting obligation, material breach of a covenant, or adverse change in tax or regulatory treatment of the Reinsurance Agreement. The Reinsurance Agreements will not provide "D" with an optional right to terminate.

[4] 77 Fed. Reg. 48207 (Aug. 13, 2012).

[5] The Division notes that both "annuity" and "reinsurance" thereof are in the list of products excluded from the swap definition when all other aspects of that definition's insurance safe harbor are met. *See* 17 CFR 1.3(xxx)(4)(i)(C).

to answer for the debt or obligation of a counterparty obligor under a swap." It differentiates "D's" Reinsurance Agreements by stating that they relate to a specific insurance risk, namely longevity risk, and that they do not, directly or indirectly, "answer for the debt or obligation of a counterparty under a swap." Therefore, the Correspondence requests that the Division also assume that "D" has concluded that each Reinsurance Agreement is not financial guaranty insurance as described in the adopting release, or as may be defined under applicable state insurance law.[6]

II. Analysis

Given the arrangement by which the longevity risk is transferred to "D" (including, without limitation, the interposition of a Bermuda cell insurance company and a foreign swap counterparty), "D" is concerned that its Reinsurance Agreement may be characterized as insurance or a guarantee of a swap, or that "D" may be viewed as a provider of, a party to, or a guarantor or insurer of a swap. Therefore, the Correspondence requests that (1) the Division not recommend to the Commission that it take an enforcement action against "D" based upon the view that the Reinsurance Agreements are "swaps" as defined by the Commodity Exchange Act and further defined by the Commission's regulations, or should be characterized as swaps; (2) the Division not recommend that the Commission characterize the Reinsurance Agreements as insurance of swaps or guarantees of swaps; and (3) in connection with relief requested in (1) and (2), the Division will not recommend that the Commission take any enforcement action against "D" based upon the view that "D" is a provider of, a party to, guarantor of, or insurer of, a swap.

Based upon the representations made by "D", the Division believes it appropriate to grant relief as described further below. In this regard, the Division notes the following facts: The Reinsurance Agreement is a traditional reinsurance contract.[7] The longevity risk coverage

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[6] As examples, the Correspondence cites the definitions of financial guaranty insurance and annuity found in the insurance laws of Connecticut, which are applicable to "C". "Connecticut Insurance Law defines financial guaranty insurance, in relevant part, as an insurance policy under which loss is payable upon proof of occurrence of financial loss to an insured claimant, oblige or indemnitee as a result of, among other events, (1) a failure of any obligor on any debt instrument or other monetary obligation to pay when due principal, interest, premium, dividend, purchase price of or on the instrument or obligation, (2) changes in the level of interest rates, (3) changes in the rate of currency or (4) changes in the value of financial or commodity indices or price levels in general. Conn. Gen. Stat. § 38a-92a(1)(A). The Connecticut Insurance Law defines an annuity as follows: 'all agreements to make periodic payments where the making or continuance of all or some of the series of the payments, or the amount of the payment, is dependent upon the continuance of human life or is for a specified term of years. This definition does not apply to payments made under a policy of life insurance.' Conn. Gen. Stat. § 38a-1(3)." The Correspondence further points out that an analysis of these definitions under New Jersey state insurance law, where "B" is domiciled would be substantially similar in all material respects to that described above for Connecticut.

[7] This statement is based on the assumption made by the Division at "D's" request, but it is also supported by the facts as presented by "D" in the Correspondence. As the Correspondence states, "D's" obligations under the Reinsurance Agreement are tied directly to the longevity risk of the Pension Plan, the actual length of the Plan Beneficiaries' lives, and the obligations of the Pension Plan to pay its Plan Beneficiaries. "D's" obligations are not

provided under the Reinsurance Agreement is either 100%, or some lesser percentage, of the actual longevity risk assumed by the Pension Plans in respect of the Plan Beneficiaries.[8] The amounts required to be paid by "D" under the Reinsurance Agreement in respect of longevity risk coverage are not affected by the terms of any of the other agreements in the Interposed Longevity Reinsurance Transaction, such that the interposed entities and agreements are merely a conduit for the payments to be made on or in respect of the Reinsurance Agreement.[9] Further, "D" is not affiliated with, nor will it become affiliated with, any of the interposed persons or any of the parties to the interposed agreements. The transaction between the Interposed Longevity Risk Transferee and the Cedant is an insurance policy for longevity risk, and "D" is providing reinsurance to the Cedant on that same longevity risk – business that it is specifically authorized to conduct by the insurance laws of the state in which the applicable "D" subsidiary is domiciled.

The Division's view might be different if the Correspondence presented different facts. For instance (by way of example, and not by limitation), if the interposed swap required, for tax or regulatory purposes, a mismatch between payments under the swap and the longevity risk assumed by the Pension Plan, and if the payment obligations under the Reinsurance Agreement increased to support payments owed by the Longevity Risk Assuming Party under its swap, resulting in the reinsurance payments exceeding the actual longevity risk borne by the Pension Plan, then further analysis might be warranted. But, that is not the case here. Under the current facts, it appears to the Division that the derivatives in the Interposed Longevity Reinsurance Transaction merely serve as a conduit for the longevity risk coverage and payments made under bona fide reinsurance transactions of an annuity risk, business that "D" is already and will continue to be authorized to conduct pursuant to state insurance laws, and that such reinsurance payments are better viewed as being passed through such conduit (a conduit created by unaffiliated third persons for their own business reasons) and not as insurance or as a guarantee of any portion of the conduit, or any of the conduit's obligations (including any of the conduit's obligations under its derivatives). Furthermore, the Division is of the view that the arrangement should not be viewed as comprising or including a swap issued by "D".

Accordingly, the Division will not recommend that the Commission take an enforcement action against "B" or "C" on the basis that, under the same facts described herein, the

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derived in any way from the ability of any other party in the Interposed Longevity Reinsurance Transaction to meet its obligations in any of the underlying transactions.

[8] The Correspondence mentions that there is only one possibility for a mismatch between the basis for the longevity payments made under the Reinsurance Agreement and actual payments made by the Pension Plans to the Plan Beneficiaries (other than due to "D" assuming less than 100% of the longevity risk), and that is due to the management of inflation risk, as discussed at length above. This fact does not alter the Division's determination in this case.

[9] The fact that a failure of an intervening party to make its required payments will automatically cause a termination of the Reinsurance Agreement (and a final settlement payment by "D" calculated as discussed above) does not alter the key point – that the structure is a conduit for the payments to be made on or in respect of the Reinsurance Agreement.

Reinsurance Agreements described herein are or should be characterized as swaps, as insurance of swaps or guarantees of swaps, or that any of such persons is a provider of, a party to, guarantor of, or insurer of, a swap.

This letter, and the positions taken herein, represent the view of this Division only, and do not bind the Commission, any other office or division of the Commission, or any other Federal agency. The relief issued by this letter does not excuse the affected persons from compliance with any other applicable requirements in the Commodity Exchange Act or in the Commission's regulations thereunder. Further, this letter, and the relief contained herein, is based upon the representations made to the Division. Any different, changed or omitted material facts or circumstances might render this letter void. In this regard, you must notify the Division immediately in the event the operations or activities of "B" or "C" change in any material respect from the circumstances outlined in this letter.

If you have any questions regarding this letter, please contact the undersigned at 202-418-5977, Amanda Olear, Associate Director, at 202-418-5283 or aolear@cftc.gov, or Elizabeth Groover, Special Counsel, at 202-418-5985 or egroover@cftc.gov.

Very truly yours,

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