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New York Probes Insurers' Use of Retained Asset Accounts

Some Observations and Context

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Spurred by recent press reports, some regulators have voiced concerns that life insurers may not be disclosing enough information about the nature of "retained asset accounts" ("RAAs") — a common life insurance industry practice where life insurers retain death benefits in accounts set up on behalf of the beneficiaries until the beneficiaries provide instruction to the insurer regarding disbursement of the funds. RAAs generally pay interest to the beneficiaries until the funds are disbursed. Late last week, New York Attorney General Andrew Cuomo disclosed that he has begun an investigation of the life insurance industry's use of RAAs.

Cuomo announced on July 29 and 30, 2010, that his office has subpoenaed eight insurers, MetLife Inc., Prudential Financial Inc., Genworth Financial Inc., Unum Group, New York Life Insurance Co., Guardian Life Insurance Co. of America, Northwestern Mutual Life Insurance Co. and AXA unit MONY Life Insurance Co. of America, for information regarding investment profits the insurers made from funds retained in RAAs and how beneficiaries are informed of the terms related to the RAAs. The U.S. Department of Veterans Affairs also has launched its own investigation into the use of RAAs for veterans' death benefits.

Critics of RAAs have questioned the fairness and legality of insurers' retention of investment profits earned from funds held in the RAAs, *i.e.*, whether the insurers unjustly benefited from the investments made with funds that belong to the beneficiaries while paying beneficiaries a low interest rate, and whether beneficiaries are properly informed of the terms of the RAAs. Critics also alleged that life insurers have misled beneficiaries by telling them the death benefits are put in a secured account while such funds are commonly part of the insurer's general account that is not guaranteed by the Federal Deposit Insurance Corporation ("FDIC"), and that insurers might be violating federal bank law that permits only banks and credit unions to accept deposits. Critics stressed that consumers must be informed that a RAA is only one of the options for the settlement of death benefits and that they have the right to immediately take a lump sum payment.

Retained Asset Accounts

The use of RAAs has been an industry-wide common practice of life insurers over the past 20 years as a method for paying out life insurance death benefits. This practice has been engaged in with the knowledge and acquiescence of insurance regulators in many states (see discussion further below). A RAA is commonly defined as a mechanism whereby the settlement of proceeds payable under a life insurance policy or annuity contract is accomplished by the insurer or an entity acting on behalf of the insurer depositing the proceeds into a checking or draft account. *See* Maryland insurance regulation COMAR 31.09.14.03 and North Carolina insurance regulation 11 NCAC 12.1601. RAAs are designed to be a temporary repository of funds while the bereaved beneficiaries are given time to make decisions on the use or investment of the life insurance proceeds. The theory is that the interest of the insured and the beneficiary are fulfilled because RAAs provide time for beneficiaries to make decisions regarding the investment of life insurance proceeds such that important financial decisions are not required immediately following the death of a loved one. Because the RAAs continue to be part of the general account of the insurer, the investment and credit risk is essentially equivalent before and after the funds are placed into the RAA. A key component of the operation

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of RAAs is that a beneficiary that is prepared to make an immediate decision with regard to disposition of the insurance proceeds may do so by requesting the lump sum immediately.

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When a RAA is used, the life insurance proceeds are temporarily put into an interest-bearing account created on behalf of the beneficiary. Most RAAs are put under the insurer's general account[1] and must be reported on the insurer's annual statement. The beneficiary is given access to the funds in the account via a "checkbook" with which the beneficiary can write a draft to withdraw funds from the RAA, including to immediately withdraw the entire amount in one draft.[2] During the time the life insurance proceeds are held in the RAAs, the insurer invests the funds that make up the RAAs and guarantees a fixed percentage of return on the funds, usually similar to the interest rate of a money-market account or fund.

Currently, there are seven states with specific rules or published bulletins governing RAAs, including Arkansas, Colorado, Kansas, Maryland, Nevada, North Carolina and North Dakota.[3] The National Association of Insurance Commissioners ("NAIC") also issued a model bulletin 16 years ago addressing the issue of RAAs.[4] The focus of the state regulations and the NAIC model bulletin generally is that a life insurer must make clear disclosure of the terms of RAAs and all settlement options the life insurer offers in accordance with the terms of the policy so that the beneficiary can make an informed decision as to whether to choose a RAA as the settlement option. Insurers also are required to inform beneficiaries that they have the right to withdraw the entire balance of RAAs at one time or to immediately take a lump sum payment of the death benefits. Insurers also must continue to offer immediate cash payment of life insurance proceeds to the beneficiaries until the entire RAA balance is withdrawn or the balance drops below the insurer's minimum payment requirements. Colorado, for example, requires that a RAA cannot be the only method of settlement offered by the life insurer.[5] Nevada specifically requires insurers to offer the beneficiaries full cash payment of the life insurance proceeds as one of the settlement options.[6] Between the NAIC's model bulletin and the specific regulations or bulletins of a number of states, insurance regulators have clearly spoken as to the use of RAAs — and the focus is clearly on disclosure and preserving the ability to immediately access all funds.

Over-Reaction Might Cost Insureds and Beneficiaries

RAAs have been commonly used by the life insurance industry as a life insurance claims settlement mechanism for more than 20 years and were initially created at consumers' request. While acknowledging that consumer interest could be harmed if RAAs are not handled in a proper manner, we cannot ignore the fact that, if properly administered, RAAs provide a helpful option for beneficiaries who have just lost a loved one and who, within a short period of time, might not desire or be able to exercise best judgment on their own behalf in the investment of the proceeds. With a properly disclosed and administered RAA, beneficiaries immediately start earning interest on their funds while at the same time are provided full access to their funds — they may withdraw the entire amount of the benefits plus interest on their account by writing a draft for the full sum. In addition, while RAAs have been criticized for providing a low interest rate, most RAAs provide an interest rate comparable to other investment options that involve funds that are readily available and do not experience significant risk of principal loss.

A potential misunderstanding in recent press reports involves how RAAs might not be "safe" because they lack protection from the FDIC. While RAAs are generally not FDIC-insured, they are nevertheless part of the funds of the insurer guaranteed by state insurance guaranty associations in every state for an amount at least equal to the FDIC's limit of $250,000 per depository per bank. According to the National Organization of Life and Health Insurance Guarantee Associations, over 49 states cover to at least $300,000 and a few states offer guaranteed coverage up to $500,000. For instance, Kansas specifically requires a life insurer to provide a written explanation of what the limit of protection is for the RAA under the Kansas Life and Health Insurance Guaranty Association Act.[7]

Another opportunity for potential misunderstanding — or at least an opportunity for an alternate point of view — stems from certain allegations that insurers make substantial profits from RAAs. Most of the press reports we have seen do not acknowledge the recordkeeping, compliance and other expenses associated with the maintenance of RAAs — all of which decrease the assumed "spread" on the earnings from these funds. Moreover, in order for an insurer to stand ready to immediately respond to draws on RAAs by beneficiaries, the universe of investment options for the portion of an insurer's general account represented by assets in RAAs is necessarily limited to highly liquid money-market type investments likely yielding returns close to those paid out on RAAs.

As pointed out by the NAIC in its news release dated July 29, 2010, and as the Connecticut Insurance Commissioner, Thomas R. Sullivan, noted in his letter dated July 30, 2010, to the Connecticut Attorney General Richard Blumenthal, with proper disclosure, consumers have generally been happy with RAAs. RAAs allow the beneficiaries to earn interest immediately under the RAAs without the need to make impulsive decisions about how to manage the life insurance proceeds, and the RAAs have generated few complaints. We agree that consumer understanding of the terms of RAAs is very important, and we recommend that insurers review their policies and practices to ensure that consumers are being fully informed of their settlement options, especially during the vulnerable time following the death of a loved one. However, to prohibit RAAs, as suggested by certain media, is unnecessary and would result in the loss of a choice that has provided benefits to consumers for over 20 years.

Going Forward—Review RAA Disclosure

The core issue that raised recent media and state regulator concern over RAAs is whether life insurers make clear to beneficiaries that they have the right to immediately take a lump sum payment and whether the terms of RAAs are fully disclosed.

The NAIC and certain states have announced that they are reviewing the disclosure requirements associated with RAAs and also are reviewing the transaction requirements/terms for the "checkbook" usage associated with RAAs. According to certain press reports, Pennsylvania might consider a regulation that would mandate lump sum payment of death benefits as a default option and will expand the disclosure required. We understand that the New York State Insurance Department plans to issue a letter to insurers urging greater disclosure of the RAAs' terms and the absence of FDIC protection.

The recent media flurry over the use of RAAs should be a catalyst for life insurers to review their disclosure policies and practices around RAAs. Insurers should consider whether the following disclosure would be beneficial to consumers in connection with their RAAs:

- The terms of the RAA, including but not limited to, the banking-type services provided to the account holder, the interest rate earned on the retained asset account, etc.;
- The rights and obligations of both the beneficiary and the insurer with respect to the life insurance proceeds;
- Description of all the settlement options available to the beneficiary (and interest rate being paid under each option, if any);
- An explanation that a RAA is only one of the settlement options available to the beneficiary[8] and that the beneficiary has the right to take immediate payment of the entire proceeds in a lump sum;
- A statement that one check or draft can be written to access the entire proceeds;
- The tax implications of the interest earned on the RAA; and
- Assuming the RAA is not FDIC-insured, the life insurer might consider disclosing such fact and explaining that the RAA is subject to the protections of the applicable state insurance guaranty association.

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New York Probes Insurers' Use of Retained Asset Accounts (cont'd.)

Endnotes

1 Retaining the assets of RAAs in the insurer's general account are expressly permitted by certain state laws. For instance, Maryland Ins. Code Section 16-108(c) provides that "[t]he life insurer need not segregate any funds held under this section (regarding policy proceeds held by insurer), but may hold the funds as part of the life insurer's general assets."

2 Note that some states consider settlement payment made when the "checkbook" is delivered to the beneficiary by the insurer, while other states consider settlement payment made when the beneficiary writes the draft(s) and actually receives the proceeds from the insurer.

3 Arkansas Insurance Dept. Bulletin 26A-91 (December 26, 1991); Colorado Insurance Division Bulletin B-4.12 (May 8, 2007); Kansas Bulletin 1995-22 (December 8, 1995); Maryland COMA 31.09.14; Maryland Insurance Administration Bulletin 10-10 (March 18, 2010); North Carolina 11 NCAC 12.1600; Nevada Bulletin of the Division of Insurance 94-5 (December 22, 1994); North Dakota Insurance Dept. Bulletin 2000-3 (August 3, 2000).

4 NAIC Model 573 Bulletin (1994).

5 Colorado Insurance Division Bulletin B-4.12 (May 8, 2007).

6 Nevada Bulletin of the Division of Insurance 94-5 (December 22, 1994).

7 Kansas Insurance Department Bulletin 1995-22 (December 8, 1995).

8 Note that a state might require a lump sum payment or at least one other settlement option be offered before the insurer can offer RAA as a settlement option.

About the Authors

Michael Renetzky is a partner at Locke Lord. His practice focuses on investment management, securities and corporate law, specifically within the insurance industry. Mr. Renetzky devotes a substantial portion of his time to counseling boards of directors on corporate governance and fiduciary duty matters, including in the mergers and acquisitions contexts. Additionally, he has considerable experience counseling clients on securities law compliance, debt and equity financing matters, investment adviser, investment company and broker-dealer regulation.

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