<u>INTERPRETIVE LETTER 2017-01 (MAY 2, 2017)</u>

STATE BANKS ARE AUTHORIZED TO INVEST IN FIXED RATE ANNUITY CONTRACTS

You recently asked the Illinois Department of Financial and Professional Regulation, Division of Banking (Division) to determine whether a State bank is authorized to purchase fixed rate annuity contracts for investment purposes. The Division's opinion is that the Illinois Banking Act (Act)[1] authorizes a State bank to purchase fixed rate annuity contracts subject to the conditions and limitations set forth below.

For purposes of this letter, under an annuity contract, the purchaser makes a lump sum payment or installment payments to an insurance company or annuity company in exchange for subsequent periodic payments from that the company for a fixed term or for a life. A fixed rate annuity contract has several defining characteristics. A fixed rate annuity earns a guaranteed rate of interest for a specific period of time. Funds invested in a fixed rate annuity are placed in a fixed account of the company and are supported by the assets in the general account of the company and subject to the claim of general creditors. A fixed rate annuity is a general obligation of the insurance or annuity company. Payment of the obligation depends on the creditworthiness of the company and is not tied to the performance of any other instrument. Finally, the fixed rate annuity is not transferable. [2]

You have provided information regarding the fixed rate annuities that [the Bank] (Bank) is considering. Specifically, the term of the annuity would be 5 years or less. The Bank would be the owner of the fixed rate annuity contracts as well as the beneficiary and annuitant. The annuities would not be used as a deferred compensation vehicle or be for the benefit of any individual.

In addition, the fixed rate annuity contracts under consideration would impose penalties for early withdrawal (surrender) of the annuity. Typically, the penalty declines over time. For example, early withdrawal from a five-year annuity is be subject to a penalty of 5% of the amount withdrawn during the first year of the contract, a 4% penalty in year two, a 3% penalty in year three, a 2% penalty in year four, and a 1% penalty in year five. Notwithstanding, the contracts typically permit withdrawal of up to 10% of principal per year without penalty.

For purposes of determining whether the Act authorizes a State bank to purchase fixed rate annuity contracts for investment, the Division finds that a fixed rate annuity contract is not an insurance contract but rather is a debt obligation. This view is consistent with long-standing published judicial decisions[3] and with the opinion of the administrator of

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[1] 205 ILCS 5/1 *et seq*.
[2] The U.S. Comptroller of the Currency has similarly described fixed rate annuities. Interpretive Letter #1021 "Investment in Fixed Rate Annuities," March 2005.
[3] *Roth v. Kaptowsky*, 393 Ill. 484, 66 N.E. 664 (1946) is a relevant Illinois decision.

national banks.[4] As a debt obligation, the Division further finds that a fixed rate annuity contract presents the equivalent risks and other safety and soundness concerns as a loan made, purchased, or participated in by a bank.[5]

In light of the Division's determination that fixed rate annuity contract is a debt obligation, the Division concludes that the Act permits a State bank to purchase fixed rate annuity contract pursuant to its authority under Section 3 of the Act to make and deal in loans and to engage in a general banking business, subject to limits and conditions enumerated below.

1. The Bank may invest in only fixed rate annuities as described in this letter.

2. Investments in fixed rate annuity rate contracts are subject to limitations of Section 32 of the Act. The Bank's purchase of fixed rate annuities from any one issuer may not exceed 25% of the amount of the Bank's unimpaired capital and unimpaired surplus.[6]

3. Consistent with safe and sound operation of the Bank and applicable federal regulatory guidance[7], and prior to any purchase of fixed rate annuities, the Bank must establish reasonable internal concentration limits for its combined holdings from all issuers. Thereafter, purchases of annuities must remain within those limits.

4. Consistent with safe and sound operation of the Bank and applicable federal regulatory guidance[8], and prior to purchasing each fixed rate annuity, the Bank must conduct an independent analysis to determine that the annuity will meet the Bank's internal underwriting standards. This analysis should exercise the same credit due diligence as it would for other debt obligations. At a minimum, the Bank must:

    a. perform a full financial statement analysis on the issuer (obligor);
    b. assess the issuer's industry position, pricing power, and management strength;
    c. assess and evaluate the issuer's source of repayment and collateral value (if any);

[4] See, OCC Interpretive Letter #1021 "Investment in Fixed Rate Annuities," March 2005. This letter summarizes federal court decisions and other states' decisions.
[5] Because the fixed rate annuity contract is not transferable, it is not considered marketable investment security under Section 33 of the Act. 205 ILCS 5/33. Fixed rate annuities have been characterized as the functionally similar to certificates of deposit. OCC Interpretive Letter #1021 "Investment in Fixed Rate Annuities," March 2005, at foot note 11.
[6] 205 ILCS 5/32(a).
[7] See, for example, FDIC Risk Management Manual of Examination Policies at https://www.fdic.gov/regulations/safety/manual/; and OCC Bulletin 2002-19 "supplemental Guidance: Unsafe and Unsound Investment Portfolio Practices," May 22, 2002, and OCC Banking Circular 181 (Rev.) "Purchase of Loans in Whole or In-Participations," August 2, 2984. The OCC documents are cited in OCC Interpretive Letter #1021 "Investment in Fixed Rate Annuities," March 2005.
[8] See, Note 7, above.

    d. gain appropriate credit approvals of Bank management and Board of Directors (or committee thereof);
    e. assign a risk rating; and
    f. ensure the lending policy addresses the type of exposure the Bank plans to acquire.

5. After purchase of the annuity, the Bank must review the credit exposure on an ongoing basis and update the risk rating as appropriate.

6. If the terms of the annuity contract include charges or penalties for early withdrawal (surrender), the Bank's must conduct independent analysis of the reasonableness of and associated risks of the charges or penalties.[9]

7. Except for payment of charges or penalties that the Bank has determined reasonable pursuant to Item 4 above, the Bank must be permitted to surrender (terminate) the annuity at any time before maturity and receive immediate access to the full value of the annuity, including principal and accrued interest.

8. The Bank may not exercise any option it may have to convert its fixed rate annuity to a variable return status or any other status other than a fixed rate annuity as described in this letter.

[END]

[9] Based on OCC Interpretive Letter #1021 "Investment in Fixed Rate Annuities," March 2005, it appears that a national bank may not purchase in annuities with charges or penalties for early withdrawal (surrender). Therefore, in light of Section 24 of the Federal Deposit Insurance Act and FDIC Rules Part 362, it is advisable that the Bank consult with the FDIC prior to purchase of an annuity.