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Re: Comments to the NAIC Contingent Deferred Annuity (A) Subgroup

Dear Mr. Schirripa and Ms. Cook:

Prudential Annuities ("Prudential") respectfully submits this letter to express our views relating to the National Association of Insurance Commissioners ("NAIC") Contingent Deferred Annuity (A) Subgroup's ("the Subgroup") review of contingent deferred annuities ("CDAs").

Prudential strongly believes CDAs are, in fact, annuities and offer another valuable guaranteed lifetime income solution for Americans to help meet their retirement income challenges. We believe life insurance companies with appropriate expertise, resources, and proven experience to appropriately design and manage the risks associated with CDAs should be allowed to deliver this attractive product to the market and thus make it available to consumers who are demanding such a solution.

We strongly support the analysis and conclusions reached by the American Academy of Actuaries as well as comment letters submitted by the Insured Retirement Institute and American Council of Life Insurers supporting the classification of contingent annuities as annuities under state law.
Our letter addresses the following topics which we believe fall in the scope of the Subgroup’s stated charge:

1. American’s Retirement Income Challenges
2. Legal Analysis of Regulatory Issues
3. Management of External Assets
4. Longevity Risk and Market Risk Management
5. Consumer Benefits and Protection
6. Reserving and Capital Requirements

1. American’s Retirement Income Challenges

According to research conducted by the RETIRE Project at Georgia State University, Americans will need an estimated 80% of pre-retirement earnings to maintain the same level of consumption in retirement.\(^1\) While Social Security continues to be the primary source of retirement income funding for a majority of Americans, for the medium-earning individual turning age 65 this year, Social Security benefits will only fulfill 41% of his or her pre-retirement income needs.\(^2\) To help bridge the pre-retirement income gap, retirees have historically relied upon other sources of funding outside of Social Security to generate guaranteed lifetime income in order to meet basic retirement needs. The most prominent source has traditionally come from employer sponsored defined benefit (“DB”) plans, which provide retirees a guaranteed income stream for life.

Over the last decade a well-publicized shift in the retirement landscape has taken place. The country has experienced a rapid decline in the number of individuals with access to a DB plan while at the same time there is a growing reliance upon saving for retirement through self-directed and funded defined contribution (“DC”) plans. This dramatic DB to DC shift has transformed traditional retirement paths to supplement Social Security known to many Americans away from the reliable source of guaranteed income of a DB plan to the uncertain retirement income course offered through a DC plan.

Today, with the predominance of DC plan offerings, a majority of Americans now carry the direct responsibility of not only building a sufficient retirement nest egg, but also preparing to sufficiently manage risk, such as longevity risk, and appropriately preserving those assets in retirement. This new retirement paradigm has, in part, helped fuel the development of annuity solutions by life insurance companies to address consumer demand for guaranteed lifetime income. The product solutions that make up the current annuity landscape have been further driven by continued consumer concerns and reluctance about traditional forms of lifetime income in general. The more popular forms of annuity product solutions include guaranteed living benefits (GLBs), such as lifetime withdrawal benefits

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\(^1\) Palmer, Bruce (June 2008). 2008 Georgia State University/Aon Retirement Income Replacement (RETIRE) Project Report. micr.gsu.edu/Papers/RR08-1.pdf

\(^2\) The 2011 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds. P. 201
(GLWBs) and guaranteed minimum income benefits and guaranteed. According to the latest research conducted by the Life Insurance Market Research Association, consumers who purchased a variable annuity elected a GLB option (when offered) 88 percent of the time with GLWBs being the most popular election.\(^3\)

Despite the growth in acceptance of guaranteed lifetime income solutions through the development of GLBs, some remain reluctant about purchasing annuities in the traditional way. This fact, coupled with the need to address America’s growing retirement income crisis, has continued to drive the creation of new products by life insurance companies by leveraging the market-tested success of today’s annuities to create new solutions, such as CDAs.

We believe that CDAs are a natural evolution from products already in the marketplace today and we strongly believe this product will serve to provide consumers with another viable solution to consider for purposes of converting personal retirement assets into an income stream they cannot outlive. Ultimately, we believe this will help advance a common public policy objective shared by all – solving America’s retirement income crisis.

2. Legal Analysis of Regulatory Issues

**CDAs under State Insurance Law**

We believe that CDAs are appropriately categorized as annuities under state insurance law. The predominant risk associated with CDAs is longevity risk, the risk historically protected against by annuities. Under CDAs, life insurance companies agree to make a lifetime series of payments, the very hallmark of an annuity contract. CDAs offer guaranteed income to a policyholder for his or her remaining lifetime that becomes payable upon the depletion of the policyholder’s covered asset account. The depletion of the covered asset account is impacted by three factors: 1) the longevity of the policyholder; 2) the behavior of the policyholder (i.e., timing and amount of withdrawals); and 3) the investment performance of the covered asset account. Once payments from the issuing insurance company begin, the continuation of those payments is solely driven by the longevity of the policyholder. Many CDAs also provide the right to annuitize covered assets at guaranteed fixed annuitization rates, another feature commonly found in annuities.

As discussed in more detail below, certain states have adopted financial guaranty insurance laws. Despite some of the views to the contrary, we do not believe that CDAs fit within the definition of financial guaranty insurance. Financial guaranty insurance provides indemnification for changes in the value of specific assets and does not refer to the diminution of a pool of assets due to the fact that an owner withdraws some of the assets to be put to use for life needs. In assessing whether a CDA should

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\(^3\) LIMRA: Guaranteed Living Benefit Riders’ Popularity Continues With Variable Annuity Buyers (December 2011).
be categorized as financial guaranty insurance, it is important to recognize the fundamental difference between changes in the value of assets due to market fluctuation and reduction of the amount of assets due to withdrawals.

To be sure, there is some element of market risk that exists with respect to CDAs (as well as variable annuities with a GLWB). However, CDAs do not reimburse for market losses. Rather, market risk impacts the timing of when the payment source for the periodic benefit shifts to the insurance company. Indeed an individual can suffer no loss ever in the investment assets and still receive payments from the insurance company – depending entirely on how long he lives. In addition, even if there were a loss, the ultimate payout amount could be much less or much more, depending again on how long the person lives and on the amount and timing of withdrawals from the account. With financial guaranty insurance, on the other hand, there is no longevity factor. Or, stated in terms of the common insurance law definition of annuities, financial guaranty insurance does not provide periodic payments where the making or continuance of such payments, or the ultimate amount of such payments, is dependent upon the continuance of human life. A lifetime series of payments is a fundamental element of an annuity.

Importantly, it needs to be recognized that the most significant characteristic of CDAs is the essential and direct connection to longevity. It is a mischaracterization of such policies to suggest that the annuity payout is due to diminishment of the value of an account, without acknowledging the critical fact that the annuity payout is only triggered by depletion of the account, and that the depletion of the account will always be dependent primarily on the longevity of the policyholder and the cumulative effect of the periodic distributions from the account during his or her life.

Because the policy protects primarily against depletion of assets by replacing the lifetime income withdrawals when the account is exhausted with payments from the insurer, it has precisely the same fundamental character as any other life annuity, that is, protection against the risk that one will exhaust his financial resources in retirement.

Moreover, the fact that the cumulative amount of benefits ultimately received from the insurer depends on how long the policyholder lives also shows that the policy does not indemnify for financial loss resulting from changes in value of specific assets. The relationship between such changes in value and the eventual number of cumulative amount of payments is secondary. The predominant factor determining the number of payments, and hence the ultimate payout, is longevity. Consequently, the product works exactly like a life annuity and nothing at all like financial guaranty insurance.

Financial guaranty insurance has no longevity risk factor whatsoever. Longevity risk is a wholly alien concept to financial guaranty insurance. Assuming financial guaranty insurance could be written on market risk, only market risk would be factored into the underwriting and reserving. Longevity risk is absolutely critical to the underwriting and reserving for CDAs.

Six states have adopted financial guaranty insurance laws that follow NAIC Model Law 1626 (financial guaranty insurance). To our knowledge; however, only one state has formally expressed the view that CDAs are financial guaranty insurance, rather than annuities. This view was premised upon the notion
that CDAs insure against loss in the value of specific assets due to market fluctuations. With respect to the other five states, a state’s adoption of a financial guaranty insurance law is in no way determinative of how a state will view a CDA. NAIC Model Law 1626 was adopted in 1986, long before CDAs were developed. Further, we are aware of states that have adopted a version of the NAIC Model Law and would nonetheless treat CDAs as annuities under their state insurance laws.

For the foregoing reasons, CDAs should not be categorized as market risk financial guaranty insurance. Rather, CDAs are in the same species as other life annuities, all with the central characteristic being a series of payments based upon a human lifetime. CDAs should be recognized as valid life insurance company products under state insurance law and regulated accordingly.

Group Insurance

There is nothing in the design of CDAs that mandates the use of a group annuity construct. In fact, CDAs can be and have been issued as individual annuities. While the group annuity form does offer some benefits to the insurer and the group contract/certificate owners in terms of the transparency of terms and conditions applicable to all parties to the agreement, the same terms and conditions can be prescribed in a service level agreement between the insurer and the provider of the asset management account and in an individual annuity contract issued by the insurer to the owner of the asset management account.

If a CDA is filed as group annuity, it must comply with applicable state law. If the defined group does not satisfy the types of groups permitted in a state including groups recognized at the discretion of the state insurance commissioner, then the product should be filed as an individual annuity. Moreover, if a CDA is compliantly filed and approved in a state as a group annuity, the timing of the certificate issuance should be properly regulated. We believe that group certificates should be issued to the owner of the asset management account when he or she elects the benefit. These group insurance issues are simply areas for the fair and transparent regulation of CDAs; they should not be barriers to their offering.

Suitability Issues

CDAs, like variable annuities, are both securities and insurance products. The life insurance industry and the broker dealer community are well versed in the dual nature of such products and the need for strict adherence to applicable suitability requirements. Together, they are well poised to comply with all applicable federal and state suitability requirements.

3. Management of External Assets

In terms of managing the risks around externally held assets, Prudential firmly believes that the risk can be managed through rigorous diligence on asset management programs prior to making the contingent annuity available to investors in those programs, including a comprehensive review of:

- Investment policy statements
• Specific program rules and guidelines
• Asset manager oversight of their rules and guidelines
• Exception policies
• Historical performance of portfolios

The CDA business model calls for remarkably similar controls and oversight as those described above. Recall, the insurance separate account in the variable annuity business provides no insurer facility to manage the risk of the protected asset. It’s the business system to deliver all control and oversight.

In the CDA business, the insurer will establish the Asset Allocation guidelines and Fund guidelines as it does in the annuity business. And, as in the annuity business, these guidelines will be delivered to the investor in the CDA contract language.

The insurer will work with the asset management partner to analyze the available asset allocation strategies employed in the asset management partner’s business. These strategies are generally described as profiles (or profile portfolios) on the asset manager’s business platform. The insurer will identify which strategies will be permitted for use with the protection product. Again, a simplified example might define that the insurer is willing to protect investor asset that have as much as 80% of their invested asset allocated to equity investment and a little as 30% of their invested asset allocated to equity assets. The guidelines will then progress into much greater detail to establish further limits on the types of equities and fixed investment can be used.

The asset manager also identifies and controls which investment strategies can be used to fulfill the asset allocation strategy. Just like in the annuity business, the asset management firm establishes an investment policy statement (IPS) and identifies/permits assets that comply with the IPS. The investment advisor has a fiduciary obligation to ensure that the investor’s assets remain invested according to that risk profile. As such, the asset management partner firm’s administrative platform has automated mechanisms to ensure compliance with the stated risk profile of the investor – much like the annuity policy administration has automated mechanisms to ensure compliance with approved guidelines. In the asset management platforms, there will likely be both proactive and reactive mechanisms and either will work in the CDA model as well.

The allocation guidelines and fund guidelines will also be captured in a legal agreement with the partner firm that manages the asset management platform (or in whatever business structure the assets are contained).

4. Longevity Risk and Market Risk Management

Longevity and market risk represent two types of risk that exist in the CDA product. Other annuity product solutions, such as SPIAs, deferred Fixed Annuities and deferred Variable Annuities with optional GLWBs also contain both longevity risk as well as market risk. Both of these risks contribute to the
likelihood that an individual will not be able to sustain income for his or her entire life from this asset pool. Thus, when an individual purchases a form of guaranteed lifetime income from a life insurance company, the life insurance company incurs both longevity risk and market risk.

**Longevity risk** is the risk of adverse financial impact due to living longer than one’s expected lifespan. In the individual context, longevity risk typically refers to the risk of outliving one’s assets. Individuals transfer their longevity risk to life insurance companies through the purchase of products which provide them with the ability to secure a guaranteed stream of income for as long as they may live. Types of products purchased for this protection include:

- Single premium immediate annuities
- Deferred variable annuities with optional lifetime income guarantees
- CDAs

Such longevity risk protection is only offered by the life insurance industry, as life insurers have the expertise and ability to manage this risk effectively. There are several ways that life insurance companies manage this risk. Two of the most significant methods are through product design and risk pooling.

Within the product design of CDAs, restrictions generally exist regarding the minimum age required for product issuance and / or when lifetime income can begin. These restrictions are included to ensure a manageable level of longevity risk for the life insurance company. Further, these products typically offer higher income guarantees for older individuals, similar to the structure of single premium immediate annuities.

The other primary way that life insurance companies manage longevity risk is through risk pooling and the diversification of longevity risk over a large number of independent lives. Significant experience exists regarding the life expectancy of pre-retirees and retirees in the United States, and this information is used to determine the appropriate longevity assumptions used by life insurance companies in the pricing, reserving and capital determination for these products. Further, many life insurance companies which offer longevity risk protection also offer mortality risk protection via the sale of life insurance solutions; thus, longevity risk is often managed at a macro-level through the natural offset with mortality risk.

**Market risk** is the risk of adverse financial impact due to equity, interest rate, and credit risk in the capital markets. Market risk is present to some degree in nearly all forms of insurance products offered by the Life Insurance industry, including:

- Term Life
- Whole Life
- Universal Life (both fixed and variable)
- Immediate and deferred annuities (both fixed and variable)
- CDAs
- Other
Market risk is commonly thought of in the context of variable products where asset performance could have an impact on potential policyholder claims. Market risk is also present in traditional products, such as term life, where the life insurer takes an interest rate risk in setting premium levels.

The presence of market risk does not modify the insurance protection, which is fundamental to the contract. The image below illustratively shows the spectrum of insurance and market risks incurred in the different product offerings by the Life Insurance Industry. It is intended to depict the varying degrees to which market risk exists in all of these types of products.

Life insurance companies will effectively manage the market risk associated with CDAs in the same manner as that of variable annuities with guaranteed lifetime income benefits. Specifically, the two key methods in which this risk is managed are product design and hedging programs.

Similar to existing variable annuity offerings, the CDA product offerings will include restrictions by the life insurance companies on policyholder asset allocation, typically requiring well-diversified investment portfolios with restrictions against excess levels of equity exposure. There are often embedded risk management features as well, whether contract-specific or fund-specific, that are intended to mitigate downside risk associated with these assets.

Insurance companies will manage the residual market risk through capital markets hedging programs. There is little to no difference between the overall hedge strategy utilized for CDAs and variable annuities with optional lifetime income guarantees. The risks being hedged, hedging targets, and instruments used to hedge are substantially similar for existing variable annuities and CDA products. CDAs require additional operational controls and contractual protections in order to ensure the ability to effectively hedge a lifetime income guarantee risk based on assets held external to the insurance company, as described in the previous section.

The programs used to manage the market risks within variable annuities have been determined to be highly effective through independent analysis.
Unlike institutions which enter into hedging arrangements as a way to profit through additional risk-taking, insurers hedge to reduce downside risk associated with insurance liabilities, and in fact will trade profit for such downside protection.

- Insurers hedge with simple and liquid instruments which are relatively easy to value and trade.
- Insurers have very little counterparty risk due to the deep and liquid trading markets employed and the collateralization of contracts.

Example

CDAs are effectively a product that allows an individual to convert personal retirement savings into a stream of income that the individual cannot outlive. This lifetime income stream is first withdrawn from the individual’s asset account. If the individual lives beyond the depletion of that account, then the life insurance company will continue the income stream from its own general account for as long as she lives. The primary driver of whether the life insurance company makes any payments is the longevity of the individual policyholder.

The following hypothetical example illustrates the concept of longevity risk protection. While it does not reflect an actual CDA product, it illustrates, in a simplified way, the function of the lifetime income guarantee provided by a CDA.

Assume a 65-year-old has $100,000 invested in an external money market account. This individual is concerned with not being able to sustain a $5,000 per year income stream for the rest of her life. She therefore purchases a CDA which promises her $5,000 in income per year for as long as she lives, with that income first being withdrawn annually from her money market account. The fee for this CDA product is simply the yield received on the money market account (this assumption simplifies the example and results in a 0% “net” account yield).

Based on these assumptions (i.e., 5% lifetime income and 0% “net” asset yield), she will exhaust her money market account if she lives to exactly age 85. Therefore, if she lives beyond age 85, the CDA she purchased will enable her to continue to receive $5,000 per year for the rest of her life, with that income provided by the life insurance company. If she passes away prior to age 85, she would not have received any CDA income payments from the life insurance company, and her heirs would receive the remaining money market fund balance as it was not fully depleted by her annual income withdrawals.

This simplified example shows that the main goal of the CDA offering is to provide protection against the individual insured living longer than her assets can sustain her retirement income needs. Therefore this product offering is an annuity given that longevity risk protection is the primary purpose. It is important to note that even in this simplified example both longevity risk and market risk are present.

**Longevity risk** - The life insurance company is exposed to longevity risk with this product resulting from the lifetime income guarantee. The life insurance company will make payments to any policyholder who lives beyond 20 years as the fund will be exhausted after 20 years of withdrawals.
Market risk - The life insurance company is exposed to market risk with this product in the form of interest rate risk, as the life insurance company’s fee revenue is tied to the yield on the money market.

While CDAs primary purpose is longevity risk protection as illustrated above, CDAs allow for that protection to be provided on various types of assets, which are substantially similar to the types of assets offered with variable annuities. The underlying character of the assets (i.e. money market, diversified investment, etc.) does not in any way alter the primary purpose of CDAs – protection against an individual not being able to sustain their annual income for the rest of their life. However, the different investment characteristics do add more market risk to the CDA offering versus what would exist in the simplified example above. An increase in market risk would not change the fact that this product offering covers an individual’s longevity risk and therefore these products are annuities.

5. Consumer Benefits and Protections

Prudential believes that, as a matter of public policy, consideration by the Subgroup should be given to the consumer benefits that CDAs provide. Combing longer life expectancies with inadequate savings, diminishing or insufficient income from defined benefit pension plans, and rising health care costs, it is clear that many Americans are facing the real possibility that they will outlive their financial resources in retirement.

Despite careful planning, Americans cannot be certain that a non-guaranteed systematic draw down of their retirement assets will last their entire lifetime. For guaranteed lifetime income, they must look to products that can only be issued by life insurers. While immediate and deferred annuities provide guaranteed lifetime income to millions of Americans, there are an estimated two trillion dollars of unprotected assets in the asset management account programs in the U.S. and that number is projected to grow to seven trillion dollars by 2020.4 The consumer demand for longevity risk protection however will not be met only by annuity products as it is clear many consumers simply do not want to transfer their assets to an insurer. CDAs offer another solution to this broad base of consumers who remain at risk of outliving their retirement assets.

If CDAs are properly characterized as annuity products within existing state regulatory structures, the consumer protections that have evolved and strengthened over the past twenty years for annuity sales will also apply to these new products. Such protections include those related to replacement activity, suitability requirements, and sales to seniors. Moreover, because CDAs, like variable annuities, are securities in addition to being insurance products, the consumer protections found in FINRA and SEC regulations, including those related to firm and broker licensing and training as well as prospectus disclosure and delivery, will also apply. We encourage a thoughtful consideration at both the state and federal level of any regulatory issues that may be unique to CDAs and modification to existing oversight as needed to protect consumers while ensuring these beneficial products remain available to them.

4 Source: Cerulli Associates
6. **Reserving and Capital Requirements**

As CDAs provide guarantees similar in nature to the lifetime income guarantees which exist on variable annuities, we believe these products should be subject to the statutory reserve guidance provided by Actuarial Guideline XLIII (AG 43) and the statutory risk-based capital requirements of the RBC C3-Phase II framework.

In its scope statement, AG 43 includes products that contain guarantees similar in nature to Variable Annuity Guaranteed Living Benefits (VAGLBs), even if the insurer does not offer the mutual funds or variable funds to which these products relate. Moreover, the guideline makes explicit reference to the intention that new products which provide guarantees similar in nature to VAGLBs would also fall within scope of the guideline. The scope of RBC C3 Phase II is the same as that of AG 43.

Further, AG 43 is clear in its guidance that only the revenues and expenses associated with the contract should be included in the projections used to determine the appropriate level of reserves and capital. State regulation, including the Actuarial Opinion and Memorandum, requires Appointed Actuaries to opine annually on the adequacy of the reserves being held by the insurance company and conform to relevant Actuarial Standards of Practice.

Prudential appreciates the opportunity to share its viewpoints in connection with the Subgroup's ongoing discussions of CDAs. Should you have any questions concerning the topics addressed in this letter, please direct them to Roman Gabriel at (973) 802-6228 or roman.gabriel@prudential.com.

Thank you very much for your consideration of this very important topic.

Sincerely,

Stephen Pelletier

President, Prudential Annuities