February 14, 2012

Felix Schirripa
Chief Actuary, New Jersey Department of Banking and Insurance
Chair, NAIC Contingent Deferred Annuity (A) Subgroup
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Dear Mr. Schirripa,

Prudential Annuities ("Prudential") respectfully submits this letter to express our views on the February 8, 2012 analysis "Contingent Deferred Annuities – Policyholder Behavior & Product Design," presented during the February 9th meeting of the National Association of Insurance Commissioners ("NAIC") Contingent Deferred Annuity (A) Subgroup ("the Subgroup").

Historical Analysis

We appreciate the historical analysis presented, which provides insights into the tradeoff between self-insuring longevity risk and the purchase of insurance to protect against longevity risk. We agree that the comparison of self-insurance to various forms of purchased insurance is valid as a general way to understand the cost / benefit tradeoff of insurance. However, there are certain assumptions and methodologies underlying the specific historical analysis presented which deem that analysis inadequate for the purpose of drawing broad conclusions about the value and risks of Contingent Deferred Annuities ("CDAs").

Assumptions
The CDA analysis hinges on two key assumptions: the income rate and the capital market environment (equity and bond returns). For much of the historical period tested, the assumption of 5% annual income is inconsistent with the historical capital market environment. Interest rates and equity returns were meaningfully higher for prolonged periods historically as compared to their current levels. However, the 5% income product tested, which represents a typical CDA product offered today, is reflective of the capital markets environment of today, not of the past. In the case of evaluating the risks and value of CDAs, the requirement for consistent capital market and product design assumptions implies the use of economic scenarios consistent with those used in the pricing, reserving, and capital calculations for these products. Economic scenarios calibrated to the NAIC Risk Based Capital ("RBC") C-3 Phase II criteria would meet this requirement, and the CDA analysis recently conducted by the Academy of Actuaries Contingent Annuity Work Group ("Academy CAWG") is based upon economic scenarios which meet this exact criteria.
The use of historical capital market assumptions to evaluate a current CDA product is analogous to analyzing a current life insurance product design (features, death benefit values, premiums) under the mortality experience of centuries past. Such analysis would show a life insurance product which could raise risk and solvency concerns due to the higher mortality of those periods. Another example would be a review of current hurricane insurance against hurricane experience of centuries past. Such analysis would show that purchasers received low value due to significantly lower claim cost experience before the last 20-30 years. It is clear that these analyses would result in inadequate determinations of the risks present and the value provided by the insurance products.

Since the capital market environment is a key driver in the design of lifetime income guarantees provided by Guaranteed Minimum Income Benefits ("GMIBs"), Guaranteed Lifetime Withdrawal Benefits ("GLWBs"), and CDAs, it is imperative that analysis of these products be internally consistent with respect to the product design and market assumptions employed, just as mortality assumptions must be internally consistent with the design of a life insurance product and storm frequency and severity assumptions must be internally consistent with the design of hurricane insurance.

Methodology
The historical test compares self-insurance to a CDA over 613 “hypothetical retirements.” These hypothetical retirements consist of 35-year periods from 1926 through 2011, reflecting actual equity and bond returns in each historical period. These 613 periods are treated independently for purposes of calculating statistical measures of risk and value under both self-insurance and CDAs. However, these rolling historical periods exhibit serial correlation, as any two consecutive periods differ by only two months’ worth of returns. Over the entire historical period, there are only two truly distinct 35-year periods. The serial correlation of inputs results in an output which is not statistically significant. Thus the historical returns, whether a single path or multiple paths derived from them, do not provide a sufficient backdrop for evaluating either the self-insurance of longevity risk or CDAs. In order to produce statistically significant results which can be relied upon, the underlying trials must be independent and sufficiently numerous. In the case of this analysis, the “trials” are the market scenarios; in order to ensure statistically significant results, a large set of independent stochastically generated scenarios should be used. The analysis recently conducted by the Academy CAWG is based on such a scenario set: 1,000 stochastic market scenarios calibrated to the NAIC RBC C-3 Phase II criteria.

Conclusions of the Historical Analysis

There were a number of observations, conclusions, and recommendations presented in conjunction with the results of the historical analysis. These ranged from general observations on the presence and degree of longevity, market, and behavior risk associated with CDAs to recommendations for significant changes to the fundamental design and value proposition of the product. We feel that only when an analysis is based firmly in sound assumptions and methodologies can any results of that analysis be relied upon for drawing conclusions and recommendations. Thus, we believe that the results of the historical analysis should not be used as the basis for broad conclusions or recommendations on CDAs.

It appears that a key conclusion of the historical analysis is that CDAs should be classified as a hybrid of financial guaranty insurance and an annuity, due to the fact that investment performance is a key driver of the depletion of the covered funds. It is problematic, in our view, to use the term "financial guaranty insurance" loosely and interchangeably with “market risk,” as these are two separate and distinct concepts. Financial guaranty
insurance is a distinct product type with very specific characteristics that may only be issued by an insurer licensed to issue financial guaranty insurance and expressly may not be issued by a life insurer. While it is well understood that market risk is the sole risk protected by financial guaranty insurance, it is not simply the presence of market risk which distinguishes financial guaranty insurance, but the manner in which market risk is protected (i.e., the actual lump-sum reimbursement of market or credit losses, where no payments are provided unless those losses occur, and no payments are made for any other reason). The presence of market risk in and of itself in other insurance products in no way indicates that those products are a form or hybrid of financial guaranty insurance. Market risk is present in some form and to some degree in all insurance products, including fixed and variable life insurance and annuity products. Even products which contain no policyholder investment component still introduce market risk to the insurance company through the pricing of and reserves held for the product. To claim that the presence of market risk associated with an insurance product represents a “financial guaranty component” warranting classification of the product as a hybrid between financial guaranty insurance and life insurance / annuities would mean that every life insurance and annuity product should be classified the same way. CDAs are clearly not financial guaranty insurance just like existing Variable Universal Life, Variable Annuities, and guaranteed lifetime income solutions available through Variable Annuities are not financial guaranty insurance.

The hybrid classification discussed during the recent Subgroup call raises significant concerns with respect to appropriate and consistent guidance for CDAs. There is no existing guidance for the “hybrid” of a financial guaranty and an annuity. The concept of a hybrid annuity does not exist under state insurance laws. Therefore, a hybrid classification raises significant confusion as to the appropriate regulatory framework to apply to CDAs. As we have described previously, the risks and benefits associated with CDAs are identical in character to those of the lifetime income guarantees (GMIBs and GLWBs) available with current Variable Annuity products. These risks are, and should be, treated the same way from an actuarial perspective (pricing, reserving, capital, and hedging), the guidance for which already exists and is applicable to both GMIBs and GLWBs. It is not appropriate to treat these risks differently for CDAs than for other products, and we do not see any actuarial justification for applying different frameworks to the same risks.

We do appreciate the Subgroup identifying CDAs as income annuities once payments begin from the insurance company. Prior to those insurance company payments, however, a CDA is identical to currently permissible Fixed, Variable, and Equity Indexed Annuities as they are all in deferred status and the individual has the right to annuitize their assets at any time - an identical right in all of these offerings, including CDAs. Also, as mentioned in previous calls and meetings, we are comfortable incorporating a required income start date similar to other currently available deferred annuities to ensure income is ultimately created from this product.

Policyholder Behavior

The discussion of the historical demonstration brought to light concerns about policyholder behavior, from both the perspective of suitability and disclosure for consumers as well as solvency risk for insurers. Policyholder behavior in this sense encompasses decisions the policyholder could make regarding the allocation of underlying assets as well as decisions around utilization of the lifetime income benefit, including lapse and withdrawal efficiency.

Asset Allocation: CDAs are not intended to have investors allocate their assets more aggressively than what is appropriate from their suitability profile. Years of actual experience have proven no material difference in allocations by investors that purchase guarantees in VAs which are identical to the guarantees contemplated in CDAs. Further, the use of more adequate economic scenarios in an analysis
would show that an individual does not need to be overly aggressive to get benefits from CDAs (see the Academy’s most recent analysis).

**Withdrawal Efficiency:** Full permitted withdrawals may occur and are always available, and fully disclosed as such, to expert and novice investors alike, but there are multiple reasons why individuals will make different decisions from those that maximize withdrawals. Tax considerations, other income sources, potential guaranteed income step-ups, and desire to leave more money to heirs are just a few of the reasons. Put another way, inefficient policyholder behavior from the life insurance company’s perspective does not necessarily mean that such behavior is inefficient from the perspective of the policyholder’s holistic retirement needs.

It is important to note that behavior predictability is the same for CDAs as for currently permissible and available VAs with income guarantees (GMIBs and GLWBs). Clear and effective statutory reserve and capital guidance already exists for VAs through Actuarial Guideline 43 (AG 43), and this guidance is intended to apply to the lifetime income guarantees made available through CDAs as well. Further, this guidance contemplates policyholder behavior risk, including prescribed behavior assumptions in the statutory reserve and capital floor required by AG 43.

In conclusion, we assert that CDAs are annuities over their entire life cycle. It is wrong to imply or conclude that the presence of market risk makes CDAs a form or hybrid of financial guaranty insurance, just as the presence of market risk in other life insurance and annuity products does not imply that those products are financial guaranty or hybrid products. We seek consistent and transparent regulations of CDAs as annuity products. We, like many of our counterparts in the industry as well as industry associations and the Academy of Actuaries, believe that the vast majority of regulations already exist and are readily applicable to CDAs. Furthermore, we believe the risks associated with the product can be managed in the same degree as risks already being managed for similar products on the market.

We strongly believe CDAs will serve to provide consumers with another viable annuity solution to consider for purposes of converting personal retirement assets into an income stream they cannot outlive. We believe the continued and expanded availability of CDAs to consumers will help advance a common public policy objective by helping more American’s meet their retirement income challenges.

We stand ready and willing to provide further input to the discussion of CDAs and to the resolution of the questions and concerns held by regulators on this matter.

Sincerely,

[Signature]

Bryan Pinsky, FSA, CFA
Senior Vice President & Actuary, Prudential Annuities