To: NAIC Life Insurance and Annuities (A) Committee Members

From: Felix Schirripa, FSA, MAAA
       Chair, Contingent Deferred Annuity (CDA) Subgroup

Date: February 22, 2012

Re: Results of the Subgroup’s Review of CDAs

Charge

The Subgroup shall review the issues identified in the Life Actuarial Task Force referral concerning contingent annuities and report the results of its review to the Committee.

Summary

- We (i.e., the Subgroup) evaluated CDAs with input from interested parties (industry, trade organizations, consumers, and professionals).
- Due to the presence of life contingent pricing components, we (majority) conclude they are best written through life companies, not P&C companies.
- These products resemble GLWB riders with variable annuities, and many of the same regulatory issues apply.
- We have regulatory concerns surrounding both solvency and consumer protection. And, Charts I and II show why.
- We encourage the Committee to accept the determination that CDAs are life products and to form a new Working Group to evaluate the solvency and consumer protections appropriate for both CDAs and GLWB riders.

Major Findings

The CDA Subgroup has reached the following determinations:

1. Due in part to the presence of life contingent guarantees, CDAs are best written by life insurance companies. They provide a guarantee of lifetime income, albeit triggered only after the depletion of the policyholder’s own covered funds. Further, managing lifetime income guarantees requires expertise (e.g., systems, pricing, and reserving) that resides with life insurers.
2. The Subgroup believes that these products also present risks akin to those in Financial Guaranty Insurance (FGI). Nevertheless, given the life contingent features found in CDAs, we further believe that P&C companies should not be allowed to write them.

3. The CDA product closely parallels GLWB riders, ignoring “form over substance” issues, so many of the same regulatory concerns apply to both.

4. Our evaluation raised regulatory matters for CDAs (and GLWB riders), involving both solvency and consumer protection.
   
   a. We note GLWB riders were introduced into the market with little regulatory discussion about the embedded FGI aspects, and under the assumption that the benefits provided were merely incidental and ancillary in nature to the underlying annuity contract.

   b. Further, over the past several years, there have been significant changes to the basic design of GLWB riders. These design changes (e.g., roll-up rates, daily ratchet-up, fees based on GWB, auto-rebalancing, etc.) are also changing the risk/reward equations for both insurers and consumers. And now the current regulatory framework is being applied to CDAs in some states.

   c. An historical backtest, prepared as part of the evaluation of CDAs, illustrated that there are risks that need to be reviewed to determine if current regulations are sufficient - - both from the perspective of solvency and consumer protection.

5. Charts I and II illustrate the leveraged nature of these products.

**Our Recommendation**

The Subgroup recommends the A Committee accept our determination that CDAs are life products and charge a new Working Group to evaluate the solvency and consumer protections appropriate for CDAs. We further believe the GLWB products merit similar evaluation by this new Working Group.
New Working Group

Outline of Issues to be Resolved

Solvency

1. Evaluate GLWB reserve and capital requirements for applicability to CDAs, giving special consideration to the unique aspects of CDAs (e.g., external ownership of assets, limited/lower revenues).

2. Given the hybrid/leveraged nature of CDAs (and GLWBs) what, if any, capital exposure limits should be imposed?

3. Evaluate need for constraints on investment management (e.g., maximum exposure to equities, employer stock, and real estate).

4. Evaluate the AG43 and C-3 Phase II aggregation rules.

5. Evaluate other suggestions mentioned in the “CDA Historical Test” materials.

Consumer Protection

1. Working in conjunction with the SEC and FINRA, evaluate adequacy of current disclosure rules, especially given the significant impact that policyholder behavior has on CDA benefits and costs. (As Charts I and II suggest CDAs are complex/leveraged financial products).

2. Consider product design standards (e.g., policyholder “guard rail” provisions including, fee discounts if withdrawals are below maximum permitted, mandatory withdrawal start dates, no fees after age 90, etc.). This issue may require an in-depth analysis of policyholder behavior statistics.

3. Evaluate need for consumer-friendly guides to CDAs/GLWBs, with particular attention to how product designs (e.g., ratchet reset frequency, and roll-up %) drive both benefits and costs.

4. Evaluate need for simplified illustrations and explanations of how these products work and, equally important, how they may fail to work.

5. Evaluate need for special periodic notices to policyholders (e.g., withdrawal rights reminder).

6. Evaluate industry practices regarding fee collections, withdrawal reminder notices, and sufficiency of customer support functions.

7. Refer to CDA Historical Test for other issues to be evaluated.
### Chart I
Illustration of Cost vs. Benefit for Hypothetical Buyers*

<table>
<thead>
<tr>
<th></th>
<th>Expert</th>
<th>Novice</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CDA Benefits Paid to Hypothetical Buyer</strong></td>
<td>$100,000</td>
<td>$0</td>
</tr>
<tr>
<td><strong>Fees Charged for Benefits Paid</strong></td>
<td>$15,000</td>
<td>$35,000</td>
</tr>
<tr>
<td><strong>% Benefits to Charges</strong></td>
<td>666.7%</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

*See “CDA Historical Test Part Two” material (pages 7 & 8) for assumptions, etc.

### Chart II
Illustration of Cost vs. Benefit for Hypothetical Buyers**

<table>
<thead>
<tr>
<th>Withdrawals Taken by Policyholder</th>
<th>100% (full) Permitted</th>
<th>50% Permitted</th>
<th>0% for 30 Yrs &amp; Then Wx All Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CDA Benefits Paid to Hypothetical Buyer</strong></td>
<td>$115,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td><strong>Fees Charged for Benefits Paid</strong></td>
<td>$11,000</td>
<td>$245,000</td>
<td>$300,000</td>
</tr>
<tr>
<td><strong>% Benefits to Charges</strong></td>
<td>1045.5%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

**Derived from “CDA Historical Test” backup materials for Portfolio A (& $100,000 initial covered funds). Illustrative only. Intended to show unpredictable, sophisticated, and leveraged nature of CDAs/GLWBs.