GUIDANCE FOR THE FINANCIAL SOLVENCY AND MARKET CONDUCT REGULATION OF INSURERS WHO OFFER CONTINGENT DEFERRED ANNUITIES

Executive Summary

In late-2012, the Life Insurance and Annuities (A) Committee (the “A Committee”) charged the Contingent Deferred Annuity (“CDA”) Working Group with evaluating the adequacy of existing laws and regulations with regard to CDAs and whether additional solvency and consumer protection standards were required. The CDA Working Group determined that CDAs do not fit into the categories of fixed or variable annuities and, therefore, do not always easily fit in existing laws and regulations governing annuities.

The CDA Working Group developed this guidance to serve as a reference for states that are either interested in modifying their annuity laws to clarify their applicability to CDAs or to help states determine how to apply their existing annuity laws and rules to CDAs. This guidance sets forth what consumer protection and financial solvency model laws and regulations should be applied to CDAs and what model laws and regulations that should not apply to CDAs. This guidance outlines what revisions, additions, and regulatory interpretations a state may wish to consider in determining how existing state laws governing annuities apply to these products. This guidance also includes regulatory guidance developed by the Financial Condition (E) Committee, Life Risk-Based Capital (E) Working Group, and the Life Actuarial Task Force for states to use in evaluating capital and reserving requirements and a checklist for reviewing the risk management capabilities of insurers seeking to offer CDAs in their state. This guidance is intended to provide a general framework for the regulation of CDAs while work on specific issues involving CDAs continues at the NAIC.

In the course of completing its charges, the CDA Working Group met with and heard testimony from the life industry, interested trade groups, consumer representatives, the U.S. Securities and Exchange Commission (“SEC”), the Financial Industry Regulatory Authority (“FINRA”), the U.S. Department of Labor, the American Academy of Actuaries (“AAA”), U.S. Government Accountability Office and the National Organization of Life & Health Guaranty Associations (“NOLHGA”) among other interested parties. This guidance is based on the information provided by these parties and the CDA Working Group’s review of existing NAIC model laws and regulations.

I. Background
   A. Classification of CDAs
In 2012, the CDA Subgroup reviewed CDAs to determine how the product should be classified. In March 2012, the A Committee and the Executive Committee and Plenary adopted the recommendations of the CDA subgroup that CDAs are annuities best written by life insurers.

**B. Definition of CDAs**

The CDA Working Group developed and the NAIC has adopted a definition of a CDA as “an annuity contract that establishes a life insurer’s obligation to make periodic payments for the annuitant’s lifetime at the time designated investments, which are not owned or held by the insurer, are depleted to a contractually defined amount due to contractually permitted withdrawals, market performance, fees and/or other charges.” Regulators should consider this definition when determining whether a product is properly classified as a CDA. If revisions to statutes or regulations are contemplated, states may wish to add this definition in their statutes or regulations.

**C. Features of a CDA**

CDAs are annuity products which transfer both investment risk and longevity risk to the insurers who issue them. A CDA can be generally thought of as a living benefit added to an investment account (“Covered Investments”), such as a mutual fund or a managed account. The underlying account is not held or managed by the insurer but is instead held by a related or unrelated third party entity. The insurer contractually restricts the type of Covered Investments that can be covered by the CDA, but the insurer does not control the investments in the underlying account. An example of this would be a CDA attached to a mutual fund held in an individual or employer-sponsored retirement account. The CDA issuer can contractually limit the CDA’s attachment to certain allowable mutual funds, but would have no control over the assets that make up those mutual funds.

A CDA has three distinct phases during the life of the contract. First, the CDA goes through an accumulation phase. This phase occurs from the date the CDA is issued until the time the participant decides to take withdrawals from the Covered Investments, typically upon reaching a certain age such as retirement age. During this phase, the amount of the CDA benefit base is determined by the value of the assets in the underlying account. As those assets increase in value (for example through investment gains or additional deposits), the CDA benefit base amount increases. The CDA benefit base may also increase due to contractual features. The CDA benefit base is a notional amount used for calculating permitted withdrawals and the benefit amount. Depending on the product design, the benefit base is calculated on a daily, monthly or annual basis. The more frequently the benefit base calculation is made, the more likely a consumer will realize increases in the benefit base.

Once a benefit base amount has been set, the CDA guarantees that the benefit base can never decrease due to declines in the value of Covered Investments as the result of investment losses. This allows the insured to mitigate the risk that future withdrawal amounts will decrease due to
market conditions. The insurer assumes some of the market risk of the Covered Investments by guaranteeing periodic withdrawal amounts based on the benefit base, which may be greater than the actual value of the Covered Investments held at the time of withdrawal, the second phase of a CDA.

The withdrawal phase occurs when the participant begins to draw funds from the Covered Investments after reaching the age specified in the CDA contract, most typically retirement age. Some product designs may allow policyholders to elect to begin withdrawals at an earlier or later age, in which case, the withdrawal percentage may be adjusted up or down accordingly. The “guaranteed withdrawal amount” under the CDA is based, under current product designs, on a specified percentage of the value of the CDA benefit base at the time distributions begin. During the withdrawal phase no benefit payments are made under the CDA and the insured is making withdrawals solely from the Covered Investments. The CDA contract sets a maximum guaranteed withdrawal amount that a participant may take. Withdrawals at or below the guaranteed withdrawal amount do not affect the amount of future withdrawals. However, should a policyholder withdraw funds above the contractually permitted amount, a pro rata reduction of the CDA benefit base and/or guaranteed withdrawal amount may occur. Excessive withdrawals could also result in termination of the CDA. During the withdrawal phase, an insured still maintains his or her assets in the Covered Investment. Thus, the value of the Covered Investments may decrease during the withdrawal phase due to market conditions. However, the guaranteed withdrawal amount will not decrease due to loss of value of the Covered Investments though such losses could have the effect of triggering payments under the CDA. Consequently, insurers will typically offer CDAs in connection with Covered Investments that can be effectively hedged or limit the type of assets a policyholder may hold in the Covered Investments during the withdrawal phase to those with low volatility.

The third and final phase is the payout or settlement phase. Upon exhaustion of the Covered Investments, the insurer begins making periodic payments equal to the guaranteed withdrawal amount for the policyholder’s lifetime. In this way, the CDA guarantees lifetime income payments during retirement. It is the Working Group’s understanding that CDA products sold to date do not include a death benefit. Since a policyholder is limited in the amount of periodic withdrawals he or she may take during the withdrawal phase, whether or not a CDA will reach the payout or settlement phase is a function of the performance of the Covered Investments, increases to the CDA benefit base, policyholder behavior, and the insured’s longevity.

For the CDA products that the Working Group reviewed, the fee for the CDA policy was calculated as a percentage of the Covered Investments or benefit base. Generally, the fee is deducted from the Covered Investments.

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1 A payout structure could alternatively be based upon a “life with period certain” structure.
2 Payments may be level or increasing depending upon product design.
3 For some CDA products an insured may elect to purchase spousal benefits. In these instances the CDA would be subject to the longevity of both spouses.
D. Federal Regulation of CDAs

The Securities and Exchange Commission (“SEC”) has not taken a position regarding whether CDAs are required to be registered as securities under the Securities Act of 1933. However, based on information received from the SEC, it is the CDA Working Group’s understanding that a product whose value derives from a registered security (e.g., a retail mutual fund that is registered with the SEC under the Investment Company Act of 1940) is also considered a security requiring registration unless a specific registration exemption applies. Since a CDA’s value is derived from the value of an underlying registered security, it would appear that CDAs need to be registered with the SEC. It is the Working Group’s understanding, based on its discussions with the life industry, that insurers have been registering CDA products with the SEC to date unless the CDA qualifies for one of the designated exemptions from SEC registration in the federal securities laws. An important exemption, for instance, is the exemption from SEC registration for annuities that fund certain retirement plans. CDAs structured as group annuities offered to 401(k) plans and similar plans typically rely on this exemption. Insurers should continue to discuss registration requirements for CDA products with the SEC.

Products registered with the SEC may only be sold by a registered financial professional through a FINRA licensed broker dealer or a registered investment advisor4. Sales of CDAs through broker dealers are subject to FINRA’s general suitability requirements. Investment advisors owe a fiduciary duty to their clients in recommending any investment product and a CDA purchase would be required to be made through a broker dealer. Registered CDAs are subject to SEC disclosure requirements, including the delivery of a prospectus, and FINRA’s advertising and marketing rules.

II. Financial Regulation of CDAs

A. Risk Management

The design of CDAs and their relationship to investments outside of the insurer’s control create risks that necessitate strong and comprehensive risk management practices by insurers. These risks included longevity risk, market risk, policyholder behavior risk, and third party risk.

Longevity risk is one of the main risks that CDAs transfer from the policyholder to the insurer. This is the risk that policyholders will live beyond their anticipated life expectancy, deplete their Covered Investments, and trigger the CDA lifetime income benefit. This risk can be managed by the insurer through product design, risk pooling, and risk management techniques that are similar to those used in other life products with longevity risk. Regulators reviewing an insurer’s handling of longevity risk should look to the insurer’s actuarial opinions to ensure that it is properly reserving for longevity risk.

4 Investment advisors who manage less than $100 million in assets must register in the state of their principal place of business and investment advisors managing assets of $100 million or greater must register with the SEC.
Another risk that is transferred to the insurer from the insured is market risk. The market risk associated with a CDA is that the amount of benefit to the policyholder varies inversely to the market performance of the Covered Investments. The value of the Covered Investments may decrease while the benefit base and guaranteed withdrawal amount are set at a higher level. Thus, when the policyholder takes the guaranteed withdrawal amount it will deplete the Covered Investments sooner than anticipated triggering the CDA benefit. For example, a large downturn in the stock market could reduce the value of the Covered Investments underlying the CDA but the CDA benefit base would remain locked in at a higher value, thus increasing the likelihood that the CDA will reach the payout phase. Insurers can manage the market risk by developing comprehensive hedging strategies similar to those used to manage the market risk associated with other life and annuity products; that is, investing in an offsetting position in related assets to those in which the insurer incurs the market risk, i.e., derivatives. Of course, hedging cannot offset all market risks and is only a method for mitigating losses and results will vary depending upon hedge effectiveness. Further, in the event there is a significant, broad-based market downturn, such as the 2008 financial crisis, CDA issuers may see a greater than anticipated increase in the number of CDAs in the payout phase because of a high number of policyholders suffering losses in the underlying Covered Investments. Regulators may wish to review an insurer’s hedging strategy to verify that it is comprehensive, it appropriately addresses the insurer’s market risks under adverse scenarios, and that an insurer is making reasonable assumptions regarding the effectiveness of the hedging strategy. An insurer must have a “Clearly Defined Hedging Strategy” to take credit for hedging in reserving (pursuant to Actuarial Guideline 43 (“AG 43”)) and risk based capital calculations (pursuant to C-3Phase 2 (“C3P2”)).

CDA issuers also incur risks based on policyholder behavior, including lapse rates, investment decisions, and the amount and timing of withdrawals. In this regard, the value of the CDA to a policyholder and, correspondingly, the level of risk to the insurer are in many ways governed by policyholder behavior. A policyholder may wish to place his or her assets in more volatile investments because if the investments increase in value, the increase is added to the CDA’s benefit base, if the investments decrease in value, the benefit base is locked in at the portfolio’s peak. From the policyholders’ risk perspective, investment increases mean a higher benefit base and investment losses mean the CDA reaches the payout phase sooner.

Similarly, whether the payout phase will be reached also will depend in part on policyholder behavior, and in particular, when the policyholder commences withdrawals and whether the policyholder takes the maximum allowable withdrawal amount. A policyholder would achieve the maximum benefit under a typical CDA by taking the maximum allowable withdrawal amount each year in order to draw down the Covered Investments and trigger the payout phase of the CDA. Insurers can manage policyholder behavioral risk through product design including restrictions on the type of investment assets that an insured may use with a CDA, limiting

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5 Please note that the Life Actuarial (A) Task Force is reviewing AG 43 and the Life Risk-Based Capital (E) Working Group is reviewing C3P2 as to how they apply to CDAs.
withdrawals amounts during the withdrawal phase, varying fees in accordance with the risk level of the Covered Investments, and decreasing benefits in the payout phase for withdrawals above the guaranteed withdrawal amount during the withdrawal phase or for withdrawals made during the accumulation phase. Regulators should review CDA products with a balanced view, ensuring that CDAs are designed to manage policyholder behavior risks while not being overly restrictive in how policyholders may use and gain value from a CDA.

Insurers who offer CDAs must also manage third party relationships and risks. Insurers establish the terms and conditions of the CDA but work with third party non-insurers who manage the Covered Investments. These third parties may collect the CDA fee, provide information regarding Covered Investments’ performance (for determining the CDA benefit base), and notify the insurer if the policyholder changes the assets contained in the underlying account (to determine if the policyholder is invested in assets allowed under the CDA contract). If an insurer does not receive timely information from the third party asset manager, it will be difficult for the insurer to administer the CDA. Insurers will need to contract with these third-parties to clarify each party’s roles and responsibilities. Similarly, insurers face counterparty risks from the parties from whom they buy hedge instruments, specifically, whether the counterparty will back the guarantees they offer.

The Financial Condition (E) Committee is developing a checklist for state regulators to use in reviewing the risk management program of insurers wishing to offer CDAs. Regulators may also wish to consider reviewing the insurer’s risk management program within the framework of The Own Risk and Solvency Assessment (“ORSA”) Model Act.

B. Risk Management Checklist

[The NAIC has not yet completed its work with respect to the development of a risk management checklist for CDAs. This document will be updated when the risk management checklist is complete.]

C. Reserve Requirements

[The NAIC has not yet completed its work with respect to the development of a risk management checklist for CDAs. This document will be updated when the risk management checklist is complete.]

D. Capital Requirements

[The NAIC has not yet completed its work with respect to the development of a risk management checklist for CDAs. This document will be updated when the risk management checklist is complete.]

III. Non-Financial Regulation of CDAs

The CDA Working Group examined existing consumer protection laws and regulations to determine how CDAs best fit within the current regulations that apply to fixed and variable annuities. In conducting this review, the Working Group determined that CDAs do not fit neatly
into either one of these categories. For example, the value of a CDA is determined, in part, by
the market performance of the underlying assets, similar to how the value of a variable annuity is
determined by the performance of a separate portfolio. Further, CDAs, if registered with the
SEC, are subject to federal securities regulation. On the other hand, a CDA resembles a fixed
annuity in that a CDA benefit consists of fixed, periodic payments upon annuitization or
depletion of the underlying assets. Additional confusion has been caused by CDA products
being filed with states as both fixed and variable annuities. Because a CDA shares qualities of
both a fixed and variable annuity, the Working Group concluded that a CDA should not be
classified in either category but instead belongs in its own category.

A. Filing Requirements

The CDA Working Group recommends that CDAs be filed with states as “Contingent Deferred
Annuities” and not as fixed or variable annuities. Based on this recommendation, “Contingent
Deferred Annuities” has been added as a filing category in the System for Electronic Rate and
Form Filing (“SERFF”). In this regard, a group and individual category has been established for
CDAs under type of insurance. (A07G Group Annuities – Special / A07G.003 Contingent
Deferred and A07I Individual Annuities – Special / A.07I.003 Contingent Deferred.)

B. Application of NAIC Model Laws and Regulations

The Working Group reviewed which non-financial model acts and regulations should apply, or
not apply, to CDAs. The Working Group’s findings are outlined below along with
recommendations about how states could interpret and/or amend their existing annuity laws and
rules.

Producer Licensing Model Act (#218)

The Producer Licensing Model Act governs the qualification requirements and procedures for
licensing insurance producers. The Producer Licensing (EX) Task Force has reviewed this
Model and determined that “producers selling CDAs should be required to obtain a securities and
variable lines license.” The Task Force did not recommend any revisions to the Model. For
CDAs that are registered as securities, regulators should verify that producers have the requisite
licenses and registration required to sell securities.

Annuity Disclosure Model Regulation (#245)

The Annuity Disclosure Model Regulation requires insurers who sell annuities to provide a
disclosure document and a buyer’s guide in connection with the sale of an annuity. The Model
applies broadly to all annuity contracts but exempts specific types of annuities including those
registered with the SEC or issued to employer-sponsored retirement plans which may have their
own disclosure requirements that preempt state law. See Section 3. Since CDAs generally fall
within one of these two categories, the Working Group found that the exemption in the annuity
disclosure model regulation for registered products and employer-sponsored plans would apply to CDAs. To the extent there are any CDAs products that do not fall within one of these two exceptions, the disclosure requirements outlined in Section 5.B. of the Model Regulation would apply.

Under the Model Regulation, the NAIC buyer’s guide is required to be provided in the sales of variable annuities “and when appropriate, in sales of other registered products.” Currently, the NAIC does not have a buyer’s guide which addresses CDAs. Providing the current buyer’s guide for fixed and variable annuities, which is inapplicable, for CDAs may confuse consumers. Therefore, the Working Group concluded that the requirement to provide a buyer’s guide would not be appropriate for CDAs.

States should review their annuity disclosure laws and regulations to determine if they need to be revised to clarify the disclosure requirements do not apply to CDAs. The NAIC is currently considering changes to the model regulation that would clarify that the exemption for registered products would include CDAs. However, the model’s exemptions for registered products and products issued to employer-sponsored plans may be broad enough for states to interpret existing law to exclude CDAs without revision to existing regulations.

Suitability in Annuity Transactions Model Regulations (#275)

The CDA Working Group determined that the Suitability in Annuity Transactions Model Regulation should apply to CDAs and that suitability review for the sale of CDAs is an important consumer protection for these products. Section 6. H.1 of the Model Act has a “safe harbor” provision that provides that sales made in compliance with FINRA requirements “pertaining to suitability and supervision of annuity transactions” satisfy the requirements of the Model Act. The Working Group has recommended that this section of the model be revised to include CDAs in the safe harbor provision so that if FINRA’s variable annuity suitability rules are applied to registered CDAs or CDA specific suitability rules are developed by FINRA in the future, that suitability review would be considered to be in compliance with the Model Act.

That being said, FINRA indicated to the Working Group that it will not require that broker dealers apply the suitability standards for variable annuities to CDA sales, though FINRA general suitability requirements would apply. If a broker-dealer does not apply FINRA’s annuity suitability standards to the sale of a CDA than the safe harbor provision would not be applicable and the suitability requirements of the Model Act would apply. However, individual broker-dealers may apply FINRA annuity suitability standards to CDAs, despite FINRA not requiring it, and that would be sufficient for the safe harbor provision to apply. State regulators should ensure that sales of CDAs are subjected to suitability review either under FINRA standards or state standards. If suitability review is not conducted under FINRA’s suitability standards than the suitability requirements of the Model Act apply.
For sales governed by the Model Act, the Working Group concluded that the existing list of “suitability information” included in section 5.1. of the Act contains all the information that is needed to examine the suitability of a CDA sale and additional factors do not need to be added to the Model Act to specifically address CDAs.

**Life and Health Insurance Guaranty Association Model Act (#520)**

The Receivership and Insolvency (E) Task Force (“RITF”) reviewed whether revisions to the model act were needed and warranted to address CDAs. After presentations from the National Organization of Life & Health Guaranty Associations (“NOLGHA”), discussions with taskforce members, and comments from interested parties, the RITF found that CDAs would fall within the definition of “annuity” in the Model Act and be subject to the same provisions for coverage, group and individual, and subject to the same limitations and broad exclusions, as other annuities. This finding was based on the assumption that CDAs are considered annuities under state law and the issuer is a member insurer under state guaranty association law.

Subject to the fact that individual state guaranty associations always have the ultimate decision of what contracts are covered, RITF has determined that, in those states that meet the above assumptions, CDAs should be covered annuities, both in the pre-payout phrase and the pay-out phrase, subject to all of the other statutory limits and exclusions that apply generally to annuities.

**Advertisements of Life Insurance and Annuities Model Regulation (#570)**

The Advertisements of Life Insurance and Annuities Model Regulation sets forth standards for the advertisement of life products. The CDA Working Group determined that this regulation is applicable to CDAs. This regulation currently applies to “annuities” which may be broad enough to include application to CDAs. The Working Group has recommended that the regulation be amended to specifically include CDAs to make clear the regulation would apply to these products. Section 3.A. of the model regulation states that for “variable contracts” where federal regulations establish disclosure requirements, this regulation is interpreted to avoid conflicts with federal regulation. The Working Group believes this section should also apply to CDAs when they are registered and subject to federal disclosure requirements. States should review their existing regulations and consider clarifying their regulations or issuing guidance that this regulation would apply to CDAs. States may also wish to clarify that application of these regulations to registered CDAs is not intended to conflict with federal disclosure requirements to avoid issues of preemption.

**Life Insurance and Annuities Replacement Model Regulation (#613)**

The Life Insurance and Annuities Replacement Model Regulation regulates insurers and producers with respect to the replacement of existing life insurance plans and annuity contracts. The CDA Working Group concluded that the Model Regulation should be amended to make clear it applies to CDAs. Section 1.C. of the Model Regulation exempts “registered contracts”
with respect to the provision of illustrations and policy summaries because those products are subject to federal prospectus and disclosure requirements. “Registered contracts” is defined in the regulation as a variable annuity contract or variable life insurance policy “subject to the prospectus delivery requirements of the Securities Act of 1933.” Because registered contracts are defined narrowly as variable products, the Working Group concluded that the term “registered contracts” should be amended to include registered CDAs that are subject to federal prospectus requirements.

**Synthetic Guaranteed Investment Contracts Model Regulation (#695)**

The Synthetic Guaranteed Investment Contracts Model Regulation prescribes terms and conditions under which life insurance companies can issue contracts that “establish the insurer’s obligation by reference to a segregated portfolio of assets that is not owned by the insurer.” The CDA Working Group made no findings regarding whether this model regulation would apply to CDAs but did note that CDAs share certain characteristics with Synthetic Guaranteed Investment Contracts. For example, the obligations under the CDA are tied to a separately managed investment account. The CDA Working Group recommended that this model regulation be subject to further review to clarify its relationship to CDAs. The A Committee has tasked the Life Actuarial Task Force with reviewing this model and its relations to CDAs and further guidance will be forthcoming from this group.

**Standard Nonforfeiture Law for Individual Deferred Annuities (#805)**

The Standard Nonforfeiture Law for Individual Deferred Annuities sets requirements and minimum values for surrender benefits due to a contract holder upon non-payment or cancellation of an annuity contract. The law applies broadly to individual annuities unless specifically exempted. Because the law broadly applies to annuities and CDAs are not specifically exempted, this law would arguably apply to CDAs. However, the CDA Working Group determined that it was unclear how nonforfeiture benefits would be calculated for CDAs under the current law as CDAs do not contain paid-up annuity, cash surrender, or death benefits, for example. Therefore, the CDA Working Group recommended that the current model be amended to specifically exclude CDAs as there is no method in the law for calculating nonforfeiture benefits as they would apply to CDAs. Thus, inclusion of CDAs in this model would cause confusion. The CDA Working Group made no recommendations as to whether nonforfeiture benefits should be required for CDAs. The A Committee is considering whether a referral is appropriate for further review of the application of nonforfeiture benefits to CDAs.