By Anne Obersteadt, CIPR Senior Researcher

The need for retirement income solutions has come to the forefront as our aging population moves into retirement, people live longer, and pensions disappear. Contingent deferred annuities (CDAs) emerged in 2008 as a way to solve the growing need for access to lifetime income, without the purchase of a traditional annuity. CDAs are a type of product designed to protect against this longevity risk. They are often marketed to advisors of mutual funds, separately managed accounts and fee-based brokerage products. However, sales of the product remain limited, due in part to regulatory uncertainties inherent with an emerging product. This article explores how CDAs work and provides background regarding the concerns raised as insurance regulators evaluate the adequacy of the current regulatory framework to govern CDAs.

What is a CDA?

This product allows the policyholder to retain ownership of their retirement assets—typically mutual funds or managed accounts. This is an important feature, as loss of control of retirement assets is one of the often-cited reasons investors do not purchase annuities. Instead, CDAs seek to provide a stand-alone benefit similar to those of a guaranteed lifetime withdrawal benefit (GLWB). As long as investors, as CDA policyholders, meet guidelines for permitted asset classes and investment types established by the insurer, a predetermined income stream is guaranteed if covered assets are exhausted during the life of the contract holder through allowable withdrawals and/or poor investment performance.

A CDA has three distinct phases: the accumulation phase, the withdrawal phase and the settlement phase. During the accumulation phase, the CDA annual guaranteed lifetime income payment is determined based on a percentage of the total assets in the separately managed account. The benefit amount can increase or decrease with the value of the assets until it is set, and then it can never be reduced due to poor market performance. The CDA moves to the withdrawal phase when the policyholder begins to draw funds from the covered assets. Benefit amounts are reduced if the policyholder exceeds withdrawal limits set in the contract. The final phase, the settlement phase, begins when the account is exhausted and the policyholder begins receiving lifetime periodic benefit payments.

Creating a Regulatory Framework

Insurance regulators are reviewing the adequacy of the current regulatory framework to ensure clear guidelines exist for the application of CDAs. Specifically, regulators are working toward identifying and addressing concerns surrounding supervisory authority, solvency, consumer protection, reserving and capital requirements. Through the NAIC’s various committees and working groups, insurance regulators are discussing the need for potential modifications to models related to annuity disclosure, suitability, producer licensing, and advertising.

The applicability of the following items is also being assessed: Actuarial Guideline XLIII—CARVM for Variable Annuities (AG 43); the Standard Nonforfeiture Law for Individual Deferred Annuities (#805) and the Synthetic Guaranteed Investment Contracts Model Regulation (#695). Additionally, National Organization of Life and Health Guaranty Associations (NOLGA) has determined CDA policyholders would be covered under the model guaranty fund law, should the insurer become insolvent. However, the particulars of guaranty fund coverage have not been determined. Ultimately, the application of the state guaranty funds is governed by each state’s law.

Product Classification

Initially, there existed much confusion on how to classify a CDA. Regulators reported receiving product filings for CDAs as variable annuities, fixed annuities, equity indexed annuities and financial guaranty insurance. This variance in filings type reflects, in part, the unique and complex nature of CDAs. Some states and insurers view CDAs as financial guaranty insurance providing asset preservation, because a CDA essentially “wraps around” an external investment account. Others believe CDAs to be various types of annuities, given their exposure to longevity and market risk. For example, in the accumulation and withdrawal phases, CDAs face market risk much the way variable annuities do. In the settlement phase, payments under CDAs share the same characteristics as fixed annuities.

As a first step, the NAIC established a definition of and a product classification for CDAs. In March 2012, the Life Insurance and Annuities (A) Committee resolved CDAs are annuities and should be sold by life insurers. Furthermore, the Committee found these products were subject to state-based insurance regulation. Acknowledging the shared characteristics, in February 2013, the Committee established

(Continued on page 7)
CDAs should be filed as distinct CDA products, and not under other annuity classifications.

*Regulatory Authority*

As stated previously, the NAIC established in 2012 that CDAs are subject to regulatory oversight by state insurance regulators. Additionally, because a CDA derives its value from an underlying registered security, they are registered with the U.S. Securities and Exchange Commission (SEC), with the exception of Employee Retirement Income Security Act (ERISA) covered plans. This means CDAs are subject to SEC disclosure requirements. Additionally, insurance producers, brokers, and investment advisors selling CDAs need to be licensed by the Financial Industry Regulatory Authority (FINRA) and comply with its suitability and fiduciary requirements. Given these determinations, the NAIC is now looking into amending its Producer Licensing Model Act (§218) to clarify producers selling CDAs registered with the SEC must be dually licensed.3

*Consumer Protections*

Suitability and Disclosure Standards

CDAs may not be suitable for all consumers and consumer advocates have expressed concern they are a poor value to consumers, who may pay annuity fees over an extended period of years and never receive a benefit. Because CDAs pay out only when the investment account is exhausted, the likelihood of a CDA reaching the payout phase is correlated to the aggressiveness of a policyholder’s investment strategy. Consumer advocates stress conservatively invested consumers may not be suitable for CDAs, as the probability of receiving a benefit is low. The converse would also be true. Similarly, investment fund restrictions within CDA contracts could minimize consumer benefits to an unfavorable level.

For this reason, consumer advocates stress the need for suitability requirements to address CDA pricing transparency, benefit expectations and the prohibition of producer compensation favoring the sale of suboptimal CDAs. Specifically, producers should provide information, such as the expected benefit ratio of CDAs and appropriate marketing demographics, to potential policyholders to reduce the possibility of being steered into suboptimal investments.4

Proponents of CDAs point out the product design allows investors to maintain ownership of their assets and secure guaranteed income protection. Additionally, because CDAs isolate coverage to guaranteed income protection, and do not provide a death benefit, they can be priced competitively against variable annuities with GLWB riders, which offer both. They contend limiting product design would raise product costs, thereby limiting sales. Furthermore, they maintain existing laws and regulations under the SEC, FINRA and state insurance departments provide sufficient suitability protections and disclosure requirements. This includes disclosure requirements, such as providing a prospectus, and complying with FINRA advertising and marketing rules.

Additional concerns were raised in a 2012 U.S. General Accounting Office (GAO) report, which found CDAs are complex products requiring policyholders to navigate many suitability and withdrawal considerations best done in conjunction with a professional advisor. The GAO indicated producers need to be adequately trained to provide appropriate advice when selling these complex products.5 Insurance regulators and consumer advocates acknowledged the need to ensure producers receive sufficient training to appropriately advise policyholders on the risks and advantages of CDAs. While CDAs share many of the same risks and characteristics as variable annuities with living benefit riders, they also have unique features requiring product specific training.

In 2013, the Life Insurance and Annuities (A) Committee charged the Contingent Deferred Annuity (A) Working Group with reviewing, among other things, the applicability of CDAs to the NAIC models related to suitability, disclosure and advertising. In April 2013, the Working Group released draft revisions to the suitability, disclosure and advertising models and asked for comment by the end of April. Included were draft revisions to the Suitability in Annuity Transactions Model Regulation (§275) to specifically reference the product and to make clear producer training requirements include CDAs. Also included were draft revisions to the Annuity Disclosure Model Regulation (§245), specifically exempting CDAs, as the SEC prospectus preempts all other state disclosures. Similarly, draft revisions to the Advertisements of Life Insurance and Annuities Model Regulation (§570) specifically referenced CDAs in the model to avoid conflict with FINRA advertising and marketing rules.6

(Continued on page 8)

---

3 NAIC Life Insurance and Annuities (A) Committee. 2013. Memorandum to the NAIC Life Insurance and Annuities (A) Committee regarding Contingent Deferred Annuity (A) Working Group Findings [Committee Document].


Coverage Under Guaranty Fund Associations
Should a CDA insurer fail, there is uncertainty about the existence and scope of guaranty fund coverage of CDAs. It is unclear whether there would be coverage of a CDA still in the accumulation stage, for example. Furthermore, assets kept on insurers books for CDAs are limited to mainly mortality reserves and fees, because the invested assets are separately managed. For this reason, consumer advocates urge the impact of a failed CDA insurer on guaranty assessments and taxes be better understood.7

NOLHGA has indicated coverage would be determined on a state-by-state basis, but it appears the product is covered under the Life and Health Insurance Guaranty Association Model Act (#520). NOLGA also stated coverage would be subject to certain limitations and exclusions, such as payment being limited to the settlement phase, but a final determination is dependent on the outcome of their multi-year review process. Separately, the Receivership and Insolvency (E) Task Force is reviewing if definitional changes to Model #521 are needed to cover CDA products.8

Financial Solvency

Managing Risks
Product design, hedging effectiveness and pricing are key components in mitigating the risks insurers issuing CDAs face. At its core, CDAs are designed to protect against longevity risk. Longevity risk is the risk policyholders will live longer than expected and thus outlive their assets. Insurers reduce their exposure to longevity risk by controlling the benefit levels, as well as the issuance and commencement ages defined within the product contract. Additionally, insurers offset their longevity risk by diversifying their product mix.

Insurers also rely heavily on hedging programs to offset longevity risk. Both CDAs and variable annuity riders are funded through fee income. However, with CDAs, insurers do not have the added advantage of relying on secondary support from revenue collected in conjunction with the underlying annuity. As a result, insurers that issue CDAs have a heightened need to ensure hedge effectiveness.

Insurers are also exposed to market risk stemming from the link between CDA benefits and the value of the covered assets. That is, benefits fluctuate with the fund performance of the separately managed accounts. Managing market risk through investment and allocation restrictions is particularly important, given covered assets are held in accounts external to the insurers. The potential for third-party advisors to deviate from investment guidelines presents operational risk to the insurer. For this reason, insurers must continually track investment activities related to the CDA.9 Insurers also make sure CDA policyholders are notified when their investments have deviated such that the CDA is at risk. The CDA policyholder is also made aware of other Investment options to which they can switch to preserve the CDA.

The fee structure on CDAs has also been identified as a potential for solvency risk exposure. Because coverage under CDAs is limited to stand-alone income guarantees and the products have no surrender value, insurers charge much lower fees on CDAs than variable annuities with GLWBs. Although the comparatively low fee structure of CDAs serves as an incentive for potential policyholders, they add little to an insurer’s capital.

CDA fees predominately cover hedging and administrative expenses, with only a small amount contributing to capital. Consumer advocates have raised a concern hedging alone may not be sufficient to protect against a down market and the asset-based fee income will not provide enough of a buffer to ensure capital adequacy during times of extreme market volatility. This solvency risk would be particularly pertinent if a market event triggered numerous CDAs in the same timeframe—a risk which could be either exacerbated or mitigated by the weighting of CDAs within an insurers’ book of business. What’s more, given the long-tailed nature of this product, there is the fear any deficiency in pricing, reserving and capital would not become evident until the payout phase.

CDAs are also exposed to policyholder behavior risk. CDA benefits begin only once the investment account has been depleted. Thus, policyholders have an incentive to maximize their benefits with aggressive investments. (However, it should also be acknowledged aggressive investment strategies could also produce more investment income, thus potentially decreasing the likelihood of depletion.) Insurers can

(Continued on page 9)

A CLOSER LOOK AT CONTINGENT DEFERRED ANNUITY ISSUES (CONTINUED)

The Life Risk Based Capital (E) Working Group has a charge to develop guidance, for inclusion in the proposed NAIC Life Risk Based Capital (E) Working Group has a charge to determine whether clarifying guidance would be useful for variable annuity guarantees, would be developed. The Life Actuarial (A) Task Force has a charge to evaluate credits are given for a “clearly defined hedging strategy.”

The Life Actuarial (A) Task Force has a charge to evaluate AG 43 to determine whether the reserve guidance, as it applies for variable annuity guarantees, would be insufficient when applied to CDAs. The Task Force will recommend changes, as appropriate, to address any deficiencies and determine whether clarifying guidance would be useful due to different nomenclature than variable annuities with guarantees.

The Life Risk Based Capital (E) Working Group has a charge to develop guidance, for inclusion in the proposed NAIC CDA guidelines, for states to how current regulations governing RBC requirements, including C3P2, should be applied to CDAs. The Working Group will recommend a process for reviewing capital adequacy for insurers issuing CDAs and prepare clarifying guidance, if necessary, due to different nomenclature then used with regard to CDAs. The development of this guidance does not preclude the Working Group from reviewing CDAs as part of any ongoing or future charges, where applicable, and is made with the understanding this guidance could change as a result of such a review.

The Life Actuarial (A) Task Force is also charged with considering revisions to Model #805 to exclude CDAs from the scope of the model. The model already exempts guarantees related to payouts of underlying investments in variable annuities. Since these guarantees are substantially similar to those of CDAs, excluding CDAs from this law also seems appropriate. The decision to exclude CDAs from the model also reflects that CDA fees represent risk charges for longevity contingency risk and do not include amounts to fund an accumulation of benefits for payout. However, not everyone agrees. Some consumer advocates believe CDAs should have a surrender value, as a life contingency calculation is included in their reserves. At the very least, these consumer advocates believe CDAs should not be excluded from the model until an alternative method for determining a nonforfeiture benefit for CDAs has been developed.

The Future
State insurance regulators are working to establish a regulatory framework which provides clear guidelines for supervisory authority and the application of regulations to ensure insurer solvency and consumer protection. Insurance regulators, working through the NAIC, achieved great progress in 2013 by establishing CDAs as an annuity product best sold by life insurance companies. In 2014, insurance regulators will continue working through the various pertinent NAIC groups to evaluate and enhance, where appropriate, the adequacy of existing laws and regulations applicable to CDAs.

(Continued on page 10)

Specifically, insurance regulators will be examining model regulations related to annuity disclosure, suitability, advertisements, replacements and non-forfeiture benefits for possible modification. Additionally, actuarial guidelines and RBC standards will be clarified to allow for clearer interpretation by insurers. Furthermore, additions to the NAIC Life Financial Reporting Blank and the development of tools to assist the states in the review of CDA product filings will be considered.

It remains to be seen if CDAs will become prevalent products within the retirement income marketplace. Product distribution has been slow, with only five insurers reporting an account value of $46.6 million for covered contracts at financial year-end 2013.\(^\text{15}\) Once the regulatory framework is established, insurers will need to illustrate the product’s value to advisors and their clients. Pairing a CDA with a non-qualified account does not offer the same tax-deferred status afforded to variable annuities. For this reason, insurers issuing CDAs may find qualified employer-sponsored plans, which offer preferential tax treatment, a stronger distribution channel.

Additionally, insurers will need to balance keeping fees, which drag down investment returns, at attractive levels, while also collecting enough to provide attractive benefits. Similarly, insurers must manage third-party risks while also allowing advisors to accomplish desired investment strategies. Finally, regulators must ensure insurers issuing CDAs can honor their long-term obligations by monitoring their use of appropriate risk control mechanisms, suitable product design, appropriate actuarial assumptions, and hedge effectiveness.

---

**About the Author**

Anne Obersteadt is a researcher with the NAIC’s Center for Insurance Policy and Research (CIPR). She has more than 13 years of experience with the NAIC performing financial, statistical and research analysis on all insurance sectors. In her current role, she has authored several articles for the CIPR Newsletter, a CIPR Study on the State of the Life Insurance Industry, organized forums on insurance related issues, and provided support for NAIC working groups. Before joining CIPR, she worked in other NAIC Departments where she published statistical reports, provided insurance guidance and statistical data for external parties, analyzed insurer financial filings for solvency issues, and authored commentaries on the financial performance of the life and property/casualty insurance sectors. Prior to the NAIC, she worked as a commercial loan officer at U.S. Bank. Ms. Obersteadt has a bachelor’s degree in business administration and an MBA in finance.

---

\(^\text{15}\) Aggregate amount reported in Exhibit 5 of the 2013 NAIC Life Annual Financial Statement.