

An Overview of Contingent Deferred Annuities & Related Issues

Summary

"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." – Results of the NAIC Subgroup's Review of CDAs (22 February 2012)

"Consumer protection laws have not caught up with regulations" (a comment from Felix Schirripa Chair, Contingent Deferred Annuity (CDA) Subgroup during the 16 February conference call)

Key points (abridged) from the 22 February Subgroup Review

1. CDAs are best written by life insurance companies. Although some risks are akin to those in financial guaranty insurance we believe these are life products and P&C companies should not be allowed to write them.
2. The CDA product closely parallels GLWBs so many of the same regulatory concerns apply to both
3. We note GLWB riders were introduced under the assumption that the benefits provided were merely incidental. Over the past few years there have been significant design changes changing the risk/reward equations for both insurers and consumers. There are risks that need to be reviewed to determine if current regulations are sufficient – both from the perspective of solvency and consumer protection.

My Take

There is a need to go back and reexamine the whole treatment of GLWBs (and by extension CDAs) because there has been more market risk than originally realized. There needs to be limits on the capital exposure to insurers related to longevity risk. In addition, there are many good GLWB designs out there, but also a few bad ones, and NAIC must create new rules to protect consumers from both bad GLWB and CDA products.

The position of the New York Department of Financial Services in opinion OGC Op. No 09-06-11, dated 25 June 25 2009 that contingent deferred annuities are a form of financial guarantee insurance is wrong because longevity is the real risk that is being covered and financial guarantee insurance does not cover longevity risk. A CDA is a lifetime income protection, not asset protection.

Neither individual states nor NOLHGA (National Organization of Life and Health Insurance Guaranty Associations) have ruled that any form of living benefit is covered by a guarantee fund. It strongly appears that payments would be covered by state guaranty funds during the settlement phase (after the account value becomes zero and the carrier is responsible for payments) since this is an annuity benefit.

Introduction

This issue is a summation of what I felt the NAIC Contingent Deferred Annuity Subgroup's concerns and conclusions were as well as a look at the whole area of CDAs. Definitions are usually found at the back of the book, but in this case it is better to get them out upfront. The nomenclature in this arena often depends on the speaker. The investment world tends to call these SALBs (stand-alone living benefits) while the annuity world calls them CAs (contingent annuities) or CDAs (contingent deferred annuities). The NAIC subgroup referred to them as SHIAs (synthetic hybrid income annuities) to differentiate them from HIAs (hybrid income annuities), which are also known as GMIBs (guaranteed minimum income benefits) or GLWBs (guaranteed lifetime withdrawal benefits). However, they really aren't stand-alone living benefits because the annuity policy must be used with the designated investment(s). They aren't hybrid annuities either because the longevity guarantee is based on annuitization. They are simply annuities. Just as index annuities were called ELIAs (equity-linked index annuities), EIAs (equity index annuities) and even hybrid annuities before everyone settled on FIAs (fixed index annuities) I believe these acronym wars will end in a few years with one victor. For continuity this issue will use the acronym CDAs and refer to the purchasers as investors.

What Is A CDA?

Conceptually, CDAs can be viewed as adding an insurance element to an investment or as separating the investment and GLWB parts of a variable deferred annuity where now the investment aspect is controlled by the investor and the insurance aspect is guaranteed by the carrier. The carrier only performs when the investment aspect is reduced to zero.

Example: An investor invests in a portfolio for \$100,000 that has a CDA permitting the investor to withdraw, say, 5%. The investor would be able to withdraw a minimum of \$5,000 each year for as long as he or she lives even if the account value goes to zero. Withdrawals are taken from the investment account. If the account value goes to zero the insurance company steps in and continues to pay the \$5,000. The insurance company charges an annual fee for this protection. The investments are taxed as investments and the annuity benefits are taxed as annuity benefits.

This is how a CDA works in its simplest form. The CDA may be attached to a mutual fund, exchange traded fund, advisory account, whether non-qualified or in a qualified plan. The withdrawal percentage may increase if the investor delays making withdrawals and may be based on the highest value of the account rather than the original investment. However, it will never be based on a lower amount than the principal (unless the investor is taking money out of the account before the lifetime withdrawals begin). Although current CDA products do not offer a roll-up feature whereby the initial payout is guaranteed to increase by at least a specific percentage each year, in the past CDAs have been registered that had a roll-up feature (Allianz, 2008, SEC File No. 333-144584)

Why Isn't A GLWB a CDA?

A CDA truly is a stand-alone benefit. The investor retains control of and owns the asset – unlike a variable annuity it is not a separate account of the carrier, it is a separate account of the investor.

The Contingent Deferred Annuity (A) Subgroup defined the difference between a CDA and a GLWB/GMIB this way (NAIC, 16 Feb 2012):

GLWB/GMIB – a contract that provides lifetime income benefits triggered by the depletion of, or change in the value of, assets held in an account for the annuitant.

CDA – also a hybrid income annuity, except that the assets in the account are not owned by the insurer.

Both GLWBs and CDAs are affected by longevity risk (outliving the income produced by your assets) and market risk (how assets are affected by volatility, interest rate, and credit risk). These risks are managed in the

same ways. However, the investment part of the CDA arrangement retains its investment characteristics unlike the annuity separate accounts that are treated as annuities.

	CDA	GLWB
Assets	Not administered by carrier	Administered by carrier
Fees	The carrier's only fee is based on the cost of the income guarantee	The carrier's fee includes the income guarantee plus mortality and expenses.
Death Benefit	No	Yes
Taxation	The investment is taxed as an investment and the annuity is taxed as an annuity	Taxed as an annuity

Are They Needed?

Although the discussion on the need for guaranteed lifetime income benefits occupied much of the material presented to the NAIC CDA subgroup, my comments will be brief because the materials didn't change any of the conclusions my analysis reached several years ago on the issue of lifetime income benefits:

- ▶ Overall, most people should not need the carrier protection. The main reason for this is mortality; the majority of the people selecting the benefit will die before the carrier needs to start paying under most situations. This is truer when the benefit is attached to a fixed rate or fixed index product, since the threat of market loss is eliminated, but should also be true if future equity market trends follow the movements of the long past and not the recent past.
- ▶ Unless the last dozen years are the pattern for the next thirty an equity based account without a CDA should produce sufficient return to provide an income for as long as the retiree lives that is at least comparable with that of a CDA payout. However, regardless of the combination of stocks and bonds used there is always a statistically significant possibility that the money will run out before death thus justifying the need for lifetime income protection.
- ▶ If lifetime income protection is purchased the retiree should pursue the most aggressive investment strategy to maximize potential income. However, an aggressive strategy ramps up the risk to the carrier if an early bear market occurs, so the carrier is best served by a conservative strategy that preserves assets. These opposing goals require regulators to ensure that the investment choices associated with the lifetime income protection are sufficiently aggressive to offer a realistic opportunity for income growth and that the fees charged for the protection are sufficient for the carrier to properly hedge the risk.
- ▶ "Contingent Annuities are one of the 'better choices' for guaranteed lifetime income because they overcome some of the reasons for consumer resistance to other forms of annuities while providing similar benefits at lower cost" (Graye, 2012). The argument that was made by Great-West Life, and I concur with their conclusion, is that CDAs will attract investors (and advisors) who will not buy a deferred or immediate annuity.

- The behavioral side of lifetime income protection was touched upon by Bryan Pinsky of Prudential Annuities on the 16 February 2012 conference call in his remarks on how contract persistency and investor benefit utilization affect financial risk to the carrier. The Milliman study on guaranteed living benefits released in May 2011 found benefit utilization increases when investment account value goes down and that persistency of products with lifetime benefits is significantly higher than expected. (www.prnewswire.com/news-releases/nearly-15-of-variable-annuity-policies-with-a-guaranteed-withdrawal-benefit-started-withdrawals-within-the-first-12-months-after-attaining-eligibility-123737939.html).
- ▶ The two ways to cover persistency and utilization risks are to charge sufficient fees so the risks can be hedged and to lessen the risk of the investment account value going down. CSA providers limit where money can be placed, usually requiring 30% to 70% to be placed in bonds and the balance in equities. This emphasis on bonds has the effect of limiting the risk of substantial account loss caused by a severe bear market early in the retirement that could quickly cause the carrier guarantee to be utilized. However it also decreases the potential income the investor would receive under most historical market scenarios.

In spite of the facts that the benefit will not be used by most people because they will die before they run out of money, and that the conservative portfolios required means that the possibility of income growth is significantly reduced – as well as what a beneficiary of the account might receive if death occurs before the assets are spent, I support CDAs for two main reasons. The first already mentioned is that there is a statistically significant probability that the portfolio will run out of money before death of the investor, regardless of how it is invested. The second reason is based on my doctoral work on cognitive biases in decision-making that theorizes that the use of lifetime income protection on a portion of the total retirement assets should result in greater income efficacy on all of the retiree's assets. In a nutshell, retirees tend to be conservative with their investments in retirement. Knowing that a portion of their retirement assets are guaranteed to produce a steady income, regardless of market volatility, should make retirees invest more aggressively with the remainder of their money thus increasing the odds of higher overall income during retirement.

Yes, there is a need for lifetime income protection. CDAs are a way to provide this protection at a lower cost than other methods.

History

In 2002 Hartford offered the first variable annuity with a guaranteed minimum withdrawal benefit (GMWB) (Marrion, 2008). The first VA with a lifetime withdrawal benefit (GLWB) was introduced in 2003 (Marrion, 2008). Also in 2006 VA carriers introduced GLWBs offering spousal continuation wherein the guarantee of lifetime payments was extended to a second life (O'Connor, 2006). All of these innovations led to 2006 being a record year for variable annuity sales.

Fixed annuity carriers did not offer GMWBs presumably because annuity owners were always guaranteed that they could receive their principal as long as they met surrender period requirements. The first index annuity carrier to offer a GLWB was American National Insurance Company in June 2006. They were quickly followed by the AmerUs Group (now Aviva). By the end of 2006 seven index annuity carriers were offering GLWBs with many more carriers preparing to launch. Also in 2006 AIG Annuity became the first stated rate annuity carrier to offer a GLWB, but fixed stated rate competitors were far slower to follow the GLWB parade than fixed index carriers had been (Marrion, 2008).

Although I seem to remember this concept was kicked around in the '80s by some no-load mutual funds, in October 2006 PHL Variable Insurance Company became the first carrier to file a CDA registration for the Phoenix Guaranteed Retirement Income Protector (GRIP) (SEC File No. 333-137802) as "an insurance guarantee offered to advisory clients." In December 2007 Allstate registered the Guaranteed Lifetime Income Annuity (SEC File No. 333-147913). On March 10, 2008, Allianz filed the Allianz Contingent Annuity (SEC File No. 333-144584). Also on that same day, Nationwide filed the Individual Contingent Immediate Income

Annuity registration to be used with Envestment (SEC File No.333-149613). On April 9, 2008, Merrill Lynch Life Insurance Company filed the Merrill Lynch Withdrawal Insurance (SEC File No. 333-150148) designed to offer the Transamerica Morningstar Fund series.

The first marketed CDA product launched on March 13, 2008, when Lockwood Capital Management Inc, a Pershing affiliate, introduced Guaranteed Retirement Income Solutions (GRIS) with a GLWB underwritten by PHL Variable Insurance Company. This was followed in May by Genworth and AssetMark (SEC File No. 333-143494) offering the LifeHarbor series of managed portfolios. Also in May 2008, Allstate introduced their CDA that could be added to the ClearTarget mutual fund, bringing a new dimension to the managed portfolio concept (Marrion, 2008).

A key point stressed by CDA proponents are lower costs to the investor. When this first round of CDA products were launched the typical VA GLWB fee was 0.65%. By contrast, then current fees of the Allstate and Genworth CDAs ranged from 0.85% to 1.25%, while the CDA fee for the Nationwide product was 1.20% and the Phoenix product was 1.25% (1.45% - joint) (Marrion, 2008). However, the average variable annuity at that time had a mortality & expenses charge of 1.40% (Korn, 2006), meaning a total average carrier cost to the investor of 2.05%. On a total insurance cost basis, the CDA fees were roughly half of the VA with a GLWB, but, of course, the CDA did not include a death benefit.

By the fall of 2011, most of these early registrations had been withdrawn. Based on my recent conversations, it appears the reasons for the withdrawals were poor sales or concerns about hedging. In February 2009, Allstate pulled their product off the market. Allianz withdrew their registration on August 3, 2010. In early 2011, Genworth stopped sales of Life Harbor Merrill Lynch (now Transamerica Advisors Life Insurance Company) withdrew their registration on August 12, 2011 stating that no sales had occurred. Nationwide and Phoenix continue to offer CDAs.

Current CDA Specs

My research indicates the carriers currently marketing CDAs are Great-West Life & Annuity, Nationwide, PHL Variable Insurance Company and Transamerica Advisor Life. I've have heard Prudential is working on a CDA but could not confirm it. Great-West offers two versions – one for pension plans and the other for retail investors. PHL has registered a number of variations of their Guaranteed Income Edge CDA. However, I believe the only one being actively marketed is the one with Investors Capital Advisory Services. The following highlights certain aspects of CDA prospects.

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Carrier	Great-West	Great-West	Nationwide	PHL Variable	Transamerica Advisors
Product	SecureFoundation Group Fixed Deferred Annuity Contract SEC File No. 333-169563	SecureFoundation Group Fixed Deferred Annuity Certificate SEC File No. 333-175423	Portfolio Innovator Individual Supplemental Immediate Fixed Income Annuity Contract SEC File No.333-149613	Phoenix Guaranteed Income Edge SEC File No. 333-161382	Group Fixed Contingent Annuity Contract SEC File No. 333-177282
Portfolio Choices	Balanced Fund or various Target Date funds	Maxim SecureFoundation Balanced ETF Portfolio	Wide choice of Envestnet managed balanced portfolios or target date portfolios	Investors Capital Advisory Services; 4 model portfolios: conservative (40% equity), conservative/balanced (50% equity), balanced (60% equity), growth (70% equity)	"As of the effective date of this prospectus, there are 119 Eligible Assets"
Equities % Limits	50% - 70%	50% - 70%	45% - 70%	40% - 70%	A minimum of 20% must be in fixed instruments – a maximum of 10% may be in small/mid cap, 25% max in international, 5% max in alternative
Minimum Investment	no minimum	varies	\$100,000	no minimum	\$100,000
Charges	0.9% Current 0.7% Minimum 1.5% Maximum	1.0% Current 0.7% Minimum 1.5% Maximum	0.9%-1.3% Current 0.9% Minimum 2.0% Maximum	2.5% Current/Max on 4% payout. 3.0% Current/Max on 5% payout.	Profile A 1.00% 1.75% - up to 50% equities Profile B 1.15% 1.90% - up to 60% equities Profile C 1.35% 2.10% - up to 70% equities Profile D 1.75% 2.50% - up to 80% equities
	"We may change the current Guarantee Benefit Fee at any time...upon 30 days prior written notice"	"We may change the current Guarantee Benefit Fee at any time...upon 30 days prior written notice"	"the Contract Fee Percentage associated with your Contract will not increase, except possibly, if you... change any terms"	The contract fee may change upon step-up, but to never more than the maximum fee.	The Certificate Fee reductions: \$500,000-\$999,999 (0.05%), \$1m to \$1,999,999 (0.1%), \$2 m+ (.15%).

Carrier	Great-West	Great-West	Nationwide	PHL Variable	Transamerica Advisors
Additional Fees		An advisor may charge up to 1.5% before it is considered an excess withdrawals	An advisor may charge up to 1.65% before it is considered an excess withdrawals	0.5% Investor Protector Program Fee. An advisor may charge up to 1.5% before it is considered an excess withdrawals	
Minimum Age (to receive payout)	55	59.5	65 (to receive payment)	65 (to receive payouts)	60 (younger spouse can't be more than 10 years younger)
Payout % Joint	55-64 (4/3.5) 65-69 (5/4.5), 70-79 (6/5.5) 80+ (7/6.5)	Based on Age & 10 Yr U.S. Treasury yield	\$100,000	4% or 5%	Based on Age & 10 Yr U.S. Treasury yield
Step-up Provisions	Yes	The income during payout could increase if either the account grows in value or the Treasury yield increases.	Yes	Yes	The income during payout could increase if either the account grows in value or the Treasury yield increases.

Two recent CDA offerings stretched the envelope in CDA design:

Great-West SecureFoundation

(Prospectus dated December 5, 2011)

Great-West has one annuity for pension plans and this one for retail investors. Unlike “non-synthetic” GLWBs – and the other CDAs – both of these plans permit the annuity fees to be changed by Great-West even if a step-up in payout has not occurred

This annuity introduces something new by linking the payout (initial and subsequent) to the yield of the 10 year U.S. Treasury Note. Here is how it works: If you begin to take withdrawals between ages 65-69 you will get 100% of the then current 10 yr U.S Treasury yield. The minimum payout would be 4% and the maximum would be 8%. If a joint person is added the payout is 90% of what the single one would be:

Example: If the 10-year US Treasury yield is 2% when payouts begin the payout factor is 4% (the minimum); if the Treasury yield is 9% the payout factor is 8% (the maximum). If the Treasury yield is 5% and a same age spouse is added the factor is 4.5% (5% x 0.9).

If withdrawals begin when the youngest covered person is between ages 59 ½ and 64 the person receives 70% of the Treasury yield subject to a minimum of 3% and a maximum of 5.6%. If the youngest covered person is between ages 70 and 74 the person receives 110% of the Treasury yield subject to a minimum of 4.5% and a maximum of 8.3%. If the youngest covered person is over age 75, the person receives 120% of the Treasury yield subject to a minimum of 5% and a maximum of 58.5%

Example: If the 10-year US Treasury Note yield is 5%: a 59 ½ to 64 year old receives 3.5% (3.15% joint); age 70 to 74 receives 5.5% (4.95% joint); age 75%+ receives 6% (5.4% joint).

Annual Review: The income could increase if either the account grows in value or the Treasury yield increases. If the payout is 100% of \$100,000 and the Treasury yield is 5% then the guaranteed payout is \$5,000. If next year the account – after the withdrawal – is worth \$110,000 and the Treasury yield remains at 5% the payout would increase to \$5,500. Or, if the benefit base was \$90,000 next year, but the Treasury yield had increased to 6.11% then the payout would increase to \$5,500. Of course, you could also have these benchmarks go in different directions – if the base increased to \$110,000, but the Treasury yield dropped to 4.5%, the new calculation would be \$4,950, so you'd stay with the previous \$5,000.

Most GLWBs have a reset feature permitting the possibility of a rising income when you have a rising stock market. This Great-West feature makes for a potential rising income if interest rates go up. Both benchmarks make sense for the carrier because the cost of hedging the longevity risk goes down as either the value of the investor's account or interest rates go up.

Transamerica Advisors Life Insurance Company (formerly Merrill Lynch Life Insurance Company.) **Group Fixed Contingent Annuity Contract** (Prospectus Dated December 19, 2011)

Trailing Great-West's SEC registration by two weeks and launched in January 2012 the Transamerica CDA also uses the 10 Year Treasury yield as a benchmark. The initial payout is based on the age of the owner (or youngest spouse if joint) and the Treasury yield.

Transamerica Advisors CDA Payouts

Single (Joint) Age at Payout	10 Year Treasury Yield When Payout Begins or Steps-Up				
	0% - 4.49%	4.5% - 4.99%	5% - 5.49%	5.5% - 6.99%	7% & Over
60	4.0% (3.5%)	4.0% (3.5%)	4.5% (4.0%)	5.0% (4.5%)	5.5% (5.0%)
61	4.0% (3.5%)	4.1% (3.6%)	4.6% (4.1%)	5.1% (4.6%)	5.6% (5.1%)
62	4.0% (3.5%)	4.2% (3.7%)	4.7% (4.2%)	5.2% (4.7%)	5.7% (5.2%)
63	4.0% (3.5%)	4.3% (3.8%)	4.8% (4.3%)	5.3% (4.8%)	5.8% (5.3%)
64	4.0% (3.5%)	4.4% (3.9%)	4.9% (4.4%)	5.4% (4.9%)	5.9% (5.4%)
65	4.0% (3.5%)	4.5% (4.0%)	5.0% (4.5%)	5.5% (5.0%)	6.0% (5.5%)
66	4.1% (3.6%)	4.6% (4.1%)	5.1% (4.6%)	5.6% (5.1%)	6.1% (5.6%)
67	4.2% (3.7%)	4.7% (4.2%)	5.2% (4.7%)	5.7% (5.2%)	6.2% (5.7%)
68	4.3% (3.8%)	4.8% (4.3%)	5.3% (4.8%)	5.8% (5.3%)	6.3% (5.8%)
69	4.4% (3.9%)	4.9% (4.4%)	5.4% (4.9%)	5.9% (5.4%)	6.4% (5.9%)
70	4.5% (4.0%)	5.0% (4.5%)	5.5% (5.0%)	6.0% (5.5%)	6.5% (6.0%)
71	4.6% (4.1%)	5.1% (4.6%)	5.6% (5.1%)	6.1% (5.6%)	6.6% (6.1%)
72	4.7% (4.2%)	5.2% (4.7%)	5.7% (5.2%)	6.2% (5.7%)	6.7% (6.2%)
73	4.8% (4.3%)	5.3% (4.8%)	5.8% (5.3%)	6.3% (5.8%)	6.8% (6.3%)
74	4.9% (4.4%)	5.4% (4.9%)	5.9% (5.4%)	6.4% (5.9%)	6.9% (6.4%)
75	5.0% (4.5%)	5.5% (5.0%)	6.0% (5.5%)	6.5% (6.0%)	7.0% (6.5%)
76	5.1% (4.6%)	5.6% (5.1%)	6.1% (5.6%)	6.6% (6.1%)	7.1% (6.6%)
77	5.2% (4.7%)	5.7% (5.2%)	6.2% (5.7%)	6.7% (6.2%)	7.2% (6.7%)
78	5.3% (4.8%)	5.8% (5.3%)	6.3% (5.8%)	6.8% (6.3%)	7.3% (6.8%)
79	5.4% (4.9%)	5.9% (5.4%)	6.4% (5.9%)	6.9% (6.4%)	7.4% (6.9%)
80	5.5% (5.0%)	6.0% (5.5%)	6.5% (6.0%)	7.0% (6.5%)	7.5% (7.0%)
81	5.6% (5.1%)	6.1% (5.6%)	6.6% (6.1%)	7.1% (6.6%)	7.6% (7.1%)
82	5.7% (5.2%)	6.2% (5.7%)	6.7% (6.2%)	7.2% (6.7%)	7.7% (7.2%)
83	5.8% (5.3%)	6.3% (5.8%)	6.8% (6.3%)	7.3% (6.8%)	7.8% (7.3%)
84	5.9% (5.4%)	6.4% (5.9%)	6.9% (6.4%)	7.4% (6.9%)	7.9% (7.4%)
85+	6.0% (5.5%)	6.5% (6.0%)	7.0% (6.5%)	7.5% (7.0%)	8.0% (7.5%)

Taxation

The IRS has ruled in several private letter rulings (PLRs) that CDAs are annuities for tax purposes (PLRs 200949007, 200949036, 201001016, 201105004, 201105005, and 201117012. The most recent ruling (PLR 201117013) sums up the current IRS view of CDAs:

1. The Group Contract and Certificate will constitute an annuity contract for purposes of § 72;
2. The Annual Benefit and Annuity Payments will be taxable as “amounts received as an annuity” using an “exclusion ratio” under § 72(b);
3. “Although the Certificate has utility only in conjunction with an eligible Account under the auspices of Sponsor, ‘controls’ the Account Owner’s activities with regard to that Account, and cannot be alienated or otherwise monetized, the Account is not so intertwined with Certificate as to be effectively part of the Certificate. Cf. Rev. Rul. 77-85; Rev. Rul. 2003-97, 2003-2 C.B. 380.”

“Therefore, the Account will not cause the Group Contract or Certificate to have a “cash value” or “cash surrender value” for purposes of § 72, and will not otherwise be part of the Group Contract or Certificate for federal tax purposes.”

4. For purposes of § 72(c)(1) and § 72(e)(6) (each defining “investment in the contract”), the “aggregate amount of premiums or other consideration paid” for the Certificate will equal the sum of all Certificate Fees paid under the Certificate plus any proceeds paid to Issuer upon liquidation of the Account in consideration for Annuity Payments;
5. Dividends that the Taxpayer receives from the assets in the Account will not fail to be treated as “qualified dividend income” within the meaning of § 1(h)(11)(B) merely because he also owns the Certificate;
6. The taxpayer’s ownership of the Certificate and the Account will not be treated as a straddle under § 1092; and,
7. The Annual Benefit will not constitute insurance or other compensation for any prior deductible losses in the Account for purposes of § 165 and the “investment in the contract” portion of each Annual Benefit will not be includible in the Taxpayer’s gross income by virtue of the ‘tax benefit rule.’

In short, the investment portion will be treated as an investment – the dividends will be treated as dividends and capital gains and losses will be taxed as capital gains and losses. The annuity portion will be treated as an annuity – the income is annuity income and the portion of income representing premium paid in will be excluded from taxation, once the carrier starts making the payments.

Regulatory

I will not attempt to opine on how CDAs may be treated under Dodd-Frank. It should be noted that the IRS has ruled in many, many private letter rulings that CDAs are annuities. The only entity that has ever alleged CDAs are not annuities is the New York State Department of Financial Services in OGC Op. No 09-06-11. The suggestion that CDAs are a form of financial guaranty insurance and not an annuity rests entirely on an opinion issued by the New York Insurance Department in 2009. However, the opinion is based on a flawed interpretation on how a CDA works.

The Department is framing the CDA as financial guaranty insurance saying the reason the carrier becomes involved is because of a loss to the investment account due to “changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general.” However, this is not the only reason, nor the most likely reason that the carrier would pay out on a CDA.

Although the carrier could pay out due to negative “changes in value” in the value of the investment account, the true protection is longevity protection of the income stream. As an example that is a direct refutation of

New York's argument, say the investment account value was \$100 and the investor withdrew \$5 a year. If there was absolutely no market or price level change in the account value at anytime the account would be worth zero at the end of 20 years. However, if a CDA was in place, the \$5 payments could continue beyond the 20 years for the life of the investor even though no "financial loss" had resulted in "changes in the value of specific assets." The key point is the account is going down in value not due to "changes in value" but due to removal of assets by the investor. The CDA is not working to recover market loss – because there isn't any – but to maintain the income stream to eliminate longevity risk for the investor.

In addition, New York argues that a CDA means the investor is held harmless from declines in the account value. On the contrary, the investor retains market risk. If the investor withdraws the investment funds from the account when the account value is worth less than the original principal the investor loses the difference. If market losses occur while the investor is receiving payments from the investment and not the CDA and the investor dies, the beneficiaries receive the decreased value of the investment account and are not in anyway made whole by the insurance company. New York attempts to dismiss this by saying "whether the indemnification is effected by the making of periodic payments over a term of years, or for the duration of the Investor's lifetime, is immaterial to the analysis" however it is material because financial guaranty insurance does not cover the longevity risk of the investor but an annuity does.

Because of these facts and the consistent IRS position that CDAs are annuities, letters from carriers and industry associations to the Subgroup were almost unanimous in stating CDAs were unequivocally annuities. There was one exception.

The Exception

The only letter received by the Contingent Deferred Annuity (A) Subgroup saying CDAs were not annuities and should not be approved was from MetLife (letter of letter January 18, 2012). However, their main argument is a CDA is financial guaranty insurance because New York ruled that it was.

MetLife says that since New York had previously adopted the NAIC Financial Guaranty Insurance Guideline and then ruled that CDAs were not annuities, that therefore any state that has also adopted these guidelines must also conclude that CDAs are financial guaranty insurance. It goes so far as to list 6 states that have passed the financial guaranty guidelines. The flawed logic loop goes like this – New York uses the NAIC Financial Guaranty Insurance Guideline, New York determines CDAs are financial guarantee insurance, therefore anyone using the NAIC Financial Guaranty Insurance Guideline must also find that CDAs are financial guarantee insurance. The problem with this logic is that it assumes, without any proof, that the New York conclusion will be reached by others. It is the same thing as saying Bill, Mary and Jane like apples, Bill does not like oranges, therefore because Mary and Jane like apples they won't like oranges. Another flaw with the position is these states adopted the financial guaranty guidelines many years before CDAs were invented. To say the states knew these guidelines would one future day apply to CDAs implies clairvoyance.

MetLife also throws in a few other unsupported arguments against CDAs:

In a variable annuity the insurer offering the GLWB selects the investments that they cover; in a CDA the carrier may not have the ability to determine which investments the CDA applies to – but the carrier does approve the investments offered in every CDA marketed to date.

In a variable annuity the insurer receives fees & profits from the base annuity as well as the GLWB which provides a revenue cushion – but those "extra" fees are used to offset the costs of providing a death benefit. A CDA does not offer a death benefit.

Hedging & reserving may be more difficult with a CDA – but MetLife offers no evidence to support this assertion.

MetLife also brings up some red herrings saying that guaranty fund coverage of CDA benefits is not clear (but neither is it clear on GLWBs) and that these violate group annuity laws (not only is this unsupported but CDAs have been issued as individual annuities too, so an appropriate form could be found).

The NAIC Contingent Deferred Annuity (A) Subgroup concluded CDAs are annuities and not financial guarantee insurance.

Solvency & Consumer Protection

“Actuarial assumptions for Contingent Annuities are not adjusted merely because the accumulation vehicle is different. Since the general account is exposed to the same risk in each case, the reserving methodology that Great-West uses is the same for Contingent Annuities and variable annuities with a GLWB and follows Actuarial Guideline 43” (Great-West Letter, April 28, 2011).

“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” (Prudential Letter).

“The statutory reserve and capital requirements for GLWBs/GMIBs and CDAs are outlined in AG 43 and RBC C-3 Phase II – Scope includes “guarantees similar in nature to GMDBs or VAGLBs, even if the insurer does not offer the mutual funds or variable funds to which these guarantees relate.

The guidance provides for rigorous measurement and certification of reserves and capital [with] calculations based on Conditional Tail Expectation (CTE 70 and CTE 90); a minimum reserve and capital reserves based on the Standard Scenario, which includes prescribed assumptions for mortality, policyholder behavior, and investment returns; stochastic scenarios calibrated to NAIC RBC C-3 Phase II criteria; reflection of only revenues and expenses associated with the contract and hedging can be reflected only if a Clearly Defined Hedging Strategy, certified by a financial officer of the company, is in place; the assumed Effectiveness Factor can be no more than 70%.” from Tim Bennett, Transamerica Advisors Life Insurance Company, Contingent Deferred Annuities, Slide 13, February 16, 2012.

Based on comments such as these, the Subgroup concluded “If hybrid income annuities can be sold by life insurers, then so can synthetic hybrid income annuities.” (naic.org/documents/committees_a_contingent_deferred_annuity_sg_120216_agenda_sg_update.pdf). However, with that in mind the Subgroup suggested that solvency issues for both synthetic hybrid income annuities (CDAs) and non-synthetic hybrid annuities (GMIBs, GLWBs) be examined in tandem with one set of solvency rules developed for both.

Are The Current Statutory Reserve Guidelines Adequate?

Milliman reported that hedging programs for guaranteed retirement income products were 94% effective during the worst of the 2008-2009 bear market, saving the insurance industry \$40 billion (Sun & Mungan, 2010). If these longevity hedging activities worked for GLWBs during a severe bear market then they should also work for CDAs. However, not everyone shares the same opinion.

The rating agency Fitch said they were concerned about the mispricing of CDA benefits specifically noting the lack of experience the industry has in this area saying “only a handful of U.S. life insurers have actually sold a [CDA] type product.” Taking a differing view from Milliman’s, Fitch stated that “due to investment guarantees embedded in variable annuity products, the industry suffered material financial losses in the 2008-2009 financial crisis.” However, Fitch wrapped up their comments by saying “we do not portend any rating impact over the near term associated with the development of CA offerings” (<http://insurancenewsnet.com/article.aspx?id=330134&type=topnews>).

Solvency is one major concern; the Subgroup has asked A Committee members to resolve these issues (naic.org/documents/committees_a_contingent_deferred_annuity_sg_a_committee_recommendation.pdf):

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 is the other big concern and they use a couple of charts in their 22 February report to show why. The first charts shows two investors investing the same money, but the expert investor maximizes his withdrawals under the CDA while the novice investor withdraws less than permitted. The Subgroup chart concludes the expert investor managed to get back an additional \$6.67 for every dollar spent in CDA fees while the novice spent \$35,000 and received zero benefit. The subgroup's suggestions for the A Committee are:

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.

The issue is carriers and investors are at cross purposes when it comes to CDAs. Since a base income is guaranteed the investor should be aggressively attempting to maximize payout by pursuing high risk-high return investments. However, the goal for the carrier is to have the investor's money last as long as possible so that the carrier does not pay out. The regulators are needed to strike a balance.

The Future OF CDAs

Creating investments that promise investors both gains and protections is essentially like trying to work alchemy in the financial markets

Tom Lauricella. 2009. Design challenge: How to make stocks safer for older investors.
The Wall Street Journal 6 July. 254.4:R11

A preponderance of evidence has led both the IRS and the NAIC Subgroup to strongly state that CDAs are annuities and not financial guarantee insurance. The Council of Economic Advisors has joined many other research groups in concluding that consumers need to be able to buy financial vehicles that insure against

longevity risk (http://www.whitehouse.gov/sites/default/files/cea_retirement_report_01312012_final.pdf). Many of the comment letters to the Subgroup strongly demonstrated that CDAs are another way for consumers to insure the risk of outliving their assets at a potentially lower cost than some other methods. At this point, it would be difficult for anyone to deny that these are annuities and that they can provide value to the consumer.

The Subgroup has concluded that the reserving and hedging risk of “synthetic hybrid” income annuities (CDAs) is essentially identical to the risk of “non-synthetic hybrid” income annuities (GLWBs & GMIBs). Instead of taking the existing rules in this area (AG 43 & RBC C3-Phase II) and tweaking them to accommodate CDAs, the Subgroup has suggested that the entire area of longevity risk, as it relates to reserving and capital exposure, be examined with the aim of establishing one cohesive set of guidelines for both. Although this may not be well received in some quarters it makes sense. When a GMIB, GLWB or CDA is purchased the buyer is betting that the carriers will be able to keep a 30 to 40 year promise to the buyer; NAIC must do their best to ensure that the promise will be kept.

Adequate reserves become even more important because neither NOHLGA nor the state guaranty funds have said how they will treat CDA income payments received as annuities if the carrier goes belly-up. Will the coverage be limited to the premium paid in – a totaling of that 0.7% to 3% fee paid by the buyer each year – or will it be based on the income the carrier has promised to pay?

Even with these questions decided, the remaining question is will investors buy CDAs? There are other ways to handle the longevity challenges from immediate annuities to fixed or variable annuities with GLWB riders. CDAs fees are lower than VA fees due to the unbundling of mortality and longevity costs. However, at a typical savings of roughly 1% to 1.4%, will enough investors be found who decide they will accept the asset allocation restrictions of both VA GLWBs and CDA, like the lifetime income but don't want to pay a mortality cost. On a pure guaranteed income basis, many of the fixed index annuity GLWBs offer far superior guaranteed growth of income than CDAs.

To build on the previous paragraph, a CDA buyer occupies a very specific niche. You have someone that is afraid of outliving their money due to market risk, but passes up the sure thing offered by a guaranteed annual increase in potential income offered by variable annuity and index annuity GLWB roll-ups. The rationale for doing this would be that the investments would outperform any guaranteed roll-up rates. However, every CDA limits the exposure to higher risk-higher return investments. In 4 of the 5 available CDAs, you must put at least 30% of your funds in bonds (Transamerica has one profile that mandates only 20% be placed in bonds, but it severely restricts the funds that may be allocated to small or mid cap equities). The CDA target market are those investors that are sufficiently risk-averse to fear the risk of outliving their money, but sufficiently risk-oriented as to accept the market risk that they can outperform the guaranteed roll-up growth offered by many GLWB annuities. In addition these are investors willing to pay 1% to 3% for longevity protection, but will not pay 1.4% for mortality protection of their investment.

The other issue is who will sell CDAs? Independent agents selling fixed or index annuity GLWBs are usually doing so due to the guaranteed growth of income or because they are not securities registered. A CDA does not offer guaranteed growth of income and it is attached to a securities product. Based on many conversations (but not empirically supported), it is my belief that there are many investment advisors, who that will never sell any type of longevity annuity. They feel it is their job as money managers to work to ensure that their client does not outlive their money; they will not sell CDAs. What you're left with are advisors, stockbrokers and securities licensed agents that do not feel certain investors need the mortality protection of a variable annuity, but need the longevity protection of the CDA.

The strongest market for CDAs may well be pension plan sponsors. CDAs allow them to continue to offer investments through familiar money managers, but also provide the lifetime benefits that the experts say their participants need.

The battle over whether CDAs are annuities or financial guaranty insurance should be all over but for the shouting and the annuities won. An unintended result, at least from the insurance industry's side, is the NAIC will probably develop tighter controls over all longevity related issues leading to higher reserve requirements and more attention paid to consumer protection.

Yes, there is a need for lifetime income protection. The insurance world has provided this for centuries through immediate annuities, and through GLWBs for not quite a decade. CDAs are another way insurers can protect consumers from uncertainty.

Resources

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NAIC Subgroup Submissions

Academy of Actuaries Submission 2-15-12

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120216_academy_submission.pdf

Industry Presentation - Education on CDAs

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120216_industry_presentation.pdf

Committee of Annuity Insurers (CAI) Letter

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120216_cai_letter.pdf

Great West Disclosure

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120216_gw_disclosure.pdf

GWLA NAIC CDA Subgroup Letter (01/26)

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120126_gwla_naic_cda_subgroup_letter.pdf

CDFA White Paper

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120126_cdfa_white_paper.pdf

CDA Historical Test Part 2

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120209_cda_historical_test2.pdf

Agenda

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120126_agenda.pdf

IRI Comment Letter

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120126_iri_comments.pdf

Transamerica Comment Letter

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120126_comments_transamerica.pdf

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American Academy of Actuaries Letter

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120126_comments_aaa.pdf

CDA Historical Test

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120126_cda.pdf

Call Summary

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120119_summary.pdf

AAA presentation

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ACLI Comments

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120119_comments_acll.pdf

MetLife Comments

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120119_comments_metlife.pdf

Call Summary

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_120119_summary.pdf

Agenda

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_111222_agenda.pdf

American Academy of Actuaries Contingent Annuity Work Group Presentation

http://naic.org/documents/committees_a_contingent_deferred_annuity_sg_111222_aaa_presentation.pdf