AMERICAN ACADEMY *of* ACTUARIES

October 28, 2011

Honorable Adam Hamm, Chair,
Life Insurance and Annuities (A) Committee
National Association of Insurance Commissioners

Dear Commissioner Hamm,

The American Academy of Actuaries[1] Contingent Annuity Work Group (CAWG) appreciates the opportunity to provide the attached analysis that we promised in our August 22 memorandum[2] to you, in order to assist the National Association of Insurance Commissioners (NAIC) in its work involving contingent annuities. The CAWG is comprised of actuaries with a broad range of experience with contingent annuities (also called "contingent deferred annuities" or "Stand Alone Living Benefits (SALBs)") and related topics.

Our analysis contains the specific topics included in the Life Actuarial Task Force's May 4 2011 memorandum to you: whether the product is an annuity or a financial guaranty product, the need for the product, the risks presented by the product, consumer issues, as well as reserving and capital considerations. Our intent in formulating this analysis was to address the actuarial components of these specific topics and others that bear on the product, including: tax treatment, Securities and Exchange Commission (SEC) treatment, nonforfeiture treatment, and state guaranty fund coverage, all of which have been raised in the course of recent discussions with the NAIC, regulators and companies. We did not intend this document to cover any or every issue that has arisen or could arise with contingent annuities, nor to provide opinions on any non-actuarial issues. However, where appropriate, we have provided information on our understanding of certain legal and other implications of the product compared with other insurance and annuity products to provide a more complete picture of the product environment.

The details of this letter support the conclusion that contingent annuities can be a beneficial annuity product for many consumers, and that the basic regulatory framework in place for other products can be applied to contingent annuities with little or no modification.

We encourage the NAIC and other state insurance regulators to seek uniformity in state laws to facilitate consistent review, issuance and regulation of these products in order to provide consumers with another product alternative that can protect against longevity risk through guaranteed lifetime income coverage.

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[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

[2] August 22, 2011 memorandum http://www.actuary.org/pdf/naic/CAWG_memo_to_A_Comm_Cont_Annuitites_110822.pdf.

If the Contingent Annuity Work Group of the American Academy of Actuaries can be of further assistance to the NAIC, please contact us.

Sincerely,

Andy Ferris, Chair	Cande Olsen, Chair
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Contingent Annuity Work Group	Life Products Committee

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1. Executive Summary

From a public policy perspective, we support finding solutions to protect against longevity risk. Contingent annuities provide protection against longevity risk or the risk of outliving one's assets. Contingent Annuities are one of those solutions. From a consumer's perspective contingent annuities can be a beneficial product since they offer a solution to this risk exposure: Many consumers are not protected against the risk of outliving their assets.

A contingent annuity is essentially a stand-alone guaranteed living withdrawal benefit, thus providing many of the same benefits and sharing many of the same risks associated with the guaranteed living benefits issued as part of variable annuity contracts.

There are differences between contingent annuities and variable annuities with guaranteed living withdrawal benefits (GLWBs):

1. A contingent annuity applies a benefit to assets not directly managed by the insurer, where variable annuities are directly maintained and managed by the insurer.
2. Contingent annuities are stand-alone contracts, but the guaranteed living benefits provided with variable annuities are directly tied to the base contract.

There are many similarities between contingent annuities and variable annuities with guaranteed living benefits:

1. Consumer protection against longevity risks by providing a guaranteed lifetime income stream
2. Consumer protection against market risks
3. Insurer ability to manage the basis risk, when the necessary contractual and operational controls between insurer and asset manager are in place
4. Similar suitability and disclosure issues,
5. Sophisticated risk management processes and comparable regulatory oversight is essential

The CAWG has reviewed the existing regulatory structure and concluded that the basic regulatory framework in place for other products can be applied to contingent annuities with little or no modification - principally since the NAIC models for reserves and risk-based capital already exist, and the fact that all states have procedures in place that can allow for approval of GLWBs. It is logically consistent to classify the contingent annuity product as an annuity from an actuarial or risk perspective, and not as a form of financial guaranty insurance. The contingent annuity has a comparable structure to other annuity products based on the risks insured and the benefits paid to the consumer. However, we do recognize that contingent annuities may not fit into the legal framework for annuities in every state. Company filing practices have also varied, creating confusion among regulatory officials and the industry.

Regardless of policy form, the CAWG believes companies need to disclose in their filings that the product is a contingent annuity. The contingent annuity product design introduces some new elements that distinguish the product from the typical GLWBs being sold in the current market. It is therefore important that both the elements that are similar and the elements that are different be clearly disclosed in product filings so that individual states are able to effectively review, approve and monitor the products.

The market potential for contingent annuities is large due to consumer need for longevity protection. Also, contingent annuities provide an attractive solution to those consumers that do not want to transfer a portion of their assets to an insurer, as would be the case with variable annuities. Careful evaluation of the product and regulatory oversight is important to protect consumers and assure that insurers are able to manage the risks and pay the promised benefits. Contingent annuity products, along with variable annuities, highlight the need for a demonstrated understanding of the risks created by these products through both sophisticated company Enterprise Risk Management (ERM) practices and appropriate regulatory oversight.

2. <u>The Contingent Annuity Product and the Value to Consumers and the Public</u>

The Contingent Annuity applies a GLWB benefit to a purchaser's assets which are not held by the life insurance company issuing the contingent annuity, but rather, are held by an outside entity with which the life insurer has a contractual relationship. Such assets (called "covered assets") usually consist of mutual funds and could be held in either nonqualified or tax qualified accounts, including but not limited to retail investment accounts, managed accounts, IRAs and 401(k)s.

The contingent annuity provides a guaranteed lifetime withdrawal benefit based on the covered assets. After reaching a specified age, the purchaser can initiate periodic withdrawals from the covered assets in an amount up to a specified percentage of a guaranteed benefit base. When and if these withdrawals exhaust the covered assets, the life insurer begins making the guaranteed lifetime income payments to the purchaser. The life insurer will continue payments for as long as the purchaser lives. For this guarantee of lifetime income, the purchaser pays a periodic fee beginning when the contingent annuity is purchased. This product can also be provided on a joint and survivorship basis, and is, from our collective understanding, currently available in a number of states.

From a public policy viewpoint, the contingent annuity can be a beneficial product for many consumers by providing protection against outliving one's assets through the guarantee of lifetime income. In recent years, more and more public policy discussions have focused on the declining access to, or attainment of, assured lifetime income for a growing number of Americans. There are many reasons to explain why individuals may not have adequate lifetime income, including the shift from defined benefit pension plans to defined contribution plans, increasing lump sum distributions from pension plans, increasing life expectancy, and, more recently, poor performance in the financial markets. It should also be noted that while many of these trends have been developing for years, some have gained more significance during the recent financial crisis.

The issues at hand do not apply solely to American's personal security but lead us to societal issues, as these trends place a strain on safety net programs that may be tapped absent other avenues to sustain lifetime income. Without a guaranteed lifetime income, even with careful planning, retirees are exposed to the risk of running out of income to cover necessities or to support the lifestyle they desire. There are many approaches and products that can assure a lifetime income for a consumer. The contingent annuity product provides another solution to those retirees looking to include assured lifetime income in their retirement planning.

Financial stability in retirement is more attainable if people can obtain guaranteed lifetime income by accessing any of their accumulated assets – both nonqualified and tax qualified accounts. Contingent annuities can make guaranteed lifetime income available more broadly by offering this product to consumers who may not otherwise consider purchasing a traditional annuity product.

3. Classification of the Contingent Annuity: an Annuity or Financial Guaranty Product

Although some states have made the determination that the contingent annuity is a type of financial guaranty insurance product, the CAWG has concluded that this product should be classified as a type of annuity product for the reasons explained in the following section:

Annuity products can provide many benefits to consumers, a primary one being the promise of protection against the risk of outliving one's assets—that is, protection against longevity risk. A financial guaranty insurance product protects against the risk of specific types of financial losses—most commonly, the risk of a bond default—and is sold primarily to institutions. The primary, in fact, sole protection provided by financial guaranty insurance is associated with the risk of a financial event, and not the risk associated with a specified life. [3]

There are many types of financial guaranty products. Bond insurance is a type of financial guaranty insurance that is most comparable to contingent annuities. Bond insurance protects institutional investors against credit risk, guaranteeing the repayment of principal and interest in the event of creditor default. The only trigger for the bond insurance payout is default, and the amount and timing of the claim is limited to the contractual principal and interest of the outstanding debt. Bond insurance contains no element of life contingency or longevity protection in either the trigger for payment, the amount of payment, or the timing of payments.

A contingent annuity is very different than financial guaranty insurance. A contingent annuity does not insure the covered assets, protect against loss of the covered assets, or promise that a specific amount of covered assets will be maintained upon occurrence of a market decline. The contingent annuity provides insurance protection with respect to a specified life, guaranteeing lifetime income payments to the purchaser following the depletion of the covered assets while that purchaser is still living irrespective of the performance of the covered assets.

While the contingent annuity provides an element of protection against loss of income due to market drops in the covered assets which may not recover to the extent originally expected, the annuity benefits are only payable after the covered assets have been exhausted. In effect, the covered assets function similar to a deductible, where the annuity only pays out if the cumulative income payments exceed the deductible. The contingent annuity does not reimburse for a loss in

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[3] The NAIC Model Financial Guaranty Insurance Guideline (October 2008) states, " 'Financial guaranty insurance' means a surety bond, an insurance policy or when issued by an insurer or any person doing an insurance business as defined in Section [insert section], an indemnity contract and any guaranty similar to the foregoing types, under which loss is payable upon proof of occurrence of financial loss to an insured claimant, obligee or indemnitee as a result of any of the following events: (a) Failure of any obligor on or issuer of any debt instrument or other monetary obligation (including equity securities guarantied under a surety bond, insurance policy or indemnity contract) to pay when due [to be paid by the obligor or scheduled at the time insured to be received by the holder of the obligation], principal, interest, premium, dividend or purchase price of or on, or other amounts due or payable with respect to**,** the instrument or obligation, when the failure is the result of a financial default or insolvency or, provided that such payment source is investment grade, any other failure to make payment, regardless of whether the obligation is incurred directly or as guarantor by or on behalf of another obligor that has also defaulted; (b) Changes in the levels of interest rates, whether short or long term, or the differential in interest rates between various markets or products; (c) Changes in the rate of exchange of currency; (d) Changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general; or (e) Other events which the commissioner determines are substantially similar to any of the foregoing. " It then further clarifies some financial instruments that shall not be included as Financial Guaranty Insurance.

market value or for a loss from less than expected investment performance at the time of that loss.

Payments may be received under the contingent annuity even where the market does not decline, but the purchaser still lives long enough to exhaust the covered assets. Further, an early decline and a later recovery in the market can also mean that no benefits are paid under the contract. Analogous to other equity-linked life insurance and annuity products, the relationship between the market performance of the asset and the benefits payable under the contingent annuity is indirect: negative / insufficient market performance is neither required for benefit payments to occur nor a direct determinant for the amount of benefits.

While there are distinct differences between contingent annuities and financial guaranty insurance, there are many similarities between contingent annuities and GLWBs that accompany variable annuities. The reasons for paying a benefit under a Contingent Annuity are identical to the reasons a GLWB rider pays out under a traditional variable annuity. Because the primary characteristic of the contingent annuity is longevity protection for a specified life regardless of market performance, and because there is not a direct relationship between the magnitude of a loss of covered assets and eventual benefits to be paid under the product, we have concluded that a contingent annuity should not be classified as financial guaranty insurance and should be classified as a type of annuity product.

4. Classification of the Contingent Annuity: Life Insurance or Casualty Insurance

Contingent annuities specifically provide a life contingent benefit, just as other annuity products provide. Although there does not appear to be definitive guidance in all state insurance laws limiting the sale of life contingent products to life insurance companies, the CAWG knows of no state that would permit a property/casualty insurance company to offer for sale an insurance product with a material life contingent component.

Based on our analysis, the CAWG has concluded that contingent annuities contain a material life contingent component, which suggests that the manufacture and sale of such a product belongs with a life insurance company. Our conclusion is based on a review of the actuarial characteristics of the product, rather than any legal review. We performed an analysis of the risks covered by the contingent annuity that demonstrates that the product provides material protection against longevity risk in addition to market risk. The details of this analysis are contained in Appendix A. Highlights of the analysis follow:

For the purposes of this report, we have defined longevity risk as living past one's life expectancy (which, implicitly means outliving one's planning horizon and therefore, potentially, one's assets). We analyzed the protection against longevity risk by quantifying the claims paid beyond a person's average life expectancy. We based our analysis on a typical contingent annuity product, where a contract holder can withdraw a fixed percentage annually (e.g., 4% or 5%) for life, starting at age 65, without affecting the guarantee.

While market performance cannot be removed under any simulation, we can isolate the impact of longevity on claims. We simulated the payment of claims if a contract holder lives to their average life expectancy (i.e., 19 years beyond normal retirement age 65) and also simulated the payment of claims if a contract holder's life expectancy differs from the average by simulating a range of life expectancy scenarios. Both simulations assume a range of market return scenarios. In the first simulation, a claim was paid in 19.8% of scenarios prior to year 19 (the average life expectancy for the modeled 65 year old male). The average size of the total claims paid by the insurer to cover the guaranteed payments was $40,064. When a range of life expectancy scenarios beyond average life expectancy is introduced into the analysis in the second simulation, the average total claim paid is $67,328, or 68% higher than in the first simulation.

The purpose of performing this analysis was to demonstrate that contingent annuity products provide a material level of protection against longevity risk in addition to market risk. Thus, the life insurance industry, not the casualty industry, has the expertise and demonstrated experience to manage these risks.

5. <u>Comparison to Other Products under the Existing Life Insurance Regulatory Framework</u>

Contingent annuities are substantially similar to GLWBs, and it is our considered judgment that the basic regulatory framework in place for GLWBs can be applied to contingent annuities.

Some existing regulatory requirements can be applied to contingent annuities—for example, Actuarial Guideline XLIII (AG43) for reserves and C-3 Phase II for risk-based capital (RBC). We have prepared the attached detailed chart (Appendix B) that compares the characteristics of contingent annuities to GLWBs, organized by the issue topics listed in the May 4 referral letter, as expanded upon in the second paragraph of this letter. The comparison chart also shows three other products: (1) a variable annuity with no guarantee riders, to provide a baseline description for the characteristics of the product to which the GLWB could be attached; (2) a deferred paid-up annuity,[4] to compare the contingent annuity to another life insurance product with characteristics in common with contingent annuities; and (3) a bond insurance product, to show a comparison of the contingent annuity product to the characteristics of a financial guaranty insurance product, to the extent there is any comparability.

Contingent annuities serve the same general and consumer need as GLWBs and deferred paid-up annuities, i.e., to guarantee lifetime income. Bond insurance serves a different need, i.e., to guarantee the loss associated with a bond default. For these reasons and many others, the comparison of contingent annuities to bond insurance products, or other types of financial guaranty insurance, is not very relevant; nevertheless, it was included in the comparison chart in Appendix B to provide a comprehensive comparison of all product types to which the contingent annuity has been compared.

Highlights of the similarities and differences, most of which are listed in the Appendix B comparison chart, follow:

[4] A deferred paid-up is an annuity with no cash surrender values prior to the commencement of annuity payments that provides for a single premium or flexible premiums over the deferral period of the contract or for a shorter limited payment period, and that provides for specified income payments beginning on a specified income commencement date for each premium paid. It is often marketed as a "longevity annuity," "longevity insurance," or a "deferred income annuity."

6. Need for the Product

- Basic Consumer Need – Contingent annuities, GLWBs and deferred paid-up annuities are marketed to individual consumers with needs for guaranteed lifetime income, but with different preferences regarding product features and accumulation of funds (e.g., who controls the assets, fund choices, etc.).

- How Basic Consumer Needs are Served – Contingent annuities are similar to GLWBs in that they both provide guaranteed lifetime income beginning at the exact time a specific set of accumulated assets runs out—that is, a seamless guaranteed lifetime income. Contingent annuities are similar to deferred paid-up annuities in that: (1) both provide guaranteed lifetime income commencing at a date in the future, under the assumption that independently owned accumulated assets will have run out, and (2) neither will provide any income payments if the purchaser dies before that future date (or, in the case of contingent annuities, if the accumulated assets don't run out). The major difference between a deferred paid-up annuity and a contingent annuity is that the deferred paid-up annuity begins on a pre-selected date, whereas the guaranteed lifetime income from a contingent annuity begins at the time the independently owned accumulated assets run out—that is, the deferred paid-up annuity does not provide a seamless guaranteed lifetime income, whereas the contingent annuity does.

7. Product Structure and Costs

- Contractual Structure –While the form of a contingent annuity contract will depend on the product design and filing methodology elected by the issuer, contingent annuities generally are issued as group fixed annuities to asset management firms, through which individual customers who purchase the lifetime income guarantee will receive group participant certificates. These certificates will describe for the certificate holder the terms of the lifetime income guarantee. For example, the certificate will define when the lifetime income guarantee is effective and the conditions under which such guarantee may be terminated. Both the contract and certificate must comply with applicable state insurance laws governing group annuities. Based on the contract structure, it is logical that certificate delivery should happen at the time of election rather than at the time guarantee payments begin.

  Asset options available with the GLWB through the variable annuity are set forth by the life insurer in the terms of the rider, whereas asset options supported by the contingent annuity are set forth by the life insurer in the terms of the group annuity contract and certificate.

  Any additional terms of the arrangement between the insurer and the asset management firm are set forth in the group annuity contract. For example, the master group contract may describe the manner in which the asset management firm will report investment activity and deliver the premiums for the income guarantee to the life insurer. Because of the critical nature of asset restrictions and monitoring requirements with respect to the management of the contingent annuity guarantee, the insurer should specify asset restrictions and related requirements contractually, and establish the appropriate operational and legal protections in the event of violations by the asset manager. The group annuity contract and certificate may indicate that the life insurer has the right to terminate the income guarantee if the investments in the purchaser's account deviate from the allowable investment allocations set forth in the annuity contract.

While, most contingent annuities currently offered take the form of the group annuity contract described in the above paragraphs, the contingent annuity may also be offered as an individual fixed annuity. In this construct, the individual who owns the asset account will be the contract holder, while a service or administrative type of agreement may exist between the entity that manages such accounts and the life insurer.

It should be noted that all comments in this letter are based on the contingent annuity group contract/individual certificate product structure described in this section. Because this structure is the most common, the CAWG has based all comments in this letter on the group annuity contract form. We understand that other product structures (e.g., individual rather than group, variable rather than fixed, separate account rather than general account) may have been filed and/or approved, but we are not commenting on those product structures in this letter.

Differences in state laws and/or product designs may result in the filing of different product designs in different states. We are not in a position to comment on different company filing practices, but the CAWG sees the value of using a common product structure in all states. Regardless of policy form, the CAWG believes the company needs to disclose in the filing that the product is a contingent annuity. The contingent annuity product design introduces some new elements that distinguish the product from the typical GLWBs being sold in the current market. It is therefore important that both the elements that are similar and the elements that are different be clearly disclosed in product filings so that individual states are able to effectively review and monitor the products.

- Holder of Invested Assets – The assets to which the contingent annuity guaranteed lifetime income payments are linked are external to the life insurance company; the assets are held by the purchaser in a personal account managed by an asset manager within parameters typically set in the agreement with the life insurance company. This procedure differs from variable annuity GLWBs, where the assets are held in a separate investment account owned and managed directly by the life insurance company. While this distinction results in some differences in contractual and operational requirements for the life insurance company, there is no impact on the characteristics of the lifetime income guarantee provided by the life insurance company to the individual purchaser and little or no impact on the management of the basis risk. For example, the insurance company may have the ability to substitute funds under a contingent annuity similar to what is allowed under a GLWB, although additional contractual and operational steps would need to be taken.

The assets of the variable annuity with a GLWB are held in a separate account owned and managed directly by the life insurance company, and the assets linked to the contingent annuity are not owned or managed by the insurance company. The rise and fall of the value of the assets for both a variable annuity and a contingent annuity rests with the investment performance of the fund (whether it is held directly by the investor or by the insurance company). Thus, a life insurance company's financial risk management activities associated with a contingent annuity lifetime income guarantee are analogous to those of GLWBs (described in greater detail below). In order to manage the risks, life insurance companies will need to establish appropriate data sharing and monitoring systems with their asset managers. Contingent annuity products, along with variable annuities, highlight the need for sophisticated company ERM practices and appropriate regulatory oversight that demonstrate an understanding of the risks created by these products.

In addition, in our review of the regulatory framework, we note that products with some similarities to Contingent Annuities—specifically, products known as "synthetic guaranteed investment contracts," or "synthetic GICs"—have for several years been considered approvable as annuity products by state insurance departments. While synthetic GICs do not contain a longevity component, the underlying assets of a synthetic GIC are not controlled by the insurance companies, making them conceptually similar to a contingent annuity. In this regard, there may be value in reviewing the regulatory oversight of synthetic GICs to determine if any regulatory practices can be applied to contingent annuities.

- Types of Investment Options – Variable annuities offer investment options (through their separate accounts) that normally are invested in mutual funds, which can include exchange-traded funds (ETFs) and fund-of-funds. These options can range from very stable funds (such as bond funds and index ETFs) to more volatile funds (such as growth or sector funds). Asset management firms normally offer investment options that are similar to those offered in variable annuities, but they also can include additional types of investments.

  While the range and characteristics of the investment options offered through both variable annuities and asset management firms can vary, the investment options that life insurers offer with the GLWB or contingent annuity products are typically required by the insurer to meet certain risk management criteria which enable life insurers to support the guarantee through a risk management program (e.g., capital markets hedging program). While the contingent annuity product will expand the availability of lifetime income guarantees to more people and more types of assets over time, the need for the covered assets to be "hedgeable" will also be an essential risk management requirement of the insurer for this product.

- Costs – To appropriately compare the costs of contingent annuities and variable annuity GLWBs, one must consider the "all-in" costs of the product, as well as the risks and expenses that such costs must cover. Longevity and market risks are the primary risks covered by both the GLWB rider and the contingent annuity. However, the contingent annuity is a stand-alone product offered by the life insurer and normally has a simple fee structure; the GLWB rider is part of a variable annuity contract that covers additional risks and expenses, and has a more elaborate fee and expense structure. The costs of the longevity and market risks, and the margins for potential fluctuations in those costs, must be covered in the pricing of both products. The more simplified fee structure of the contingent annuity provides the only means to cover these costs and margins. The more elaborate fee structure of the variable annuity and GLWB rider must also cover additional risk and expense costs, such as enhanced death benefits and commissions. In addition, for a variable annuity with a GLWB, life insurers can use fees (profits) from the underlying product to fund shortfalls in the GLWB (that is, benefits less fees), whereas life insurers can't do that with contingent annuities.

8. Consumer Issues

- Tax Treatment – In several private letter rulings, the Internal Revenue Service has ruled that for tax purposes, contingent annuities are considered to be annuities (Appendix C).

- SEC Treatment – Like GLWBs, contingent annuities are treated as securities under the federal securities laws, specifically the Securities Act of 1933 (Appendix D). This treatment requires insurance companies to, among other things, deliver an SEC prospectus to a purchaser at the point of sale, as well as deliver an updated prospectus annually. Contingent annuities are registered with the SEC except where specific exemptions apply (for instance, the "pension exemption" would apply to Contingent Annuities offered in connection with 401(k) plans).

- Nonforfeiture Treatment – Contingent Annuities have some characteristics of single premium immediate annuities (SPIAs) and some features found in many deferred annuities. They are similar to SPIAs in that payout guarantees are set at issue. They are similar to deferred annuities in that they might not begin payout until years after issue. They are dissimilar to deferred annuities because the premiums paid do not accumulate to determine the annuity payout, but rather are in the nature of risk charges for a longevity contingency. Consequently, it is logical to treat contingent annuities similarly to SPIAs, which would exempt them from the Standard Nonforfeiture Law for Individual Deferred Annuities (SNFLIDA) and not require paid-up nonforfeiture benefits.

  This interpretation is also consistent with the current treatment of GLWBs, to which contingent annuities are inherently similar. Variable annuities are not subject to the SNFLIDA; consequently, laws and regulations are mute on the treatment of GLWBs attached to them. The variable annuity model does not address this either. To clarify this interpretation, an actuarial guideline could be drafted to address contingent annuities directly. Ultimately, the appropriate nonforfeiture requirements for contingent annuities should be recognized in changes that LATF is currently considering for the nonforfeiture law. Additional analysis of contingent annuities with respect to nonforfeiture requirements is outlined in Appendix E.

- Portability – While variable annuities are not portable from one life insurance company to another, they are usually portable between distribution partners (such as broker-dealers) that sell and service products for the same life insurance company. The contingent annuity product introduces an additional complexity for life insurance companies, since the particular covered assets available through each contingent annuity contract are unique to each asset manager and not as easily portable. Thus, the portability of a contingent annuity from one asset manager to another adds a new complexity for life insurers if it is to be required, and a possible concern to consumers if it is not. If the guarantee is not portable, this restriction should be fully disclosed in the contingent annuity group contract and participant certificate.

- State Guaranty Fund Coverage – Since the contingent annuity product is most like a GLWB from the perspective of life insurer liability for a guaranteed lifetime income, it is would be consistent that state guaranty fund coverage for contingent annuities be similar to the coverage for GLWBs. With both contingent annuities and GLWBs, the lifetime income guarantee becomes a liability of a life insurer's general account when the certificate is issued or the rider is added. The covered assets supported by a contingent annuity, as with the GLWB separate account assets, are in no way protected by a state guaranty fund.

  There is also need for clarification with respect to the fairness of assessing all insurance companies (as opposed to only companies issuing contingent annuities) for the contingent annuity risk coverage of an insolvent insurer. Confirmation or clarification from the state guaranty funds, with input from the National Organization of Life and Health Guaranty Associations (NOLHGA) and state regulators would be welcomed on these and other topics regarding state guaranty fund treatment for both GLWBs and contingent annuities.

  We have described the guaranty fund issues based on our understanding; however, guaranty fund coverage involves many legal issues and is therefore outside of the scope of this report.

- Suitability – As with the sale of any product, consumer safeguards regarding suitability need to be in place. Suitability guidelines and regulations should be reviewed by the NAIC with assistance from a broad range of experts on the topic to determine if contingent annuities pose any unique suitability issues that would necessitate a change to existing regulations.

9. Reserves, Capital, and Other Risk Management Considerations

- Reserves – Statutory reserve guidelines for contingent annuities are the same as for GLWBs and are already addressed under AG43. Section II of AG 43 says, in part:

  A) *The Guideline applies to contracts, whether directly written or assumed through reinsurance, falling into any of the following categories:*

……….

3) Group annuity contracts that are not subject to CARVM, but contain guarantees similar in nature[4] to GMDBs, VAGLBs, or any combination thereof; and

4) All other products that contain 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, where there is no other explicit reserve requirement.[5]

[4] The term "similar in nature," as used in sections II)A)3) and II)A)4) is intended to capture both current products and benefits as well as product and benefit designs that may emerge in the future. Examples of the currently known designs are listed in footnote #5 below. Any product or benefit design that does not clearly fit the Scope should be evaluated on a case-by-case basis taking into consideration factors that include, but are not limited to, the nature of the guarantees, the definitions of GMDB and VAGLB in sections III)A)1) and III)A)2) and whether the contractual amounts paid in the absence of the guarantee are based on the investment performance of a market-value fund or market-value index (whether or not part of the company's separate account).

[5] For example, a group life contract that wraps a GMDB around a mutual fund would generally fall under the scope of the Guideline since there is not an explicit reserve requirement for this type of group life contract. However, for an individual variable life contract with a GMDB and a benefit similar in nature to a VAGLB, the Guideline would generally apply only to the VAGLB-type benefit, since there is an explicit reserve requirement that applies to the variable life contract and the GMDB.

- Capital – Statutory risk-based capital requirements for contingent annuities are also already addressed by the current requirements. The scope of the C-3 Phase II RBC requirements with respect to contingent annuities is the same as for AG 43, except for an additional sentence in item # 4) which further explains this item as noted below:

  All other products that contain guarantees similar in nature[1] to GMDBs or VAGLBs, even if the company does not offer the funds to which these guarantees relate, where there is no explicit reserve requirement (other than AG VACARVM) for such guarantees. If such a benefit is offered as a part of a contract that has an explicit reserve requirement other than AG CARVM[2], the methods of this capital requirement shall be applied to the benefit on a stand-alone basis. [emphasis added]

- Hedging – Both with GLWB riders offered through variable annuities and with contingent annuities, life insurers generally manage the risks associated with changes in the market value of the liabilities through capital markets hedging programs. These hedging programs operate in fundamentally the same way for both GLWBs and contingent annuities.

- Reinsurance **–** Because the lifetime income benefit risk is the same for variable annuity GLWBs and contingent annuities, life insurers may reinsure this risk for both contingent annuities and GLWBs in a similar manner.

- Unique Risks – As with GLWBs, the life insurance company should be able to demonstrate, as part of the product approval process, that it has the proper risk management systems in place to mitigate the unique risks of this product. Examples of such risks include:

    - Potential for Accelerated Growth – Due to differences in distribution and the availability of a possibly broader set of investable assets, the contingent annuity market has the potential for larger sales volumes and more rapid growth than the current variable annuity GLWB market. Contingent annuity writers should ensure that sufficient operational controls and risk management systems are in place to manage the operational and financial risks introduced by large volumes.

    - Operational Issues Related to Third Party Asset Ownership **–** There may be more operational challenges involved with receiving timely and accurate information from the asset management firm for effective hedging of the assets. In addition, it is essential for the insurer to have a strong relationship with the asset manager in order to monitor and respond to any changes in investment strategies or fund offerings.

  Further, regulators should also be monitoring the specific risks posed by this product, both to an individual company and the insurance market in aggregate.

10. Conclusion

As stated earlier, the American Academy of Actuaries' CAWG has concluded that contingent annuities can be a beneficial product for many consumers. Consumers will be well served if the life insurance industry and regulators work together to interpret (utilizing written guidelines if needed), or make changes to, the existing regulatory framework allowing the product to be available to more consumers.

In arriving at these conclusions, we have reviewed the most common contingent annuity product structure in the market today. We recognize, however, that the contingent annuity market is in an early stage of development, and that product designs are likely to evolve. We expect interest in this market to grow, as consumers understand the product's benefits, leading to even more varied product designs.

Based on the issues we have explored thus far, we have concluded that much of the regulatory framework that is already in place for other products can be applied to contingent annuities with little or no modification, especially to the extent that most states have adopted or plan to adopt the NAIC models for life reserves and capital, and the fact that all states have procedures in place for approval of GLWBs, which is a very similar product.

A contingent annuity is essentially a stand-alone version of the guaranteed lifetime withdrawal benefit (GLWB) currently offered with many life insurers' variable annuity contracts. However, the contingent annuity product design introduces some new elements that distinguish the product from the typical GLWBs being sold in the current market. It is therefore important that both the elements that are similar and the elements that are different be clearly disclosed in product filings so that individual states are able to effectively monitor and regulate the products.

Appendix A
Analysis of Market and Longevity Risk of Contingent Annuities

Executive Summary

Under a contingent annuity contract, the contract holder is guaranteed fixed, lifetime payments if their covered assets are depleted. The covered assets can be depleted by negative market returns, contract holder withdrawals, or both. With contingent annuities, a contract holder can withdraw a fixed amount per year without affecting the benefit base, where that benefit base drives the guarantee and the payment of a claim under the contingent annuity contract. In a typical product, a contingent annuity contract holder can withdraw 5% annually for life from the covered assets starting at age 65. For a 65-year old that can expect to live an additional 19 years, on average, he/she can withdraw that 5% and could expect that the covered assets will be greater than zero in the absence of market volatility (i.e., 19 payments equal to 5% of covered assets will result in 95% of the covered assets being drawn down). As such, the contract holder is most concerned with living past their life expectancy -- their longevity risk.

The contingent annuity protects the contract holder against this longevity risk. In this appendix, the Contingent Annuity Work Group (CAWG) analyzes the relative protection against market and longevity risks provided by this product from the contract holder's perspective. Our intent is to show the relative protection provided by a typical contingent annuity product. If a contract holder chooses to independently manage their longevity risk by reducing their guaranteed payments, then the longevity risk protection would no longer be as large relative to the market risk protection. In the same respect, if a contract holder made excess withdrawals, with no impact on the guaranteed payment, then the protection from market risk would increase as a percent of the total risk protection. As described in more detail below, we simulated the payment of claims if a contract holder lives to the average life expectancy and also simulated the payment of claims if a contract holder's life expectancy differs from the average by simulating a range of life expectancy scenarios. Both simulations assume a range of market return scenarios.

In this example, the total accumulated claims paid by the insurer over the life of the contract were used to assess the market and longevity risk of these types of products. In the first simulation, a claim was paid in 19.8% of scenarios prior to year 19 (the average life expectancy for the modeled 65-year old male). The average size of the total claims paid by the insurer to cover the guaranteed payments was $40,064. When a range of life expectancy scenarios beyond average life expectancy was introduced into the analysis in the second simulation, the average total claim paid was $67,328, or 68% higher than in the first simulation. Looking at claims paid when lifespan exceeds the average life expectancy, the comparison of claims attributable to longevity risk versus market risk only is even more dramatic. For example, when life expectancy falls in the 95th percentile (i.e., the person will live 28 years past age 65 instead of the average of 19 years), the average claim is $146,013.

Methodology

A cash flow model was created that projects cash items such as the covered assets, guarantee base, withdrawal amount, and potential claims or benefits paid over the life of the contract holder. Claims were defined as the amount of the guaranteed benefits paid once the covered assets of a contract holder's underlying investments have been depleted. As mentioned earlier, this depletion could occur due to adverse returns of the investment, contract holder withdrawals, or both.

A model of a representative product was designed, allowing for the simulation of claims under different market conditions and different longevity assumptions. In the first simulation, we simulated the claims paid due to market performance while holding the longevity component constant; specifically, the first simulation assumed deterministic mortality where the contract holder's lifespan was equal to their life expectancy. In both simulations, cash flows were projected assuming 1,000 market return scenarios applied to the covered assets. In the second simulation, we simulated the claims paid under varying life expectancies. The second simulation assumed a stochastic mortality process that allowed the length of contract holders' life to be variable. In this second simulation, we modeled the cash flows over 1000 random market return scenarios and 1000 mortality scenarios for a total of 1,000,000 scenarios (i.e., 1000 X 1000 = 1,000,000). Claims were projected until the death of the contract holder.

The remainder of the appendix provides further details on the results and conclusions of the analysis as well as the model and the methodology used to evaluate the risks of this product.

Product Design

The hypothetical contingent annuity modeled allows a contract holder to invest their initial premium in a fund with moderate risk exposure to the equity markets. Any gains or losses from the performance of the covered assets are directly reflected in the market value of their account. A guaranteed withdrawal base (GWB) is tracked and set equal to the initial premium. The GWB can "ratchet up" to the value of the covered assets if the market performance increases the value of the covered assets. Specifically, the new GWB will be equal to the greater of

(1) the prior GWB or
(2) the then-current value in the covered assets.

The GWB is the basis on which withdrawals are calculated for the lifetime of the covered person(s). The participant can receive the benefit as either a single or joint life contract holder.

- For a single life election, the lifetime annual withdrawal percentage was assumed to be 5% of the GWB
- For a Joint Life election, the lifetime annual withdrawal percentage was lower than the single life withdrawal percentage and was assumed to be 4.5% of the GWB

The withdrawal amount is guaranteed for the life of the contract holder, even when the covered assets have been depleted.

In our analysis, we modeled a typical product design. Results would vary based on the specific product design chosen.

Assumptions Used in the Risk Analysis

Scenarios

1000 scenarios were created based on historical monthly index return data for the S&P 500 over the last 30 years. These scenarios were created to meet the calibration requirements for equity scenarios established by the American Academy of Actuaries' C-3 Phase II Work Group for the C-3 Phase II risk-based capital calculations.

AAA equity calibration criteria				
Calibration Point	1 year	5 Year	10 Year	20 Year
2.5%	**0.78**	**0.72**	**0.79**	**n/a**
5.0%	**0.84**	**0.81**	**0.94**	**1.51**
10.0%	**0.90**	**0.94**	**1.16**	**2.10**
90.0%	**1.28**	**2.17**	**3.63**	**9.02**
95.0%	**1.35**	**2.45**	**4.36**	**11.70**
97.5%	**1.42**	**2.72**	**5.12**	**n/a**

The scenarios were created using a regime switching lognormal model. The following parameters define the characteristics of the equity index in high volatility and low volatility regimes. These values were calculated based on historical data as of 5/31/2011 for the S&P 500 index.

	Regime 1		Regime 2	
	Expected Return	Volatility	Expected Return	Volatility
Equity	17.87%	11.07%	-8.29%	22.45%

The expected transition probabilities were calculated to be:

Probability of Transition from 1 to 2	4.90%
Probability of Transition from 2 to 1	11.13%

Modeling Assumptions

Model points were analyzed for male, female and joint life contract holders at age 65. A moderate asset allocation was assumed with 60% exposure to the equity markets and 40% to fixed income. These policies were assumed to be at issue and "at-the-money" with the value of initial covered assets and guaranteed base of $150,000. The life expectancy was calculated based on the mortality rates of the Annuity 2000 Basic Table. The following table further details the assumptions used:

Age	65
Sex	M, F, Joint Life
Equity Allocation	60%
Deferral Period	0
Withdrawal Rate	Single life = 5%, Joint Life=4.5%
Fund fees	0.75%
Rider Fees	1.00%
Value of Initial Covered assets	150,000
Guaranteed Benefit Base	150,000
Life Expectancy	M=19yrs, F=22yrs, JL = 26yrs

<u>Results</u>

The total accumulated claim paid by the insurer over the life of the contract was used to assess the market and longevity risk of these types of products. These claims are a measure of the total benefit that is paid to the contract holder who has chosen to invest in a contingent annuity product.

The table below details the results for a male contract holder age 65. Here we show the distribution of claims if we assume this contract holder lives with certainty to their life expectancy of 19 years beyond age 65 (deterministic mortality). With a withdrawal rate of 5%, we know that in the absence of market risk and fees, this contract holder would receive 20 years of payments before their covered assets would be depleted (i.e., 20 payments equal to 5% of covered assets will result in 100% of the covered assets being withdrawn). The claims incurred in this simulation are a result of the performance of the covered assets in each scenario and the depletion of the covered assets prior to duration 19 (i.e., only market performance is affecting the claims).

Male – Age 65

Frequency of Claims	19.80%
Percentile	Total Claims
1%	1,182
5%	6,323
10%	12,107
25%	21,467
50%	39,356
75%	54,731
90%	72,331
95%	78,335
99%	85,423
Max	91,867
Average Claim	40,064
Standard Deviation	22,280

Next, we examined the distribution of claims once we introduced variability in the length of life of this contract holder (stochastic mortality).

Frequency of Claims	19.77%
Percentile	Total Claims
1%	1,205
5%	7,078
10%	13,063
25%	31,134
50%	62,004
75%	97,389
90%	128,015
95%	146,013
99%	181,974
Max	494,952
Average Claim	67,328
Standard Deviation	44,518

We observe similar results for female contract holders:

Female – Age 65

	Deterministic Mortality	Stochastic Mortality
Frequency of Claims	26.60%	23.78%
Percentile	Total Claims	Total Claims
1%	4,570	1,549
5%	10,062	9,037
10%	17,342	16,872
25%	32,036	39,707
50%	59,198	76,609
75%	82,809	116,383
90%	101,148	150,715
95%	110,739	171,050
99%	124,129	213,312
Max	126,750	556,754
Average Claim	58,292	81,372
Standard Deviation	31,062	51,658

The following table summarizes the increase in claim size for both males and females when stochastic mortality is introduced.

	Increase in Claim Size with Stochastic Mortality	
	Male age 65	Female age 65
95th Percentile	86%	54%
99th Percentile	113%	72%
Max	439%	339%
Average Claim	68%	40%
Standard Deviation	100%	66%

Additional Sensitivity Testing

Similar analysis was performed for joint life products. The models of joint life products showed a similar distribution of claims compared to the single life model described above.

We also performed sensitivity analysis on the impact of higher, unscheduled contract holder withdrawals. Unscheduled withdrawals will affect the level of "in-the-moneyness." In-the-moneyness refers to the difference between the actual covered assets and the benefit base. If a contract is in-the-money, the contingent annuity will pay out. Similar results for claims distributions were obtained for varying levels of in-the-moneyness.

Key Findings

For males age 65, the market risk-only simulation showed that a claim was paid in 19.8% of scenarios prior to year 19. The average size of the total claims paid by the insurer to cover the guaranteed payments was $40,064. This is calculated as the total accumulated claims paid by year 19. When stochastic mortality is introduced into the analysis, the average total claim paid is $67,328, or 68% higher. Looking at claims paid when lifespan exceeds the average, the comparison of claims attributable to longevity risk versus market risk only is even more dramatic. When life expectancy falls in the 95th percentile (i.e., the person will live 28 years past age 65 instead of the average of 19 years), the average claim is $146,013. Results for females showed a similar trend.

APPENDIX B
CONTINGENT ANNUITY PRODUCT COMPARISON CHART
(NOTE: For "VA Only," "VA w/GLWB," and "CA" products, only the Accumulation Period--not the Annuity Payout Period--is considered.)

Product:	**Variable Annuity with No Living Benefit Riders "VA Only"**	**Variable Annuity with Guaranteed Lifetime Withdrawal Benefit Rider "VA w/GLWB"**	**Deferred Paid-up Annuity "DPA" (also known as Longevity Annuity)**	**Contingent Annuity "CA" (aka Contingent Deferred Annuity)**	**Financial Guaranty Insurance "FGI" Bond Insurance**
1. Market for the Product					
a. Basic Consumer Need	• Tax-Deferred Wealth Accumulat'n • Participation in Equity Markets • Guaranteed Lifetime Annuity	• Tax-Deferred Wealth Accumulat'n • Participation in Equity Markets • Guaranteed Lifetime Income • Guaranteed Lifetime Annuity	• Guaranteed Lifetime Annuity	• Guaranteed Lifetime Income • Guaranteed Lifetime Annuity	• Bond Default Protection
b. How Basic Consumer Needs are Served	Provides tax-deferred asset accumulation from investments in multiple mutual funds via insurer's separate investment account, with option to convert accumulated assets into guaranteed lifetime annuity.	Same as "VA Only," but with a more limited choice of funds that also provides the safety net of guaranteed lifetime income, without annuitizing the account, if accumulated assets (in VA contract) being drawn down become exhausted before death.	Provides safety net of a guaranteed lifetime annuity starting at a pre-selected date, irrespective of results of any other investments in providing income.	With a limited choice of funds held with an asset management firm, provides safety net of guaranteed lifetime income, without annuitizing the account, if accumulated invested assets (held w/ the asset mgmt firm*) being drawn down become exhausted before death.	Ensures that interest and principal of a bond will be paid in full and on time.
c. Consumer Profile	Clients of fin'l advisors who want the tax deferred accum and lifetime annuity bens of a deferred annuity but also want the personal invst control and flexibility of (and can tolerate the market risk associated with) investing (indirectly) in mutual funds.	Individuals just like the "VA Only" individuals, except they value liquidity and are willing to pay an extra fee and endure investment-choice limitations to be able to take guaranteed minimum withdrawal amounts for life without taking annuity income.	Individuals who are accumulating, or who have accumulated, their wealth for retirement their own way, since they value liquidity, and who are also willing to pay a fee (the single premium) for an additional guarantee to ensure continuation of lifetime income past a certain pre-determined age.	Customers of an asset management firm*****, who otherwise are individuals just like the "VA w/GLWB" individuals, except they do not choose a VA contract for various reasons.	A bond issuer, like a municipality, that wants the bond to receive the higher rating of the insurance company.
2. Product Manufacture and Distribution					
a. Typical Insurance Contractual Form	Individual annuity contract	Individual annuity contract + rider	Individual Deferred Paid-up Annuity contract	Group annuity contract with asset mgmt firm; Certificate to purchaser	Financial Guaranty Insurance Contract
b. Types of Manufacturers					
(1) Holder of Invested Assets	Life Insurers	Life Insurers	(None, but it's assumed that DPA is part of overall plan for wealth accumulation and lifetime income)	Asset management firm* with which insurer has a contractual relationship	Municipalities and other bond issuers
(2) Guarantee (GLWB, DPA, CA, FGI)	Life Insurers	Life Insurers	Life Insurers	Life Insurers	Monoline Financial Guaranty Insurance Companies
c. Methods of Distributing Insurance	Representatives that are both state-insurance-licensed and SEC–registered	Representatives that are both state-insurance-licensed and SEC–registered	Representatives that are state-insurance-licensed	**Group Annuity:** Direct to Asset Mgmt Firm **Group Certificate:** Investment Advisors that are both state-insurance-licensed and SEC–registered	Direct – Insurer to Bond Issuer
3. Product Construction and Features					
a. Types of Investment Options	Offered through insurer-owned Separate Investment Account: • Mutual Funds (MFs) • Exchange-Traded Funds (ETFs) • Fund of Funds	Offered through insurer-owned Separate Investment Account: • Mutual Funds (MFs) • Exchange-Traded Funds (ETFs) • Fund of Funds	Insurer's General Investment Account	Offered through asset management firm*: • Mutual Funds (MFs), ETFs • Managed Accounts (MAs) • Other invested assets	Municipal or other types of bonds
b. Control of Investment Decisions	Insurer chooses invst options; Purchaser chooses allocations; Fund managers make specific investment decisions	Insurer chooses invst options available for Guarantee; Purchaser chooses allocations within insurer limits; Fund managers make specific investment decisions	Insurer makes all investment decisions (General Investment Account), within state regulatory limits	Insurer chooses invt options avail for Guarantee; Purchaser (w/Investment Advisor) chooses allocations within insurer limits; Fund managers make specific investment decisions	Insurer makes all investment decisions, within state regulatory limits
c. Triggering Event for Guarantee (when insured benefits payable)	(Not Applicable)	After pre-chosen age, if still alive and VA Account Value is exhausted	At pre-selected date, if still alive	After pre-chosen age, if still alive and Covered Assets are exhausted	(Not Applicable)

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CONTINGENT ANNUITY PRODUCT COMPARISON CHART

(NOTE: For "VA Only," "VA w/GLWB," and "CA" products, only the Accumulation Period--not the Annuity Payout Period--is considered.)

Product:	**Variable Annuity with No Living Benefit Riders "VA Only"**	**Variable Annuity with Guaranteed Lifetime Withdrawal Benefit Rider "VA w/GLWB"**	**Deferred Paid-up Annuity "DPA" (also known as Longevity Annuity)**	**Contingent Annuity "CA" (aka Contingent Deferred Annuity)**	**Financial Guaranty Insurance "FGI" Bond Insurance**
d. Charges and Fees Paid by Individual	**VA Contract** – Loads, CDSCs, monthly / annual charges **Separate Invt Acct** – M&E risk chgs **Investment Options** – Invst mgt fees, other exp chgs, 12b-1 fees	**VA Contract** – Loads, CDSCs, monthly / annual charges **Separate Invt Acct** – M&E risk chgs **Investment Options** – Invst mgt fees, other exp chgs, 12b-1 fees **Guarantee** – rider charges	Implicit in guaranteed annuity benefit (not identified separately, as in an "unbundled" product)	**Investment Advisor** – Advisory fee **Asset Management Firm*** – Program fees **Investment Options** – Invst mgt fees, other exp chgs, 12b-1 fees **Contingent Annuity** – Fee based on % of Covered Assets or Benefit Base	Implicitly added to the price of the bond.
e. Death Benefit (excludes additional DBs available at extra cost)	VA Contract's Account Value or, if greater, Sum of Premiums paid less any Withdrawals	VA Contract's Account Value or, if greater, Sum of Premiums paid less any Withdrawals	(None)	None (any assets in purchaser's managed asset account remain part of purchaser's estate upon death)	Bond and related transactions continue to estate or beneficiary
4. Tax Treatment (specifically, federal income tax treatment for the individual purchaser)	NQ: Gains in contract not immediately taxable; pre-annuity distributions taxed on LIFO basis, with penalty if Age < 59½; annuity income taxed using exclusion ratio TQ: Same as NQ for gains; all pre-annuity distributions (same penalty rule) and annuity income fully taxable	Same as "VA Only"; all income withdrawals and GLWB benefits are considered pre-annuity distributions	Gains in contract not immediately taxed, whether NQ or TQ, before annuity income begins; pre-annuity distributions cannot be taken; annuity income taxed just like "VA Only" (based on whether NQ or TQ)	NQ: Invt gains in Covered Assets taxable in year earned (like other retail investments); pre-annuity distrs. of Covered Assets not taxed again; pre-annuity CA income benefits taxed using exclusion ratio (investment in contract = Σ CA fees); CA annuity income taxed using possibly different exclusion ratio TQ: Invt gains in Covered Assets not immediately taxed; pre-annuity distrs. of Covered Assets fully taxed (with same penalty rules); taxation of CA pre-annuity income and annuity income not yet clear	(Not Applicable)
5. SEC Treatment					
a. For Invested Assets	Must be registered and offered with a prospectus (the usual "pension" and "private" exceptions apply).	Must be registered and offered with a prospectus (the usual "pension" and "private" exceptions apply).	(Not Applicable)	Covered Assets generally must be registered and offered with a prospectus (the usual exceptions apply).	(Not Applicable)
b. For the Guarantee	(Not Applicable)	Included with VA prospectus.	Not a registered security; no prospectus needed.	Since CA benefits are based on the value of registered securities, CAs must be registered and offered with a prospectus (with the same exceptions).	Not a registered security; no prospectus needed.
6. Nonforfeiture Treatment					
a. For the Account Values	Based on SNFLIDA	Based on SNFLIDA	(Not Applicable)	(Not regulated by state insurance laws.)	(Not Applicable)
b. For the Guarantee	(Not Applicable)	Based on SNFLIDA	None (based on SNFLIDA)	None (based on SNFLIDA)	(Not Applicable)
7. State Guaranty Fund (SGF) Coverage (not uniform across all states)					
a. For the Account Values	Still open to interpretation and possibly different treatment by state guaranty funds	Still open to interpretation and possibly different treatment by state guaranty funds	(Not Applicable)	(None – Not regulated by state insurance laws.)	(Not Applicable)
b. For the Guarantee	(Not Applicable)	Guarantee becomes insurer's general acct. liability when rider issued, and SGF coverage commences then.	SGF covers deferred annuity payments as soon as contract issued.	Guarantee becomes insurer's general acct. liability when certificate issued, and SGF coverage commences then.	None (for states surveyed)
8. Reserve Requirements					
a. For the Account Values	Actuarial Guidline 43	Actuarial Guidline 43	(Not Applicable)	(Not regulated by state insurance laws.)	(Not Applicable)
b. For the Guarantee	(Not Applicable)	Actuarial Guidline 43	CARVM (Fixed Annuity)	Actuarial Guidline 43	As required by state ins. regulator
9. Risk-Based Capital Requirements					
a. For the Account Values	C3 Phase II	C3 Phase II	(Not Applicable)	(Not regulated by state insurance laws.)	(Not Applicable)
b. For the Guarantee	(Not Applicable)	C3 Phase II	C3 Phase I	C3 Phase II	As required by state insurance regulator

* The term "asset management firm" is used to represent the bank, asset manager, investment firm, or mutual fund company with which the life insurance company contracts, to offer the insurer's contingent annuity on specific assets or asset management programs held at the asset management firm.

Appendix C

Tax Law Treatment of Variable Annuity Minimum Living Benefits, Contingent Annuities, and Financial Guaranty Insurance

This Appendix describes our collective understanding of the current IRS treatment of lifetime income benefits made available by life insurance companies through optional benefit riders on variable annuity contracts or through contingent annuities. This Appendix is intended to supplement and help frame the comprehensive review of contingent annuities being prepared by the CAWG. Our understanding is based on generalized familiarity with the Internal Revenue Code and related private letter rulings (PLR). While we have made every effort to state only the facts related to the IRS treatment for the purposes of this report, the legal aspects of the application of the Internal Revenue Code falls outside of the scope of actuarial expertise, and therefore no reliance on this report should be considered as implied to any specific tax situation.

The applicable tax rules for payments from an annuity depend on whether it is a qualified or a nonqualified annuity. An annuity contract is typically considered to be nonqualified unless it is issued in connection with a tax-qualified pension, profit-sharing, or retirement plan or arrangement. Premiums paid for nonqualified annuities are paid in after-tax dollars. That is, nonqualified premiums are not deductible from gross income for federal income tax purposes. The focus of this appendix generally addresses nonqualified annuities, although both variable annuity living benefits and contingent annuities are also issued in connection with qualified plans.

Tax Treatment of Annuity Contracts

The tax treatment of payments from annuity contracts is governed by Section 72 of the Internal Revenue Code ("the Code"). This section specifies that the tax treatment differs depending on whether or not distributions are received before the annuity starting date, generally the first day of the first period for which an amount is received as an annuity. Amounts received before the annuity starting date are includable in income except to the extent that they represent a return of the investment in the contract, (premiums or other consideration paid for the contract, minus the aggregate amount previously received under the contract that was excludable from gross income). Partial withdrawals, surrenders and loans are taxed under an income-first rule at ordinary income tax rates. In addition, certain distributions may be subject to penalty taxes. Since income is included in gross income only when received, the effect is to permit the interest or earnings credited to the annuity contract to accumulate on a tax-deferred basis. If all or some part of the value of an annuity contract is applied to provide a stream of periodic payments, each of those payments will be partly includable in income and partly excludable as a return of capital, pursuant to an "exclusion ratio."

Definition of an Annuity

Amounts under an annuity contract will obtain federal income tax deferral treatment only if the contract is treated as an annuity for federal tax purposes. Although the Code contains numerous references to an "annuity contract," that term is not directly defined in the statute. However, the defining characteristics can be found in regulations, case law, and certain statutory provisions. According to Income Tax Regulations, an "annuity contract" that is subject to the rules of Code Section 72 includes a contract that is recognizable as an annuity under the "customary" practices of life insurance companies.[1] In addition, a variable annuity contract must comply with the investment diversification requirements of Internal Revenue Code Section 817(h) and must not provide the policyholder with excessive control over the investments underlying the contract.

A contract that does not provide for annuitization options that result in the systematic liquidation of principal and interest or earnings, but rather provides solely for the payment of interest or earnings on the principal amount of an invested fund with the principal remaining intact, is typically not treated as an annuity contract for federal income tax purposes (per a combination of case law and regulations). If such a contract is non-variable, the contract will typically be considered an agreement to pay interest and the owner of the contract will be taxed on the interest accruing to the account value. If it is a variable contract, it will most likely be considered a mutual fund for tax purposes, and the owner will be taxed accordingly. However, we are unaware of any guidance from the Internal Revenue Service on this issue.

Minimum Guaranteed Living Benefits

In general, distributions from an annuity contract do not depend on the source of the payment. That is, whether a payment is from the base contract or an additional benefit, the tax treatment is the same, as long as the benefit is considered a part of the annuity contract and not some other form of benefit (e.g., life or disability insurance). In this regard, amounts payable under an annuity contract (whether or not it has been annuitized) to a beneficiary after the death of the contract owner or annuitant are taxable to the beneficiary, when received, under the normal Code Section 72 rules.[2] Thus, payments under a variable annuity minimum living benefit would be treated in the same way as any other distribution, consistent with the form of the living benefit coverage.

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[1] See Treas. Reg. Section 1.72-2(a)(1).

[2] See Rev. Rul. 79-335, 1979-2 C.B. 292 (If the beneficiary of a variable annuity contract elects to receive the lump-sum payment under the contract, the excess of the amount received over the amount of the consideration paid for the contract is, as in the case of a fixed deferred annuity, includible in the gross income of the beneficiary.) Modified and superseded by Rev. Rul. 2005-30 2005-1 CB 1015

Contingent Annuities

The IRS has addressed the status of non-qualified contingent annuities in a series of private letter rulings[3] addressing issues related to both policyholder and insurance company tax.[4] In each instance, the IRS determined that the contingent annuities that were the subject of the rulings are annuities for tax purposes and not some other type of financial instrument, such as a derivative. Among the conclusions that the IRS has reached (which apply to the specific annuities reviewed here):

1. The contingent annuity is an annuity contract for purposes of section 72.
2. The fees charged for the contingent annuity is included in the insurer's taxable income under IRC section 803(a)(1).
3. The annual benefit provided under the contingent annuity (i.e., the periodic payments that commence once the linked investment account is exhausted) contract, and any traditional annuity payments provided, will be taxable as "amounts received as an annuity" using an "exclusion ratio" under section 72(b).
4. For purposes of sections 72(c)(1) and 72(e)(6) (defining "investment in the contract"), the "aggregate amount of premiums or other consideration paid" for a contingent annuity will equal the sum of all periodic charges paid for it plus any proceeds paid to the insurer upon liquidation of the investment account in consideration for annuity payments.
5. The contingent annuity's interaction with the linked account does not interfere with the otherwise applicable tax treatment of the assets in the investment account, e.g., the arrangement is not a straddle (which would defer the deduction of losses incurred in the account's investments) and dividends that the contingent annuity owner receives from the assets in the investment account will not fail to be treated as "qualified dividend income."
6. The annual benefit will not constitute insurance or other compensation for any prior deductible losses in the account for purposes of section 165.
7. The activities of the insurer in offering and issuing the contracts are within the scope of the "life insurance exception" of the "mark-to-market" rules of Internal Revenue Code section 475 as set forth in Regulations section 1.475(c)-1(d).[5]

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[3] Private letter rulings only apply to the taxpayer they are issued to, but are indicative of the current IRS thinking in the matter

[4] See PLRs 200949007 (July 30, 2009), 200949036 (July 30, 2009), 201001016 (Sept. 14, 2009), 201105004 (Nov. 2, 2010), 201105005 (Nov. 2, 2010), 201117012 (January 20, 2011), 201117013 (January 20, 2011), 201128017 (March 17, 2011), and 201129029 (March 17, 2011).

[5] **Issuance of life insurance products.** A life insurance company that is not otherwise a dealer in securities within the meaning of section 475(c)(1) does not become a dealer in securities solely because it regularly issues life insurance products to its customers in the ordinary course of a trade or business. For purposes of the preceding sentence, the term life insurance product means a contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract. See sections 72, 817, and 7702.

Treatment as an Annuity

As noted above, the rulings conclude that the contingent annuities reviewed will be treated as an annuity contract for purposes of section 72. This treatment is important to both issuer and purchaser. For the issuer, it clarifies a company's reserve deductions and tax reporting and withholding obligations with respect to the contingent annuities. For the purchaser, it means that the annuity payments will be eligible for "exclusion ratio" treatment under section 72(b). With respect to the conclusion that the contingent annuities will be annuity contracts, the rulings cite the Code as not providing a comprehensive definition of an annuity. As a result, the rulings focus on the various requirements applicable to annuities under the regulations set forth by the Treasury Department, as well as on descriptions of annuities in the legislative history of section 72, case law and several secondary sources.

The rulings state that the contingent annuities possess two of the key characteristics of annuity contracts described in the legislative history of section 72(e), in that each contingent annuity represents "a promise by the life insurance company to pay the beneficiary a given sum for a specified period" and is "used to provide long-term income security." When PLRs 200949007, 200949036 and 201001016 were under consideration, the company requesting the PLR provided the IRS an actuarial analysis showing that the contingent annuity contracts being reviewed were far more sensitive to the risk of the owner's longevity than to market risk affecting the value of the assets. The "predominant" risk insured against, the IRS therefore concluded, is the longevity risk, while the market risk protection is "incidental." [6] In PLR 200949007, the IRS pointed out that "[a]n actuarial analysis of the premise underlying the [contingent annuity contract that was the subject of the ruling] concludes that the arrangement is substantially more sensitive to the risk of longevity than in volatility of the securities markets, and that the predominant risk mitigated is longevity risk with incidental market risk protection." Based on this actuarial evidence and the manner in which the contracts operate, the IRS concluded that the fundamental insurance provided by contingent annuities is protection against longevity risk, just as with a traditional deferred lifetime annuity.

Casualty Loss Rules

As a general rule, the Internal Revenue Code generally allows individuals to claim a deduction for losses incurred in any transaction entered into for profit. Because contingent annuity owners will purchase, sell, or exchange assets in the underlying accounts with the goal of making a profit, they generally will be entitled to deduct losses they incur in connection with such activity. The owner could experience such investment losses if he or she sells or exchanges assets at a price that is lower than the owner's adjusted basis in the assets. The Code, however, also places certain restrictions on a taxpayer's ability to claim loss deductions. In particular, a loss is not

[6] Since the pertinent analytical sections in the various letter rulings are largely alike, quotations and citations are from the first letter ruling, PLR 200949007.

deductible if the taxpayer receives compensation for the loss through "insurance or otherwise." Thus, if the individual has a reasonable prospect of recovering the loss through a claim for reimbursement, he or she cannot deduct the loss until it can be ascertained with reasonable certainty whether or not the reimbursement will be received.[7]

The IRS considered the question of a contingent annuity as a form of casualty insurance in PLR 200949007, mentioned above. In this ruling, the IRS found that the relationship between any individual market loss in the designated fund and any eventual periodic payments under the contract is "too tenuous and too contingent on a number of factors for the payments to be considered compensation for any given market loss." Under a contingent annuity, systematic withdrawals of principal, not just market losses, contribute to depletion of the designated fund. If the contract owner lives long enough, he/she will eventually begin to receive the periodic payments from the insurance company whether or not any losses were sustained. Further, the amount of compensation the contract owner will receive "depends on how long he lives, and is not tied to the amount of the losses." Thus, the fact, amount, and timing of the periodic payments are contingent on a number of factors, including not only a particular market loss, but also other market losses, offsetting market gains, the owner's withdrawal rate, and – "most significantly – the owner's life span." The IRS thus concluded that the periodic payment feature of the contract "is not structured to replace or reimburse either individual or overall market losses" in the designated fund. Because there is no reimbursement for losses realized on designated fund assets, the owner may currently deduct them since they are not losses compensated for by insurance or otherwise under Section 165(a). The IRS has concluded that contingent annuities are not the equivalent of casualty insurance such as financial guaranty insurance.

Qualified Retirement Plans and IRAs

Like deferred annuities, qualified retirement plans and individual retirement accounts are accorded tax deferral and other favorable tax treatment, to support the national interest in retirement security. There is increasing interest on the part of employers and employees in including contingent annuities in these plans. This interest reflects, among other things, the widespread substitution in recent years of defined contribution plans for defined benefit plans and the resultant loss of guaranteed pension incomes, the pending retirement of the baby boomer generation, and ongoing improvements in longevity. Contingent annuities fit well into the typical structure of tax-qualified retirement savings plans, and provide cost-effective protection against longevity and other risks to retirement income security.

The U.S. Department of the Treasury and the Labor Department continue to give active consideration to promoting lifetime income products in retirement plans. The limited guidance

[7] Internal Revenue Code Section 165

issued to date (there are no rulings yet directly on contingent annuities) treats guarantees similar to contingent annuities as annuities for purposes of the tax qualification rules.[8]

Financial Guaranty Insurance

Typically, financial guaranty insurance provides a guarantee of a bond issuer's obligation to pay principal and interest on the insured bonds when due. The policies provide that in the event of a bond issuer's default, the insurer will pay principal and interest to the bondholders as originally scheduled for the issue's remaining life or until the issuer can resume the payments on its own. Financial guaranty insurance used in this manner enhances the credit quality of an offering so that issuers receive a higher credit rating than otherwise, resulting in interest cost savings. Under a typical financial guaranty insurance contract, a single premium is paid at the time the contract is issued, based on the assumption that the insurance will remain in force until maturity of the insured bond.

The tax treatment with respect to bondholders is the same as it would be under the original bond, since they are receiving the payments due, except they are being paid to the issuer by the insurer. Unless there is a default in the payment of the bond, this has no effect on a bondholder, as losses can be deducted under Code Section 165 only if “not compensated for by insurance or otherwise.” Insofar as contingent annuities are more sensitive to longevity risk than to securities-based losses, they are distinguishable from financial guaranty insurance from a tax standpoint.

Conclusion

It is apparent to the CAWG, from the private letter rulings issued by the IRS that, from a federal income tax standpoint, contingent annuities are viewed as annuities subject to the Code’s rules governing such instruments.

[8] See PLRs 200951039 (Sept. 21, 2009) and 201048044 (Sept. 9, 2010).

Appendix D

Federal Securities Law Treatment of Variable Annuity Living Benefits and Contingent Annuities

This Appendix describes the federal securities law treatment of lifetime income benefits made available by life insurers through optional benefit riders on variable annuity contracts or through contingent annuities. Within the Appendix we have included supplemental information to provide additional perspective on the policy debate surrounding contingent annuities. The information provided is based on our understanding of the actions generally taken by life insurance companies selling either variable or contingent annuities, as well as a general knowledge of relevant securities laws, particularly related to variable contracts. While we have made every effort to state only the facts related to federal securities law for the purposes of this report, the application of securities laws falls outside the general expertise and practice of actuaries, and therefore no reliance on this Appendix should be considered as implied to any specific situation related to federal securities law treatment.

Generally speaking, the federal securities laws applicable to insurance products are the Securities Act of 1933 (the "1933 Act"), the Securities Exchange Act of 1934 (the "1934 Act"), and the Investment Company Act of 1940 (the "1940 Act"). The 1933 Act requires registration of securities with the U.S. Securities and Exchange Commission (SEC) prior to their offering, and prescribes the form and content of disclosure about the securities that must be made to potential investors. The 1934 Act generally regulates the manner of distribution and solicitation of investors for securities, and the 1940 Act applies substantive requirements to the operation of funding vehicles classified by the 1940 Act as "investment companies."

<u>Variable Annuities with Living Benefits</u>

Variable annuities are subject to regulation under the federal securities laws. The primary federal securities laws that regulate variable annuities and the separate accounts through which they are issued are the 1933 Act, the 1934 Act, and the 1940 Act. To the extent that a variable annuity provides a living benefit, or a series of optional living benefits, those benefits are regulated as a part of the underlying variable annuity.

Because variable annuities are securities, variable annuities must be registered with the SEC under the 1933 Act before they can be offered for sale to the public. However, there are two specific exceptions to this particular rule:

1. Under the "pension exemption," if a variable annuity is offered only in connection with plans qualifying under Section 401(a) of the Internal Revenue Code ("the Code"), and/or

in connection with trusteed governmental plans qualifying under section 457 of the Code, then the contract is exempted from the registration requirements of the 1933 Act; and,

2. Private placement annuities, not sold in connection with a public offering are exempt.

However, contracts that are offered to retail investors, or in connection with IRAs or annuity plans under section 403(b) of the Code, generally must be registered under the 1933 Act. Even with these exceptions, however, issuers and others involved in marketing non-registered variable annuities, remain subject to the anti-fraud provisions of the 1933 Act.

With respect to the above noted application of the 1933 Act to variable annuities offered to retail investors, another requirement is that purchasers of registered variable annuities receive a prospectus. Since living benefits are integrated with the underlying variable annuity, the disclosure for various forms of benefits is integrated throughout the variable annuity prospectus under which the benefits are to be provided.

The 1934 Act generally requires variable annuities to be distributed through registered broker-dealer firms and their registered representatives. Agents selling variable annuity contracts must be licensed and supervised by a broker-dealer that is registered with the SEC and is a member of the Financial Industry Regulatory Authority (FINRA), in addition to being licensed as insurance agents under states' insurance laws. Advice to retail customers on the purchase of variable annuity products is also subject to FINRA's suitability requirement for variable annuities. Under the 1934 Act rules, broker-dealers are required to send confirmation statements to contract owners after financial transactions are made that involve a variable annuity contract.

The 1940 Act places an extensive federal regulatory structure on investment companies, including separate accounts and underlying funds. However, some separate accounts and funds such as those used in connection with tax-qualified retirement plans, are not subject to the 1940 Act. The 1940 Act governs how variable annuities and shares of underlying funds are issued and redeemed. The SEC does not regulate individual variable annuity fees and charges, however, the 1940 Act makes it unlawful for any registered separate account funding variable annuity contracts, or for the sponsoring insurance company, to sell any such contract unless the fees and charges deducted under the contract are, in the aggregate, reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company. In this regard, the insurer must represent in the annuity contract's registration statement that the fees and charges are reasonable.

<u>Contingent Annuities</u>

Contingent annuities provide a guaranteed lifetime income payment stream similar to that of variable annuity GLWBs; however the contingent annuity guarantee is related to the value of mutual funds or other assets held by contract owners outside of the insurance company's separate accounts. The contingent annuity lifetime income guarantee is typically structured as a group fixed deferred annuity contract between the life insurer and the asset management firm, with group participant certificates issued to individuals who purchase the contingent annuity. To the extent that a contingent annuity is issued as a fixed annuity, it is arguable that no SEC registration of the contract is required, in that an “insurance or endowment or annuity policy” is exempt from registration pursuant to Section 3(a)(8) of the 1933 Act. However, since Section 2(a)(1) of the 1933 Act defines “security” to include investment contracts and guarantees of securities, life insurers have generally taken the more conservative approach and chosen to register the contingent annuities on either Form S-1 or S-3.

To the extent that the product is offered in connection with certain qualified retirement plans, a contingent annuity would be exempt from registration under the 1933 Act. For example, if a contingent annuity is offered only in connection with plans qualifying under Section 401(a) of the Internal Revenue Code, and/or in connection with trusteed governmental plans qualifying under section 457 of the Code, then the contract can generally rely on the so-called “pension exemption” from the registration requirements of the 1933 Act.

Currently, a number of life insurers have registered contingent annuity products with the SEC, The SEC registration process for contingent annuities has generally been applied to modified guaranteed annuities or other fixed annuities registered as securities with the SEC. We understand that, the contracts typically have been registered on the same SEC registration forms as are used for modified guaranteed annuity contracts (i.e., Forms S-1 and S-3 referenced above; variable annuities use a different registration form). The producer licensing and other applicable FINRA requirements that apply to registered contingent annuities have been the same requirements that apply to registered modified guaranteed annuity contracts. Therefore, as with modified guaranteed annuity contracts, sales of contingent annuity contracts must comply with FINRA’s just and equitable principles of trade, FINRA’s rules of fair dealing with customers, and FINRA suitability rule 2111.

The offering of registered contingent annuities typically has included the delivery of an SEC prospectus at the point of sale or other time when prospectus delivery is generally required by the 1933 Act. As with other SEC registered insurance products, the offering of contingent annuities typically has been classified as a “continuous offering,” thus the prospectus must be kept current through an annual updating process, and that updated prospectus must be delivered to existing contract owners. A prospectus contains extensive disclosures around the risks, fees, and benefits of the product, as well as detailed information around the interrelation of the annuity contract and the investment account. This ensures that consumers are informed of all aspects of the product. Unlike variable annuities, contingent annuity contracts have not been subject to the 1940 Act, the federal statute governing mutual funds, separate accounts, and other types of investment companies.

Appendix E

Contingent Annuity Nonforfeiture Considerations

Contingent annuities have characteristics similar to single premium immediate annuities (SPIAs), but also have some features generally found in deferred annuities. Contingent annuities were not anticipated when the Standard Nonforfeiture Law for Individual Deferred Annuities (SNFLIDA) was enacted in 1976; consequently, they are not effectively addressed by SNFLIDA, either by inclusion or exemption. The background of SNFLIDA, the application of SNFLIDA to contingent annuities, and a possible direction for interpreting the law to address contingent annuities are described below, with the conclusion that contingent annuities should be treated similarly to SPIAs, namely, exempted from SNFLIDA.

Contingent Annuities and SNFLIDA

SNFLIDA applies to deferred annuities; SPIAs are exempted. SPIAs are generally defined as annuities that commence payout within thirteen months. Contingent annuities have some characteristics of SPIAs and some elements of deferred annuities. Contingent annuities provide a guaranteed income, similar to SPIAs, but might not begin payout until years after issue, which is a characteristic that is more similar to deferred annuities. The failure to fit cleanly within either category suggests to us that the intent and functionality of SNFLIDA should be considered as part of this analysis.

Similarity of Contingent Annuities to SPIAs

SPIAs are based upon payment of a premium and a consequent guarantee of a periodic income benefit. Because the contract is already paid up there is no need for a paid-up nonforfeiture benefit. Consequently, SPIAs are exempted from the SNFLIDA. Contingent annuities similarly consist solely of payment of a premium and guarantee of a periodic income benefit. Although the guaranteed income benefit, and therefore the exact payment that comes from the contingent annuity, is not known quantitatively at issue, the guaranteed benefit cannot be changed by the insurer and is determined by terms in the contract. These similarities suggest contingent annuities merit treatment similar to that of SPIAs, which would exempt them from nonforfeiture requirements.

Dissimilarity of Contingent Annuities to Deferred Annuities

Deferred annuities are based upon payment of a premium and subsequent payment of income benefits that are determined by the accumulation of the premium. Income benefits under a contingent annuity are not based on the accumulated value of premiums, but rather are based on contractual guarantees of periodic income in the contract and the performance of an external fund; consequently, there is considerable difference between a contingent annuity and a deferred annuity. This suggests that the deferred annuity approach is not the best model for contingent annuity nonforfeiture.

If contingent annuities were subject to the SNFLIDA, they could be exempt from the requirement of cash surrender benefits, as allowed by the provisions of SNFLIDA. The only issue would be whether they would be required to provide a paid-up income benefit that is based on accumulated premiums. The premiums for a contingent annuity are not creating an accumulation that determines income benefits; consequently, the paid-up annuity concept within SNFLIDA does not fit Contingent Annuities. The premiums paid for a contingent annuity are in the nature of risk charges for an uncertain longevity contingency. Although the wording of SNFLIDA might indicate a paid-up benefit is required, such a requirement would not be consistent with the spirit of SNFLIDA.

Interpretation of SNFLIDA

Based on the preceding analysis, the CAWG has concluded that contingent annuities should be exempted from the provisions of the SNFLIDA. This would recognize that although SPIAs were identified as the only type of guaranteed payout annuities in the context of SNFLIDA, they actually were an indicator of how all guaranteed payout annuities should be addressed. Now that products have evolved that commence guaranteed income payments later than the thirteen months (the common statutory definition of a SPIA), it is logical to broaden SPIA exemption treatment under SNFLIDA to an exemption for all guaranteed income annuities. It should further be noted that the guaranteed income payments under a Contingent Annuity are similar to the life contingent portion of payments under a SPIA with certain and life payments; consequently, a Contingent Annuity is effectively a sub-category of a SPIA.

In the short term, this treatment could be achieved through an actuarial guideline. Ultimately, the appropriate nonforfeiture requirements for contingent annuities should be recognized in changes that LATF is looking at for the nonforfeiture law.

Consistency with Guaranteed Lifetime Withdrawal Benefits on Variable Annuities

Although contingent annuities are generally structured as fixed annuity products, the guaranteed income benefits under a contingent annuity are essentially the same as those under guaranteed lifetime withdrawal benefits (GLWB) on variable annuities, except that the guarantee applies to an external account. The results of the suggested approach for contingent annuities are consistent with the current treatment of GLWB on variable annuities, namely, that there is no cash surrender value and no paid-up value.