AMERICAN ACADEMY *of* ACTUARIES

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September 12, 2014

Ted Nickel
Chair, Contingent Deferred Annuity (A) Working Group
National Association of Insurance Commissioners

Dear Commissioner Nickel:

The American Academy of Actuaries[1] Contingent Annuity Work Group (CAWG) understands that the Contingent Deferred Annuity (A) Working Group has exposed for comment the *Guidelines for The Financial Solvency and Market Conduct Regulation of Insurers Who Offer Contingent Deferred Annuities*. In response, the CAWG has prepared comments and suggested edits, as shown on the following pages.

We thank the Working Group for considering our comments. If you have questions, please contact Brian Widuch, Life Analyst at the American Academy of Actuaries (widuch@actuary.org; 202-223-8196).

Sincerely,

Andy Ferris, MAAA, FSA
Chairperson
Contingent Annuity Work Group
American Academy of Actuaries

Cande Olsen, MAAA, FSA
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[1] The American Academy of Actuaries is an 18,000-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.

DRAFT

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

Executive Summary

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

The CDA working group developed these guidelines to serve as a reference for states interested in modifying their annuity laws to clarify their applicability to CDAs. These guidelines set forth what consumer protection and financial solvency model laws and regulations should be applied to CDAs and what model laws and regulations that would not apply to CDAs. The guidelines outline what revisions, additions, and regulatory interpretations may be necessary for a state to clarify how existing state laws governing annuities apply to these products. These guidelines also includes a checklist and regulatory guidance developed by the Life Risk-Based Capital (E) Working Group for states to use in evaluating the capital requirements and risk management capabilities of insurers seeking to offer CDAs in their state. These guidelines are intended to provide a general framework for the regulation of CDAs while work on specific issues involving CDAs continues at the NAIC.

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

I. Background

A. Classification of CDAs

CDAs are hybrid products which on their face appear to have elements of both annuities and financial guarantee products. The CDA subgroup reviewed CDAs to determine how the product should be classified. In March 2012, the A Committee adopted the recommendations of the CDA subgroup that CDAs were a hybrid life product best written by life insurers.

B. Definition of CDAs

During the course of its review, the working group determined that CDAs did not neatly fit into the categories of fixed or variable annuities. In this regard, while a CDA in its accumulation phase resembles a variable annuity, a CDA more resembles a fixed annuity in its payout phase. The working group determined that a distinct definition of CDAs was needed for regulators, the industry, and consumers. The

NAIC has adopted a definition of CDA's as "an annuity contract that establishes a life insurer's obligation to make periodic payments for the annuitant's lifetime at the time designated investments, which are not owned or held by the insurer, are depleted to a contractually-defined amount due to contractually-permitted withdrawals, market performance, fees and/or other charges." Regulators may wish to include this definition in their statutes and regulations and use it in determining whether an annuity product would be considered a CDA.

C. Features of a CDA

CDAs are hybrid products which transfer both investment risk and longevity risk to the insurers who issue them. A CDA can be generally thought of as a living benefit added to an underlying retirement account. The underlying account is not held or managed by the insurer but is instead held by a related or unrelated third party entity. While the insurer may contractually restrict the type of investment assets and products related to a CDA, it does not control the investments in the underlying account. An example of this would be a CDA attached to a mutual fund held in an individual or employer-sponsored retirement account. The CDA issuer can contractually limit the CDA's attachment to certain types of mutual funds, but would have no control over the assets that make up that mutual fund.

A CDA has three distinct phases during its lifespan. First, the CDA goes through an accumulation phase. This phase occurs from the time the CDA is purchased until the time the participant decides to take withdrawals from the separately managed account. The amount of the CDA benefit base may be~~is~~ determined in various ways, such as:

a) maximum value of accumulated deposits
b) deposits "rolled up" at a specified percentage, including possibility of accumulation at 0%
c) the greater of (a) and (b)
d) the value of the assets in the underlying account if greater than the calculated benefit base

~~As those assets increase in value (for example through investment gains or additional deposits), the CDA benefit base amount increases.~~ Depending on the product design, the benefit base ~~is~~ may be calculated on a daily, monthly or annual basis. ~~The more frequently the benefit base calculation is made, the more likely a consumer will realize investment gains in the benefit base.~~

Once a benefit ~~base~~ amount has been set, the CDA guarantees that the benefit amount can never decrease due to investment losses. In other words, should the underlying assets decrease in value due to poor market performance, the CDA's benefit amount does not decline. This allows the insured to mitigate the risk that retirement payouts will decrease due to market conditions. The insurer assumes some of the market risk of the underlying asset by guaranteeing payments based on the underlying assets' peak level or a "rolled up" amount, which may be greater than the actual ~~amount of funds~~value of the covered assets held at withdrawal, the second phase of a CDA.

The withdrawal phase occurs when the participant begins to draw funds from the separately managed account, most typically upon retirement. During the withdrawal phase no benefit payments are made under the CDA and the insured is receiving income solely from the funds in their underlying account. The CDA contract sets a maximum periodic withdrawal amount that a participant may take. The withdrawal amount under current product designs is often a set percentage of the benefit base; for example five percent of the benefit base per year. Withdrawals at or below those permitted by the contract do not affect the benefit base level established during the accumulation phase. However, should a participant withdraw funds above the contractually permitted amount, the amount of benefits available under the CDA decreases, potentially all the way to zero. During the withdrawal phase, an insured still maintains the investments in an underlying set of ~~fund~~covered assets. Thus, the amount of funds available to the insured may also decrease during the withdrawal phase due to market conditions. However, like in the accumulation phase, decreases in ~~funds~~ covered assets due to market changes do not reduce benefits. It is likely that most insurers will address this issue by limiting the type of assets an insured may hold in the underlying account during the accumulation and withdrawal phases to those with low volatility.

The third and final phase is the payout ~~or settlement~~ phase. Upon exhaustion of the underlying account, the CDA begins making periodic benefit payments under a payout structure which often lasts until the insured's death, but could alternatively be based upon a 'life with period certain' structure. The amount of those payments is ~~a percentage of the benefit base amount set during the accumulation phase less any penalties or reductions for withdrawals above the contractual limits during the withdrawal phase. If there are no penalties or reductions imposed, the periodic benefit payment is~~ equal to the contractually permitted withdrawal amount ~~during~~ at the end of the withdrawal phase. In this way, the CDA offers guaranteed~~s~~ ~~level~~ lifetime income payments during retirement. Those payments may be level or increasing, based on product design. It is the working group's understanding that CDA products sold to date do not include a death benefit~~; however, guaranteed lifetime withdrawal benefits, which are similar to CDAs, on some variable annuity and indexed annuity products do have such benefits~~. Since an insured is limited in the amount of periodic withdrawals he or she may take during the withdrawal phase, whether or not a CDA will reach the payout or settlement phase is a function of the performance of the underlying investment assets and the insured's longevity[1].

For the CDA products that the working group reviewed, the fee for the CDA policy was calculated as a percentage of the underlying assets or benefit base. Generally, the fee is not paid directly from the insured but instead deducted and paid by the administrator of the underlying ~~fund~~covered asset.

D. Federal Regulation of CDAs

There is a question as to whether CDAs are required to be registered as securities with the Securities and Exchange Commission ("SEC"). The SEC has not taken a position regarding whether CDAs are required to be registered as securities. However, based on information the SEC shared with the working group, it is the working group's understanding that a product that is a derivative of a registered security is also considered a security requiring registration. Since a CDA's value derives from the value of an underlying registered security, it would appear that CDAs need to be registered with the SEC. It is the working group's understanding, based on its discussions with the life industry, that insurers have been registering CDA products with the SEC to date. Companies should continue to discuss registration requirements for CDA products with the SEC.

Products registered with the SEC may only be sold through a FINRA licensed broker dealer or a registered investment advisor[2]. Sales of CDAs by broker dealers are subject to FINRA's general suitability requirements. Investment advisors[3]~~advisors~~ owe a fiduciary duty to their clients in recommending any investment product and a CDA purchase would be required to be made through a broker dealer. Registered CDAs are subject to SEC disclosure requirements, including a prospectus, and FINRA's advertising and marketing rules.

[1] For some CDA products an insured may elect to purchase spousal benefits so in these instances the CDA would be subject to the longevity of both spouses.

[2] ~~Investment advisors who manage less than $100 million in assets must register in the state of their principal place of business and investment advisors managing assets of $100 million or greater must register with the SEC.~~

[3] Investment advisors who manage less than $100 million in assets must register in the state of their principal place of business and investment advisors managing assets of $100 million or greater must register with the SEC.

II. Financial Regulation of CDAs

A. Risk Management

The design of CDAs and their attachment to ~~funds~~ covered assets outside of the insurer's control create unique risks that necessitate strong and comprehensive risk management practices by insurers. These risks included longevity risk, market risk, policyholder behavior risk, and third party risk.

Longevity risk is one of the main risks that CDAs transfer from the insured to the insurer. This is the risk that policyholders will live longer than expected and trigger the CDA lifetime income benefit by depleting the ~~funds~~ covered assets in their retirement account. This risk can be managed by the insurer through product design, risk pooling, and risk management techniques that are similar to those used in other life products with longevity risk. Regulators reviewing an insurer's handling of longevity risk should look to the company's actuarial opinions to ensure that insurers are properly reserving for longevity risk.

Another risk that is transferred to the insurer from the insured is market risk. The market risk associated with a CDA is that the amount of benefit to the insured varies ~~according~~ inversely to the market performance of the underlying assets. For example, a large downturn in the stock market c~~w~~ould ~~lower~~ reduce the value of the ~~funds~~ covered assets underlying the CDA while the benefit remains locked in at a higher value, thus increasing the likelihood that a CDA will reach the payout phase. Insurers can manage the market risk by developing comprehensive hedging strategies; that is, investing in an offsetting position in related assets to those in which the insurer incurs the market risk, i.e., derivatives ~~etc~~. Of course, hedging cannot offset all market risks and is only a method for mitigating losses and will vary depending upon hedge effectiveness. Regulators may wish to review an insurer's hedging strategy to verify that it is comprehensive, it appropriately addresses the insurer's market risks, and that an insurer is making reasonable assumptions regarding the effectiveness of the hedging strategy. An insurer must have a "Clearly Defined Hedging Strategy" to take credit for hedging in reserving (pursuant to Actuarial Guideline 43 ("AG 43")) and risk based capital calculations (pursuant to C-3Phase 2 ("C3P2"))[4].

CDA issuers also incur risks based on policyholder behavior, including lapse rates, withdrawal timing and amounts, and investment decisions. In this regard, the value of the CDA to an insured and, correspondingly, the level of risk to the insurer are in many ways governed by policyholder behavior. For example, because CDAs take away some of the down-side market risks of the insured's investments, a CDA may encourage an insured to invest in riskier investments. An insured ~~can~~ may wish to place his or her assets in more volatile investments because if the investments increase in value, the increase is added to the CDAs benefit base, if the investments decrease in value, the benefit base ~~is~~ may be locked in at the portfolio's peak. Thus, from the insured's risk perspective, investment increases mean a higher benefit base and investment losses mean the CDA reaches the payout phase sooner.

Similarly, whether the payout phase will be reached also will depend in part on policyholder behavior. To maximize benefits under the CDA, a reasonable insured should take the maximum allowable withdrawal amount every period of the withdrawal phase in order to draw down the underlying ~~funds~~ covered assets and trigger the ~~settlement~~ payout phase of the CDA. To maximize benefits, the insured would take the allowable withdrawal limit absent a liquidity need.

Insurers can manage policyholder behavioral risk through product design including limiting the investment assets that an insured may hold in the underlying portfolio, ~~limiting withdrawals amounts during the withdrawal~~reducing benefits for withdrawals during the accumulation phase, varying fees in accordance

[4] Please note that the Life Actuarial (A) Task Force is reviewing AG 43 and the Life Risk-Based Capital (E) Working Group is reviewing C3P2 as to how they would apply to CDAs.

with the risk level of the underlying investments, and decreasing benefits for withdrawals above those allowed under the policy. Regulators should review CDA products with a balanced view~~;~~, ensuring that CDAs are designed to manage policyholder behavior risks while not being overly restrictive in how insured~~'~~s may use and gain value from a CDA.

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

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

B. Financial Checklist
   [In Development]
C. Reserve Requirements
   [In Development]
D. Capital Requirements
   [In Development]

III. Non-Financial Regulation of CDAs

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

A. Filing Requirements

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

B. Application of NAIC Model Laws and Regulations

Because CDAs do not fit neatly within existing categories, the working group reviewed which non-financial model acts and regulations should apply, or not apply, to CDAs. The working group's findings and how states may wish to amend their laws to apply to CDAs are outlined below.

Producer Licensing Model Act (#218)

The Producer Licensing Model Act governs the qualification requirements and procedures for licensing insurance producers. Because some current CDAs are registered as securities, the working group reached a preliminary conclusion that the requirements for selling variable annuities should be applied to CDAs but determined that further review was warranted. As such, the working group recommended that this model be reviewed to determine if the license required to sell variable annuities would be appropriate for the sale of CDAs or whether revisions were necessary to apply the model act for the sale of CDAs. The A committee has tasked the Producer Licensing (EX) Task Force with reviewing this model with regard to CDAs. ~~Because~~ For CDAs that are registered as securities, regulators should verify that producers have the requisite licenses and registration required to sell securities.

Annuity Disclosure Model Regulation (#245)

The Annuity Disclosure Model Regulations requires insurers who sell annuities to provide a disclosure document and a buyer's guide in connection with the sale of an annuity. The model applies broadly to all annuity contracts but exempts specific types of annuities including those registered with the SEC and those covered by ERISA. See Sections 2B.(1)(a),(b), 3D.(1). ~~Since~~ When CDAs are being registered with the SEC, the federal prospectus and other disclosure requirements may preempt state disclosure requirements. The working group recommended that CDAs continue to be registered as securities and, as such, the working group found that the exemption in the annuity disclosure model regulation for registered products would apply to CDAs.

Comment [A1]: We suggest brief discussion of applicability of state disclosure requirements for CDAs that are not registered and therefore do not qualify for such exemption.

The Model Regulation does provide that the NAIC buyer's guide is required to be provided in the sales of variable annuities "and when appropriate, in sales of other registered products." Currently, the NAIC does not have a buyer's guide which addresses CDAs and providing the current buyer's guide for fixed and variable annuities, which is inapplicable, for CDAs may confuse consumers. Therefore, the working group concluded that the requirement to provide a buyer's guide would not be appropriate for CDAs.

States should review their annuity disclosure regulations to determine if they need to revise the regulation to make clear the disclosure requirements do not apply to CDAs. The NAIC is currently considering changes to the model regulation that would clarify that the exemption for registered products would include CDAs. Alternatively, the model's exemptions for registered products and products covered by ERISA plans may be broad enough for states to interpret existing law to exclude CDAs without revision to existing regulations. States may wish to consider issuing guidance to insurers that the regulation does not apply if revisions to the regulations regarding CDAs are not contemplated.

Suitability in Annuity Transactions Model Regulations (Model # 275)

The working group determined that the Suitability in Annuity Transactions Model Regulations should apply to CDAs and that suitability review for the sale of CDAs is an important consumer protection for these products. The working group concluded that the existing list of "suitability information" included in Section I of the Act contains all the information that is needed to examine the suitability of a CDA sale and that additional factors do not need to be added to specifically address CDAs. It should be noted that among the suitability information to be considered is the existing assets of the consumer "including investment and life insurance holdings." The working group determined that, as a part of suitability review, it was important that the insured's underlying assets be suitable for the addition of a CDA. ~~For example, the addition of a CDA to a certificate of deposit may be unsuitable because the fees for the CDA might absorb an unreasonable amount of the certificate of deposits rate of return undermining the insured's investment goals.~~ The working group concluded that the category for existing investment assets would encompass suitability review of the ~~investment funds~~covered assets underlying the CDA.

Comment [A2]: We have recommended removal of this sentence, as the product may be suitable in interest rate environments higher than today's. Alternatively, the sentence could remain with a qualifying phrase such as "in the current low interest rate environment,"

It should also be noted that section H.1 of the suitability model act has a "safe harbor" provision that provides that sales made in compliance with FINRA requirements "pertaining to suitability and supervision of annuity transactions" satisfy the requirements of the model act. The working group has recommended that this section of the model be revised to include CDAs in the safe harbor provision because if FINRA's variable annuity suitability rules are applied to CDAs or CDA specific suitability rules are developed by FINRA in the future, that suitability review would be considered to be in compliance with the model act.

That being said, FINRA indicated to the working group that it will not apply the suitability rule for variable annuities to CDAs. Because FINRA is not currently applying specific annuity suitability rules to the sale of CDAs, the working group believes CDAs fall outside the "safe harbor' provision and sales of CDAs would be governed by the suitability requirements of the model act. This interpretation will avoid any regulatory gaps between state and federal law. The safe harbor provision may be applicable in the future if FINRA applies specific annuity suitability rules to CDAs.

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

The working group reviewed the issue of guaranty fund coverage but did not determine whether CDAs are covered under state guaranty funds. The National Organization of Life & Health Guaranty Associations ("NOLHGA") testified before the working group that their review of CDAs was not complete but stated that it appeared that CDAs were eligible for coverage under the Model Act subject to a number of caveats and possible limitations. The working group also notes NOLHGA's statement that individual guaranty fund coverage is ultimately a state by state determination.

The working group found that the issue of guaranty association coverage would likely vary from state to state. On one hand, a CDA is sold by life companies and would seem to be covered under guaranty funds like other life products. On the other hand, some guaranty funds exclude coverage for products that involve the transfer of investment risks or guarantees of employer retirement plans. CDAs would arguably fit into these categories. Each state should review its guaranty fund coverage laws to determine whether CDAs are covered by those funds.

The A committee has tasked the Receivership and Insolvency (E) Task Force with determining whether revisions to the model act are needed and warranted to address CDAs.

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

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

Life Insurance and Annuities Replacement Model Regulation (#613)

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

Synthetic Guaranteed Investment Contracts Model Regulation (#695)

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

Standard Nonforfeiture Law for Individual Deferred Annuities (#805)

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