

Comments of the Center for Economic Justice
Contingent Deferred Annuity Working Group
Draft Recommendations and Report

March 7, 2013

CEJ thanks the working group for the more detailed recommendations and for the report which together provide the working group's thinking and rationale for its recommendations. CEJ asked the working group last November for these documents to better enable us to engage with the working group and thanks the working group for doing so.

Background – Consumer Need for Lifetime Income Products

Historically, consumers created lifetime income security by working. With defined benefit plans provided by employers, a consumer working the majority of his or her life built retirement security through a pension plan. Over the past thirty years, this has changed as employers have eliminated defined benefit plans and replaced them with defined contribution plans with the result that, instead of working the majority of your life to ensure a retirement, individuals must now work the majority of their lives and become investment experts to protect their retirement. A host of companies, including life insurers, have come up with a variety of products to help consumers meet their new lifetime income needs, while harvesting massive fees from consumers in the process.

Life insurers have provided some essential products to help consumers with lifetime income needs, including certain life insurance products and traditional annuities. Pooling exposures to insure the mortality risk of many consumers, however has not been sufficient for life insurers. Life insurers want to compete with other firms providing investments to consumers and now offer a variety of products which primarily guarantee against investment losses instead of mortality risk.

The apex of this trend, which had previously peaked with variable annuities (VA) with guaranteed returns and guaranteed lifetime withdrawal benefits (GLWB), is the CDA derivative of the VA with GLWB.

CDAs appear to be a very poor value for consumers

From what we have been able to learn, CDAs appear to be a very poor value for consumers. The expected benefits for a portfolio of consumers purchased this product appears to be a very small percentage of the fees paid and an even smaller percentage of the fees paid plus foregone investment opportunities on those fees paid. It is doubtful that these products could meet a regulatory standard that benefits provided be reasonable in relation to fees charged. It is

reasonable and necessary for regulators to evaluate the expected benefit ratio of CDAs and provide, or require such information be provided, to consumers to better empower consumers to make informed choices.

While we agree that consumers need lifetime income insurance products, we disagree with the proponents of the CDA that CDAs are needed to address these consumer needs. In our view, this product is not necessary to assist consumers with lifetime income needs since other, better value products are available. In our view, CDAs are more likely to create hardships for consumers down the road to than they are to benefit consumers. What is certain is that CDAs will be immensely profitable for insurers for several years until any benefit payments begin.

If CDAs are sold, it is essential for regulators to get regulation right first time

The problems with CDAs will only appear decades down the road and only in a period of financial or economic crisis that limits regulators' ability to address the problems. Consequently, it is essential that, if regulators are going to greenlight this risky product, regulators establish the necessary regulatory structure to ensure fair sales, fair products, solvent insurers and consumer protections. The various regulatory actions cited in the proposal and report – and additional actions we discuss below – must be in place before these products are approved by state insurance regulators. Consumers simply cannot afford another regulatory debacle like long term care insurance in which products were allowed into the market without the necessary regulatory and consumer safeguards.

The recommendations highlight a number of issues, but for most of those issues, the working group recommends that some other group look at the issue and take the necessary action. We applaud the working group for identifying most of the relevant issues and for indicating that additional expertise is needed to address those issues. However, given the extensive number of outstanding regulatory issues and questions, it seems obvious to us that the working group should be recommending a moratorium on approval of CDAs by state insurance regulators unless and until these many regulatory issues are addressed.

We strongly disagree with the IRI and ACLI position that the NAIC should forego formal review of many of the issues raised by the working group because it would result in “thousands of consumers not having access to these very beneficial and needed products.” While it is clear that CDAs are not needed for consumers to have access to lifetime income protection products, it is unclear that these product are beneficial to consumers. Given that CDAs are very long-term investments by consumers and that problems will likely not show up for decades – at which point consumers will have lost their opportunity for alternative investments – it is imperative for regulators to establish that these products can, in fact, be beneficial for consumers and establish the regulatory safeguards to ensure that the products actually are beneficial to consumers.

In addition, we suggest several other issues for the working group or other NAIC committees, task forces or working groups to examine:

1. **Guaranty Fund Coverage**

The working group draft states:

The working group has not analyzed whether CDAs are covered under the GA Model Act and does not believe it is the appropriate venue for such a review. The working group will recommend that the A committee direct the appropriate NAIC Committee, Task Force or Working Group to review the definition of CDAs and the other findings of this working group and determine whether amendments to the GA Model Act are needed and prudent.

Putting aside the issue of whether CDAs are currently legally covered by state guaranty funds, it is important to ask, what would guaranty fund coverage of a CDA look like? The bulk of the CDA fees paid by consumers goes to hedging expense with another large portion of the fee going to administrative costs to track investments on a daily basis. Other portions of the CDA fees go for profit and reserves. There are very limited assets backing up the guarantee because the bulk of the fees go out the door as hedging expense. Does a guarantee of CDA benefits make any sense within the current guaranty fund structure? If the CDA insurer has failed because it has closed blocks of CDA business with no fees coming in and all CDA holders are in payout phase, what kind of burden does this place on other insurers and taxpayers for guaranty fund assessments?

To illustrate this point, consider an insurer selling annuities with GLWB becoming insolvent. The assets of the insurer transferred to the guaranty fund will include the annuity assets plus the fees for the GLWB rider. If an insurer selling only or predominantly CDAs becomes insolvent, the assets transferred to the guaranty fund will be limited to the small mortality reserves and collected fees. We suggest that the guaranty fund scenario is qualitatively different for traditional annuities – or other insurance products – than for CDAs. This issue – whether the current guaranty fund structure is likely to provide any substantive protection for consumers and the implications of required assessments on insurers and taxpayers in the event of a CDA-insurer insolvency – should be examined and discussed before the product is approved for sale.

2. Systemic Risk

The recommendations and paper focus the financial and solvency regulatory issues on the insurer selling the product, which is consistent with the state solvency regulatory framework. However, the recent financial crisis has made clear that bad or poorly designed financial products not only threaten consumers purchasing the products and companies selling the products, but these bad products threaten the financial system and consumers and businesses not purchasing or selling the products. As we have stated to the working group in prior meetings, CEJ believes that widespread sales of CDAs create systemic risk. Consequently, we **applaud and strongly support** the following recommendation for an NAIC level review of actuarial assumptions, hedge effectiveness, adequacy of enterprise risk management as part of capital and reserving requirements.

However, the working group notes that AG43 and C3P2 are Principles Based guidelines that are subject to credits for a “clearly defined hedging strategy” and therefore evaluation of the capital and reserving requirements for CDAs should be ongoing at the NAIC level, and states will need to monitor the actuarial assumptions, hedge effectiveness, and the adequacy of enterprise risk management used by insurers issuing CDAs.

This is particularly important because an individual company’s hedging practices can interact with other company’s hedging practices to create systemic risk. In our view, this an essential financial solvency tool for regulators and one that should be in place before the NAIC or states endorse or approve sales of the product. Further, any report or recommendations from the working group should include an analysis and discussion of systemic risk posed by CDAs.

Another issue of particular importance to regulatory oversight of CDAs is regulatory expertise to evaluate CDA-insurer hedging practices. The NAIC has indicated that state insurance regulators need significant preparation to be able to implement the shift to principles-based reserving, even though state insurance regulators have always had been involved in evaluating insurer reserves. If state insurance regulators must develop additional skills and expertise for PBR, even greater preparation is necessary for oversight of the hedging programs of insurers which are as important, if not more important, to CDA-insurer solvency than mortality reserves. The working group’s report should include an evaluation of state regulators’ current capabilities to effectively monitor CDA-insurer hedging practices and, as with preparation of PBR, set out a road map for state insurance regulators or NAIC staff to acquire this expertise.

3. Sales Practices

The recommendations and report indicate several instances of variable annuity regulation as applicable to CDA. The variable annuity – as opposed to the GLWB rider on the variable annuity – has nothing in common with CDA. Selling a derivative on an annuity is different from selling the annuity.

The report of the actuarial subgroup in early last year showed clearly that, because the CDA insurer assumes the downside of investment risk, the rational consumer purchasing a CDA would invest in the riskiest types of investments permitted by the insurer. What safeguards are needed to ensure that consumers purchasing CDAs do not make the types of investments for which the likelihood of a CDA benefit is nil?

Our review of the annuity suitability model indicates a significant problem with application of the model to CDAs. Proponents of the CDA explain that the product will be sold to wrap around the consumer's or employer's investments (which are not insurance products and not assets of the insurer.) The annuity suitability model carves out exemptions in Section 4 for a variety of retirement investments or funds. Yet, the purpose of CDAs is precisely to wrap around and provide security for some of the items specifically exempted from application of the suitability model, including employee pensions and employer pension and deferred compensation plans.

Similarly, the annuity disclosure model contains the same exemptions for annuities used to fund certain employee pension and employer pension and deferred compensation plans. In addition, there is nothing in either the suitability or disclosure models which address consumer protections for:

- Limits on Adding to the Investment Account
- Fee Increases
- Mismatch of Investments with CDA benefit structure

4. State of the Market – who’s selling to whom, how much and in what circumstances, in what states as what types of products and what is the expected benefit ratio of CDAs.

Any review of CDAs should include factual information about the state of the CDA market today and recent trends. This is particularly important given the uncertain and disparate regulatory treatment across the states to date. The working group’s report should include information on which states have approved the product, how the product was approved (e.g., what type of product), the insurers receiving approval, the volume of sales, the types of customers and the characteristics of the products sold to date (e.g., CDAs wrapped around conservative or aggressive investment choices.) This information about CDA sales to date is essential for verifying the claims made by proponents of CDAs and for developing the roadmap from the current situation to the final regulatory framework. It is also essential information for regulators and the public to better understand how CDAs are being sold and in what volume.

We strongly urge the working group to include evaluations and estimates of the benefit ratio of CDAs – the ratio of aggregate lifetime CDA benefits to aggregate lifetime fees paid by consumers. In addition, the report should include a ratio of aggregate lifetime CDA benefits to the sum of aggregate fees paid by consumers plus the average aggregate return on these fees if invested instead of paid to the CDA insurer. These benefit ratios are critical information for consumers to evaluate the value of CDAs and to correct the asymmetric information between consumers and insurers.

5. Consumer Testing

Before greenlighting this product, NAIC should commission consumer testing of the product and various required disclosures to ascertain consumer understanding of key features of the product and to identify safeguards that should be in place to overcome asymmetric information and consumer biases. Such consumer testing is consistent with the recently adopted best practices for consumer disclosures and best regulatory practices employed by other financial regulators.

6. The Overall Recommendation

The report and recommendations can be interpreted as an endorsement and approval of CDAs as a product that insurers should be able to sell to consumers and that is certainly how IRI and ACLI are framing the report and recommendations. From what we have seen, the product is a poor value for consumers and raises consumer protection, solvency and systemic risk concerns. The working group’s recommendations set out a number of activities for regulators and the NAIC to accomplish to be capable of regulating the product – a disturbingly long list for a product already being sold.

Moratorium

Given the large number of regulatory issues for which the working group seeks additional expertise and analysis, we ask that the working group recommend that states place a moratorium on the sales of CDAs until the NAIC and state insurance regulators have substantially completed these tasks. Currently, regulatory treatment is inconsistent across the states and regulatory knowledge of the products and issues is limited. Given the consequences of poor initial regulation of a long-term insurance product, it is imperative for regulators to make sure the solid foundation is in place before big sales of the product – surely the history of the LTCI has taught regulators that lesson.

7. Additional Comments

The working group has provided a solid regulatory definition of CDAs. It would be useful to provide a plain-language definition for consumers for use in disclosures and marketing materials.

The working group has indicated that the Annuity Disclosure Model Law does not apply to products that are also registered securities because the SEC prospectus preempts all other state disclosures. It would be useful to direct a working group to develop proposals to the SEC for information and information format to be included in any CDA prospectus.

The working group has indicated that the Standard Nonforfeiture Law for Individual Deferred Annuities does not apply. There is a need for consumer protection in this area. What recourse would a consumer have if, after paying the CDA fees for many years, the CDA insurer decides to stop offering the product and is unable to transfer the policies to another insurer?

The working group has indicated that the Life Insurance Annuity Replacement Model – applies. How so? What policy would be replaced? How would this work?

The working group recommends amending the Producer Licensing model to make clear that the same licenses that are required to sell variable annuities are required to sell CDAs. As mentioned above, there is a difference between an annuity and a derivative of an annuity. Selling the CDA is different from selling a variable annuity and it is unclear that training to sell a variable annuity would reasonably prepare a producer to sell a CDA.

Thank you for your consideration of our comments.