CDAs and the Law

By Kerry Pechter *Thu, Jan 24, 2013*

Contingent deferred annuities (CDAs) are on the minds of insurers these days and took up a fair portion of yesterday's seminar on securities products of insurance companies at the Practicing Law Institute in New York.

"We don't even know all the questions, let alone all the answers," said insurance and securities lawyer Joan Boros at the start of the annual seminar on Securities Products of Insurance Companies at the Practicing Law Institute in Manhattan yesterday.

Boros, an attorney of counsel with the Washington law firm of Jorden Burt, who has chaired the event with fellow attorney Jeffrey S. Puretz of the Dechert law firm for many years, was describing the uncertainty that seems to dominate Wall Street and Washington these days.

"This is the present theme of our economy and regulation," she pointed out to a roomful of lawyers who came to acquire continuing education points and to learn the latest on the regulation of insurance products whose value is linked in some way to the securities markets. She was talking specifically about the difficulty of risk management and risk assessment in the current environment.

For instance, contingent deferred annuities (CDAs), aka stand-alone living benefits, are on the minds of certain life insurers these days, and took up part of yesterday's seminar. These products, which Prudential and Great-West are impatient to bring to market, wrap a guaranteed lifetime withdrawal benefit around a portfolio of mutual funds for an annual fee of about one percent.

The products have been closely scrutinized by state regulators. A working group of the National Association of Insurance Commissioners (NAIC) removed one hurdle to sales of the product last March by determining that CDAs were insurance products and not financial guarantees, which life insurers can't sell.

But the group decided that it needed more time to study the consumer protection issues and the solvency (i.e., reserve requirement) issues that the products raise. The working group met again in late November, but the proceedings haven't been made public. Since CDAs are deemed regulated securities as well as insurance guarantees, the working group has also consulted with the Securities & Exchange Commission (SEC) and with FINRA, the investment industry's self-regulator.

James R. Mumford, first deputy secretary of the Iowa Insurance Department, fielded Boros' questions about CDAs.

"CDAs themselves are very simple products," he said. "They aren't as complex as variable annuities, but their administration and regulation is complex. Administration is so complex that only the largest insurance companies can issue them. Smaller companies won't be able to handle the administration unless they outsource it to third parties" at prohibitive expense.

He was emphatic in distinguishing CDAs from variable annuities. "You have to be careful in saying that

CDAs should be regulated like VAs. They aren't VAs. In the SEC's eyes, and in FINRA's eyes, they are not subject to Securities Act of 1940, and the FINRA variable annuity rules wouldn't apply to them. The SEC looks at them as securities."

"We are looking closely at the reserve requirements [for CDAs]. Insurance regulators want to make sure that the reserves are adequate for claims in 40 or 50 years from now. The regulators have learned a lot about reserving for variable annuities since 2008, so they feel fairly comfortable with CDAs. Most of us agree that AG43 is the more appropriate actuarial guideline for CDAs. The recommendations coming from the CDA working group are very important, will set precedent for products coming in future."

At yesterday's seminar, Bill Kotapish, assistant director of the Office of Insurance Products at the SEC, was asked about the types of product disclosures that his agency wants to see when it receives so-called S-1 or S-3 filings for new CDA products.

With these products, "there's a very real risk, and it needs to be pointed out, that [contract owners] might not live long enough to receive the income benefit. If you don't outlive your assets, you won't reap the benefit," Kotapish said. He added that people need to be clearly warned that excess withdrawals can scotch the lifetime income guarantee.

The SEC has other concerns. "In the case of the CDAs, when there's a relationship between the insurance company and manager of the assets and the benefit is attached only to assets managed by that entity, what happens if that relationship is terminated for any reason?" he said.

Kotapish also saw a "huge risk" to the contract owner if the insurance company suddenly decides that the underlying assets have become too volatile and says that the investments initially covered by the lifetime income guarantee no longer meets its risk/return parameters.

CDAs differ from variable annuities, and aim at a different market. In a variable annuity, the underlying investments dwell in a separate account at the insurer. In a CDA, the investments are held in an advisory account at a broker dealer. Significantly, withdrawals from a CDA-protected account aren't taxed like withdrawals from variable annuities, where gains must come out first and are taxed as ordinary income.

CDAs could open up a huge new market for insurance companies, since they might appeal to Boomers, who currently hold hundreds of billions of dollars in savings in managed accounts or brokerage accounts, who want some protection from running out of money in their old age but who resist buying an annuity for tax or liquidity reasons.