Retirement Income
JOURNAL

Float Through Retirement on a CDA

By Kerry Pechter *Tue, Jul 10, 2012*

Contingent deferred annuities (CDAs) are income guarantees for managed accounts. Their biggest regulatory hurdle may have been cleared last February, when an NAIC committee agreed that CDAs are annuities and not financial guaranty insurance.

As variable annuity manufacturers search for fresh markets for their lifetime income guarantees, they can't help but drool over the estimated $2.55 trillion that's held in fee-based retail managed accounts at hundreds of large and small asset management firms across the U.S.

Selling annuity products into that channel is problematic, however. Most of the advisors on managed accounts don't sell commissioned products or don't want to move money from a taxable to a tax-deferred account. They may also believe that diversification is the only portfolio insurance their clients will ever need, even in retirement.

Yet the owners of retail managed accounts, especially those age 55 and older, are now widely agreed to have a growing interest in protection from longevity risk and sequence of returns risk–an interest that their fee-based advisors may not feel they can afford to ignore.

To respond to that interest, and to neutralize the qualms of fee-based advisors, certain life insurers have designed a relatively new class of products variously called contingent deferred annuities (CDAs), stand-alone living benefits (SALBs), synthetic annuities" or withdrawal insurance.

It's not clear yet how rich the CDA business will be or when it will kick in. Insurers still have to win the approval of some skeptical state insurance commissioners. They also need to convince fee-based advisors that the insurance value of CDAs outweighs their costs. It might also help if insurers can conjure up a better name for CDAs—the word "annuities" is still a liability for most advisors and investors.

Some of the remaining questions about CDAs will be cleared up in the fall, when a National Association of Insurance Commissioners committee and the Government Accountability Office finish their review of the adequacy of the reserve requirements and the consumer protections that will apply to CDAs. Assuming that those reports don't yield any big surprises, the path to wider state approval of CDAs should finally open.

The biggest regulatory hurdle to CDAs appears to have been crossed last February, when the NAIC's first CDA committee agreed that CDAs are annuities, because they are life-contingent. On that point, the committee sided with Prudential Financial and Transamerica and against MetLife and the State of New York Insurance Commissioner, who both claimed that CDAs are financial guaranty insurance, because they are contingent on "changes in the value of specific assets." The State of New York made its ruling in September 2009, when Eric R. Dinallo was superintendent.

Swap meet

For those who are new to the CDA concept, here's a brief primer. In its simplest terms, it functions like a swap contract. As the owner, you're guaranteed a fixed stream of income from a given portfolio—about 5% of your designated portfolio for life—while a life insurer deals with the risk that the portfolio value might drop to zero before you die.

You pay the insurer an annual premium about 1% of the original value of the portfolio to assume that risk. If your portfolio is exhausted before you die, the insurer protects you by paying you your 5% until you die. If your portfolio is never exhausted, the insurer will have paid you nothing out of its own pocket and any remaining assets go to your beneficiaries when you die.

That type of contract should sound familiar, because a CDA resembles a GLWB in a variable annuity, but with a couple of important differences that are essential to making it attractive to fee-based advisors and managed account platforms.

On the one hand, a CDA is like a GLWB in that the insurance company puts some restriction on what you can invest in, so that you can't abuse the guarantee by taking huge risks. On the other hand, a CDA differs from a variable annuity in that the underlying mutual funds or ETFs are held in a retail managed account, not in a separate account at the insurance company. Second, the assets can be in a taxable or tax-deferred the retail managed account; variable annuity separate accounts are always tax-deferred.

The first CDA was offered by the Phoenix Companies through Lockwood Advisors (now an affiliate of Pershing owned by Bank of New York Mellon) at the end of 2007. Some people trace the intellectual foundation of subsequent CDAs to a paper published in the spring of 2009 by Moshe A. Milevsky, Huaxiong Huang and Thomas S. Salisbury in the *Journal of Wealth Management*.

That article proposed a new kind of insurance contract that the authors called the Ruin-Contingent Life Annuity, which would pay out only if the owner was still alive and only if his or her assets were exhausted by a combination of systematic withdrawals and/or poor market performance.

In the case of the Milevsky RCLA, the underlying assets would be invested in an index fund, and the pricing of the product would depend on several factors, including the chosen withdrawal rate and the level of the index at the time the contract was purchased. Most importantly, the contract would not require the client to give up control over the assets.

Pros and cons

For a near-retiree who already has a managed account at a wirehouse like Morgan Stanley Smith Barney or at a TAMP (turnkey asset management platform), and who is comfortable with the costs and benefits of investing within such a structure, the advantage of the CDA is pretty clear: For a relatively small additional fee, the retiree can guarantee that she'll never run out of income.

There are other pluses. If your managed account is taxable, you don't have to move the money into a tax-deferred account. Your advisor can continue to rebalance and harvest gains and pay capital gains tax. And it's not necessarily a permanent commitment. After you retire, if several years of bull markets indicate that you're very unlikely ever to run out money, you can lapse the contract.

On the downside, you do have to move your assets into one of the approved model portfolios specified in the CDA contract, or at least re-allocate your assets to fit the approved allocations. Then there's the expense. Although CDAs don't have the mortality & expense risk fees or the death benefit fees associated with variable annuities, you'll still have to pay 1% to 1.5% wrap fee to the firm that manages your account.

The cost of the CDA itself ranges from a low of about 100 basis points for a low-risk portfolio with single-life protection to a high of 390 bps (in the pending Phoenix product), for an all-equities portfolio with joint-and-survivor protection. (It's possible that you may end up paying an additional fee to advisory platform; it's not entirely clear what incentive the platform has to sell the annuity in the first place. The Phoenix CDA contract includes a 50 basis point annual fee for the account manager.) As with a GLWB, the policyholder faces the constraint that if he or she withdraws more than the allotted amount (usually 5%) in a single year, the level of future annual income may drop.

Early candidates

Although several companies have filed prospectuses with the SEC for CDA-type products over the past five years, few if any are available at the moment to retail investors. (See the feature in today's RIJ.)

The Phoenix Companies recently filed applications for four separate CDAs, to be offered at four different asset management firms. Genworth created a CDA but dropped it when it dropped out of the variable annuity business. Allianz Life filed for a CDA but never launched it, according to spokesperson Sara Thurin Rollin.

Nationwide created a CDA a few years ago to market through advisors at Envestnet, the Chicago advisor platform, but that product has languished. "Nationwide is hopeful to offer SALB products again in the future," a company spokesman told RIJ. "However, we have faced some challenges that have caused us to put our current SALB offerings on hold. The challenges include obtaining state approvals for large states, and technology integration."

Moshe Milevsky, who says he is an "informal consultant" to two CDA manufacturers, thinks that consumers may eventually learn to think about buying CDAs the way they think about buying "home, car, life or travel insurance," given that their life savings deserves to be insured as much as their car or home does.

But before that happens, he told RIJ, "there are a number of behavioral obstacles that people will have to overcome" before they agree with economists that CDAs are a good idea. In response to a question about the life insurance industry's underpricing of variable annuity living benefits prior to the financial crisis, he said, "I think the insurance companies have learned their lesson from [the crisis], and are better—although not perfect—at quantifying the risks."

Because insurance products are regulated at the state level, CDAs will have to be approved by insurance commissioners in key states before they can gain much momentum. At least some of those commissioners are waiting to hear from a second NAIC committee and from the GAO on their confidence in the ability of CDA issuers to handle the market risk, longevity risk, operational risk and policyholder behavior risk that they're taking on.

The America Academy of Actuaries generally approves of CDAs. In a June 27 presentation to the NAIC, Cande Olsen of the American Academy of Actuaries' Contingent Annuity Work Group argued that the same regulatory framework—Actuarial Guideline 43 (AG43) and C3-Phase II—that governs reserving for variable annuities will work for CDAs. She also claimed that, with synthetic GIC products, regulators already have experience regulating products with funds outside the insurers' control.

As with variable annuity GLWBs, the biggest danger to insurers would probably not come from market risk. Equity markets would generally bounce back long before the guarantee was exercised—as occurred after the 2008 financial crisis. A greater danger might be the possibility that medical science will find a way to extend the baby boomers' average life expectancy by five or 10 years.

CDAs do not pose one of the serious risks to insurers that GLWBs do: The risk that, because of an extended market downturn, carriers will not be able to recover, through asset-based fees, the sizeable upfront commissions that they have to extend to intermediaries when selling B-share variable annuities. With CDAs, insurers don't bear the distribution expense.