Contingent Annuity Analysis

Contingent Annuity Work Group (CAWG)
American Academy of Actuaries

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Overview of Report

- Executive Summary
- Product Design and Value to Consumers
- Annuity or Financial Guaranty Product?
- Life Insurance or P/C Insurance?
- Consumer Need and Comparison to Similar Products
- Product Structure and Costs
- Consumer Issues
- Reserves, Capital & Other Risk Management Considerations
- Conclusion

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Executive Summary

- Contingent Annuities (CAs) can be a valuable product choice for many consumers as a way to protect against longevity risk
- Functions in a very similar manner to the Guaranteed Lifetime Withdrawal Benefit (GLWB) offered through a variable annuity
- Basic regulatory framework is in place
  - Reserves (AG 43)
  - RBC (C-3 Phase II)
  - Need for:
    - Disclosure in policy form filings
    - Coordinated and well-developed company risk management

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Product Design & Value to Consumers

- CA Basic Product Design
  - A stand-alone GLWB Design
  - With Covered Assets held outside the life insurance company
- Expands solutions for guaranteed lifetime income
- Enables use of existing accumulated assets for guaranteed lifetime income without requiring policyholders to transfer their assets to an insurance company

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Annuity or Financial Guaranty Product?

- Financial guaranty products (e.g., bond insurance):
  - Protect against specific types of financial losses
  - Contain no life contingent element
- Life annuities:
  - Protect for a lifetime and hence protect against outliving one's assets
  - Contain a life contingent element
- Relationship between market performance and CA payments is indirect:
  - CA payments will be payable for a lifetime even if market does not decline
  - An early decline and later recovery in the market may mean no CA payments are made if insured dies before payments would begin

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Life Insurance or Casualty Insurance?

- CAWG found no definitive guidance in state law

But

- CAs provide a life contingent benefit
- A CAWG risk analysis starting on the next slide demonstrates that CAs include a material life contingent component
- CAWG finds life insurers, not P/C insurers, have the expertise, data and demonstrated experience in life contingencies needed to manage these risks

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CAWG Risk Analysis

- For the purpose of this risk analysis, *longevity risk* is defined as "outliving one's assets when systematic withdrawals are intended to deplete the covered assets by the end of the insured's lifetime"
- Longevity risk is composed of two components – market return component and life contingent component

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CAWG Risk Analysis

- Developed a base simulation where the life contingent component stays constant at the average life expectancy of a 65-year old male and only the market return component varies
- Expanded the base simulation to assume the lifetime of the 65-year old male varies (longevity risk simulation)
- Compared the two simulations

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CAWG Risk Analysis

- Assumes the following product:
  - Initial covered assets and a guaranteed benefit base (GBB) of $150,000
  - Value of GBB "ratchets up" yearly if the account value increases above the current GBB
  - Issued to a male age 65
  - Withdrawals of 5% of GBB each year

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Base Simulation Results

- Approximately 20% chance of an individual outliving their assets prior to life expectancy
- The average amount paid by the CA would be about $40,000
- In the most extreme case, the CA would pay out about $92,000

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Longevity Risk Simulation Results

- Approximately 20% chance of an individual outliving their assets (coincidently the same as the base scenario)
- The average amount paid by the CA would be about $67,000 – 68% more than the base simulation
- In the most extreme case, the CA would pay out about $495,000 – 438% more than the base simulation

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CAWG Risk Analysis Summary

- The risk analysis shows that the life contingent component is a material component of the risks covered by this product
- The benefits of a CA to an individual can be significant because the actual lifetime will fall within a wide range of possible lifetimes, unknown at time of purchase
- The longer one lives after the assets are exhausted, the greater the benefit of the CA product to the consumer
- A similar analysis could also be applied to a GLWB

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Consumer Need and Comparison to Similar Products

- CAs, GLWBs and longevity annuities (paid-up deferred annuities) all meet the need for guaranteed lifetime income
- CAs provide guaranteed lifetime income based on the value of independently held assets
- GLWBs provide guaranteed lifetime income based on the value of insurance company-held assets
- Longevity annuities provide guaranteed lifetime income beginning at a pre-selected age, often around age 85

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CA Product Structure and Costs

- Group fixed annuities are issued to asset management firms
  - Individual customers of the asset management firm receive group participant certificates
  - Asset options and other terms are set forth in group annuity contract and certificates
- Other CA product structures are offered by insurers, but less common than the group annuity structure

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CA Product Structure and Costs

- CA covered assets differ from those of a GLWB in that they are external to the life insurance company
- The group annuity contract sets the terms to ensure assets are managed as expected, including establishment of:
  - Acceptable investment strategies
  - Appropriate data sharing
  - Risk monitoring systems
- Synthetic GICs require similar contractual arrangements

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CA Product Structure and Costs

- CA investment options and allocation limitations are comparable to those of GLWBs
- CAs have a need similar to GLWBs for covered assets to be "hedgeable" with reasonable precision and at reasonable cost

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CA/GLWB Product Structure and Costs

- A traditional Variable Annuity + GLWB product construct has more elaborate fee structure than a CA
  - The more elaborate VA GLWB structure covers additional costs associated with base variable annuity contract features such as guaranteed death benefits and commissions
  - Life insurers can use the fees (i.e., profits) from the base VA product to fund shortfalls in the GLWB, whereas the only source of revenue for CAs is the CA fee.
- The CA product fee must cover all costs associated with the product

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Consumer Issues

- **Tax Treatment** - In several private letter rulings, the IRS ruled that CAs are considered annuities for tax purposes
- **SEC Treatment** - CAs, like GLWBs, are generally registered as securities (except for certain qualified retirement plans)
- **Nonforfeiture Treatment** - Paid-up nonforfeiture benefits are not required since the premiums do not accumulate to determine a payout, but are in the nature of risk charges for a longevity contingency risk

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Consumer Issues

- **Portability** – If the guarantee is not portable, such restriction should be fully disclosed in the CA group contract and participant certificate
- **State Guarantee Fund Coverage** – Expect to be similar to GLWBs
- **Suitability** – Suitability safeguards are important and should be reviewed by the NAIC with assistance from a broad range of experts on the topic

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Reserves, Capital and Other Risk Management Considerations

- **Reserves** - Statutory reserve guidelines for CAs are the same as for GLWBs and are addressed under AG 43
- **Capital** - Statutory RBC requirements for CAs are also addressed by current requirements
- **Hedging** – For both GLWBs and CAs, life insurers generally manage the risks through capital markets hedging programs

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Reserves, Capital and Other Risk Management Considerations

- **Reinsurance** – When life insurers reinsure CAs and GLWBs, similar risk transfer arrangements are established
- **Unique Risks** – Life insurers should be able to demonstrate, as part of the product approval process, that robust and effective risk management systems are in place to mitigate CA's unique risks, e.g.:
  - Potential for accelerated growth
  - Operational issues related to third party asset ownership

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Conclusion

- CAs can be a beneficial product for many consumers
- Much of the regulatory framework is already in place, especially to the extent that:
  - Most states follow the NAIC models for reserves and capital for GLWBs
  - All states have procedures in place for approval of GLWBs
- Any differences and similarities to GLWBs should be disclosed in product filings
- CAs present life insurers with risks similar to those of GLWBs, as well as certain unique risks, all of which demand strong, comprehensive ERM practices by the life insurer and appropriate regulatory oversight by the state

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