

December 2012

RETIREMENT SECURITY

Annuities with
Guaranteed Lifetime
Withdrawals Have
Both Benefits and
Risks, but Regulation
Varies across States



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Why GAO Did This Study

As older Americans retire, they may face rising health care costs, inflation, and the risk of outliving their assets. Those entering retirement today typically face greater responsibility for managing their retirement savings than those who retired in the past. Lifetime income products can help older Americans ensure they have income throughout their retirement. VA/GLWBs and CDAs, two such products, may provide unique benefits to consumers. According to industry participants, while annuities with GLWBs have been sold for a number of years, CDAs are relatively new and are not widely available. GAO was asked to review issues relating to these financial products. This report (1) compares the features of VA/GLWBs and CDAs and examines potential benefits and risks to consumers and potential risks to insurers, and (2) examines the regulation of these products and the extent to which regulations address risks to consumers. GAO analyzed insurance company product information, proposed and final rules and regulations, and studies and data related to retirement and product sales. GAO also interviewed federal and state regulators and selected insurers, consumer advocates, and industry organizations.

GAO provided a draft of this report to NAIC and SEC. Both provided technical comments, which have been addressed in the report, as appropriate.

View [GAO-13-75](#). For more information, contact Alicia Puente Cackley at (202) 512-8678 or cackley@gao.gov.

RETIREMENT SECURITY

Annuities with Guaranteed Lifetime Withdrawals Have Both Benefits and Risks, but Regulation Varies across States

What GAO Found

Annuities with guaranteed lifetime withdrawals can help older Americans ensure they do not outlive their assets, but do present some risks to consumers. Two such products, variable annuities with guaranteed lifetime withdrawal benefits (VA/GLWB) and contingent deferred annuities (CDA), share a number of features but have some important structural differences. For example, both provide consumers with access to investment assets and the guarantee of lifetime income, but while VA/GLWB assets are held in a separate account of the insurer for the benefit of the annuity purchaser, the assets covered by a CDA are generally held in an investment account owned by the CDA purchaser. Consumers can benefit from these products by having a steady stream of income regardless of how their investment assets perform or how long they live, while at the same time maintaining access to their assets for unexpected or other expenses. VA/GLWBs and CDAs are complex products that present some risks to consumers and require them to make multiple important decisions. For example, consumers might purchase an unsuitable product or make withdrawal decisions that could negatively affect their potential benefits. Several insurers and regulators GAO spoke to said it was important for consumers to obtain professional financial advice before purchasing these products and making key decisions. These products can also create risks for insurers which, if not addressed, could ultimately affect insurers' ability to provide promised benefits to consumers.

VA/GLWBs are considered to be both securities and insurance products, and are therefore covered by both federal securities regulations and state insurance regulations. For CDAs, the National Association of Insurance Commissioners committee responsible for life insurance and annuities products has determined CDAs to be life insurance products subject to state law and regulation for annuities. According to SEC officials, existing CDAs have been registered as securities with SEC, and therefore are covered by both federal securities laws and regulations, and state insurance regulations. At the state level, NAIC has developed state disclosure and suitability regulations for annuity products. However, states differ on the extent to which they have adopted these annuity regulations, and some do not have protections at all. As a result, consumers in states that have adopted different regulations may benefit from different levels of protection. NAIC and state regulators told GAO that they are currently reviewing the regulations of CDAs. In March 2012, NAIC began reviewing existing annuity regulations to determine whether any changes are needed to address the unique product design features of CDAs, including potential modifications to annuity disclosure and suitability standards. It is also reviewing what kinds of capital and reserving requirements may be needed to help insurers manage product risk. In addition, NAIC and the National Organization of Life and Health Guaranty Associations are each working to determine whether state insurance guaranty funds, which protect consumers in the event insurers become insolvent, cover CDA products. Both agree that each state will have to reach its own conclusion about whether their particular state guaranty fund laws allow for CDA coverage. Until these regulatory issues are resolved, consumers may not be fully protected.

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Abbreviations

CDA	contingent deferred annuities
FINRA	Financial Industry Regulatory Authority
IRA	individual retirement account
NAIC	National Association of Insurance Commissioners
NASD	National Association of Securities Dealers
NOLHGA	National Organization for life and Health Guaranty Associations
SEC	Securities and Exchange Commission
VA	variable annuities
VA/GLWB	variable annuities with guaranteed lifetime withdrawal benefits

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Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

December 10, 2012

The Honorable Herb Kohl
Chairman
Special Committee on Aging
United States Senate

The Honorable George Miller
Ranking Member
Committee on Education
and the Workforce
House of Representatives

Longevity risk, or the potential for outliving one's financial resources in retirement, is a critical issue for today's older Americans. Life expectancy for many older Americans grew significantly from 1980 to 2010, and today's retirees may face a greater number of years than earlier generations for which they will require income. They also face the risks of inflation and rising health care costs. Because of a decrease in defined benefit retirement plans that guarantee retirees a certain level of income for life, workers entering retirement today also typically have more responsibility for managing their retirement savings than previous retirees and must make difficult investment and withdrawal decisions.

Recent market turbulence has also sparked questions about retirement account values and longevity risk, and many Americans already retire without sufficient savings to sustain them throughout a lengthy retirement. For example, a recent study showed that only 42 percent of those surveyed had calculated how much in savings they would need for retirement, and the percentage of Americans saving for retirement had declined by 9 percent from 2009 to 2012.¹ Products with guaranteed lifetime withdrawals, such as variable annuities with a guaranteed lifetime withdrawal benefits rider (VA/GLWB) and contingent deferred annuities (CDA) can potentially help older Americans plan for retirement and address longevity and market risks by providing guaranteed income even after retirement assets are depleted. However, some industry participants

¹The Employee Benefits Retirement Institute and Matthew Greenwald and Associates, *2012 Retirement Confidence Survey* (Washington, D.C.: March 2012).

suggest that VA/GLWBs and CDAs are complex products which involve potential risks for both consumers and insurers.

In response to questions you have raised about annuities with guaranteed lifetime withdrawals, this report:

- compares the features of VA/GLWBs and CDAs, and examines the potential benefits and risks to consumers and potential risks to insurers of these products; and
- examines the regulation of these products and the extent to which regulation addresses any identified risks to consumers.

To compare the features of VA/GLWBs and CDAs, we analyzed specific insurance company products to obtain information on how the products function, including how investment gains and losses are treated, how withdrawal amounts are determined, and what happens when a consumer's investment account is depleted. We also interviewed insurance company officials to verify our understanding of their products and VA/GLWBs and CDAs in general. To identify potential benefits and risks to consumers, we analyzed the product information we obtained and also interviewed insurers, consumer advocates, and state insurance regulators. To understand the potential risks these products pose to insurers and how they manage these risks, we also interviewed NAIC officials and reviewed information from insurers and stakeholder groups. We also obtained data from industry organizations on the sale of annuity products with guaranteed lifetime withdrawals. We discussed the sources and reliability of the data with officials from these organizations and found the data sufficiently reliable for the purposes of this report.

To determine how VA/GLWBs and CDAs are regulated and the extent to which regulation addresses identified concerns, we identified regulations and processes used by federal and state regulators, as well as any proposed regulations, and compared them with the risks to consumers that we identified as part of the work under the previous objective. We reviewed model laws developed by NAIC, specific state regulations, and SEC and FINRA rules. We also interviewed NAIC, state, SEC and FINRA officials to determine how VA/GLWBs and CDAs are regulated. We also interviewed other stakeholder groups, such as consumer advocates and industry organizations, to gain their perspective on issues related to regulation of lifetime income products considered in our review. Appendix I contains additional information on our scope and methodology.

We conducted this performance audit from February 2012 to November 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Annuities

An annuity is an insurance agreement or contract that comes in a number of different forms and can help individuals accumulate money for retirement through tax-deferred savings, provide them with monthly income that can be guaranteed to last for as long as they live, or both. A variable annuity is an insurance contract in which a consumer makes payments that are held in a separate account of the insurer. While the insurance company is the owner of the separate account assets, the assets are held for the benefit of consumers. In return, the insurer agrees to make periodic payments beginning immediately or at some future date. The purchaser's payments can be directed into a range of investment options, typically mutual funds, which the insurer makes available in a separate account for the benefit of consumers. Purchasers may withdraw assets from their contracts at any time prior to annuitizing—that is, to convert the account into some form of lifetime payments.

VA/GLWBs protect consumers against outliving their retirement assets and the effects that market losses on those assets can have on lifetime income by allowing them to withdraw a certain percentage each year until death. If the market performs well, the consumer may receive larger withdrawals, but if the market performs poorly, the consumer still receives the set withdrawal amount.

VA/GLWB sales have grown in recent years. Data from LIMRA show that from 2008 to 2011, the number of VA/GLWB contracts in force rose from 1.5 million to 2.8 million and that average annual sales were around \$58 billion.² During that same period, total VA/GLWB assets held in insurers'

²LIMRA is a financial research firm that provides consulting and research services to its over 850 member financial services firms.

accounts increased from \$133 billion to \$323 billion. According to the Insured Retirement Institute, states with the highest sales of variable annuities in 2010 were California, New York, Florida, Texas, Pennsylvania, and New Jersey.³ In addition, LIMRA data on the demographics of VA/GLWB consumers show that in 2010 the average age of the consumer purchasing a VA/GLWB was 61 and the average age at first withdrawal was 68. Typically, the average annual withdrawal has been around \$5,500. Also according to LIMRA, the average amount of a VA/GLWB contract sale from 2007 through 2010 was around \$106,000.

Like a GLWB rider, a CDA is an insurance contract that provides guaranteed lifetime income payments if a consumer's investment account is exhausted, whether through withdrawals or poor market performance. In this case, the investment account contains the "covered assets"—typically mutual funds or managed accounts. However, the insurance company does not have ownership of the assets underlying the CDA, which are typically held in brokerage or investment advisory accounts owned by the CDA purchaser. Similar to a VA/GLWB, a CDA contract defines how much a consumer is able to withdraw—for example, 5 percent of the benefit base annually. Even if the value of the covered assets drops to zero, the insurance company has guaranteed the 5 percent withdrawal benefit (based on the benefit base value when lifetime withdrawals began) and continues making the annual payments to the consumer. Whether or not a policyholder receives payment from the insurance company selling the CDA is contingent upon the covered assets dropping to zero. On the basis of the products we reviewed, fees on CDAs are calculated as a set percentage of the investment assets or benefit base per year. These fees do not include any fees the consumer might pay related to the underlying investment that is covered by the CDA. Such investment management fees are paid to the investment company, not the insurer.

³The Insured Retirement Institute is a trade association that provides research and information to its members, including financial firms and advisors.

Regulation

State insurance regulators are responsible for overseeing insurance products, while SEC and FINRA are responsible for the oversight of securities. Federal and state regulators consider variable annuities to be both insurance and securities products, and GLWB riders that are attached to variable annuities to be an additional insurance benefit. The National Association of Insurance Commissioners committee responsible for life insurance and annuities products has determined CDAs to be life insurance products subject to state law and regulation for annuities. According to SEC officials, existing CDAs have been registered as securities with SEC, and therefore are covered by both federal securities laws and regulations, and state insurance regulations.

Insurance is unique among financial services in the United States in that it is largely regulated by the states. State insurance regulators are responsible for enforcing state insurance laws and regulations, including those covering the licensing of agents, reviewing insurance products (including variable annuities) and their rates, and examining insurers' financial solvency and market conduct. State regulators typically perform financial solvency examinations every 3 to 5 years, and they generally undertake market conduct examinations in response to specific consumer complaints or regulatory concerns.⁴ State regulators also monitor the resolution of consumer complaints against insurers. State insurance laws focus on solvency, market regulation, and consumer protection. In addition to state insurance regulators, NAIC—a voluntary association of the heads of insurance departments from the 50 states, the District of Columbia, and five U.S. territories—plays a role in insurance regulation. While NAIC is not a regulator, it provides guidance and services designed to more efficiently coordinate interactions between insurers and state regulators. These services include providing detailed insurance data to help regulators understand insurance sales and practices; maintaining a range of databases useful to regulators; and coordinating regulatory efforts by providing guidance, model laws and regulations, and information-sharing tools.

Federal securities laws and SEC rules govern the securities industry in the United States. SEC's mission is to protect investors; maintain fair,

⁴State regulators periodically perform financial examinations of insurance companies to investigate their accounting methods, procedures, and financial statement presentation. Market conduct exams by state regulators help ensure fair and reasonable insurance prices, products, and trade practices to protect consumers.

orderly, and efficient markets; and facilitate capital formation. SEC oversees key participants in the securities markets, including securities exchanges, securities brokers and dealers, investment advisers, and mutual funds. The Securities Act of 1933 (1933 Act) regulates public offerings of securities, requiring that issuers register securities with SEC and provide certain disclosures, including a prospectus, to investors at the time of sale.⁵ Investors may rely on broker-dealers and investment advisers for information or advice about securities, including insurance products such as VA/GLWBs and CDAs. Money managers, investment counselors, and financial planners who, for compensation, engage in the business of providing advice to others about securities, including asset allocation advice, are subject to the antifraud provisions of the Investment Advisers Act of 1940.⁶ Large investment advisers, those with \$100 million or more of assets under management, generally are subject to SEC registration and regulation under the Investment Advisers Act and accompanying rules. Investment advisers with assets under management of less than \$100 million generally are regulated by the states.⁷ Securities, including annuities that are securities, are subject to registration and disclosure requirements under the 1933 Act, and large investment advisers providing advice about securities must be registered with SEC. Broker-dealers that are engaged in the business of buying and selling securities generally are subject to broker-dealer regulation at the federal and state levels. FINRA is the largest regulator of securities firms doing business with the public in the United States. All registered securities broker-dealers who do business with the public must be members of FINRA and their personnel must be licensed with FINRA. FINRA oversees almost 4,500 brokerage firms and approximately 630,000 registered securities representatives.

⁵Securities Act of 1933, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a *et seq.*).

⁶Investment Advisers Act of 1940, 54 Stat. 847 (1940) (codified as amended at 15 U.S.C. §§ 80b-1 *et seq.*).

⁷The Investment Advisers Act of 1940 was amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) to provide that mid-sized investment advisers, those managing assets between \$25 million and \$100 million, generally be exempt from federal registration requirements and subject to state regulation. Small investment advisers managing assets under \$25 million were already exempt from federal registration requirements under the Investment Advisers Act prior to Dodd-Frank.

Features of VA/GLWBs and CDAs May Benefit Consumers but also Pose Risks to Consumers and Insurers

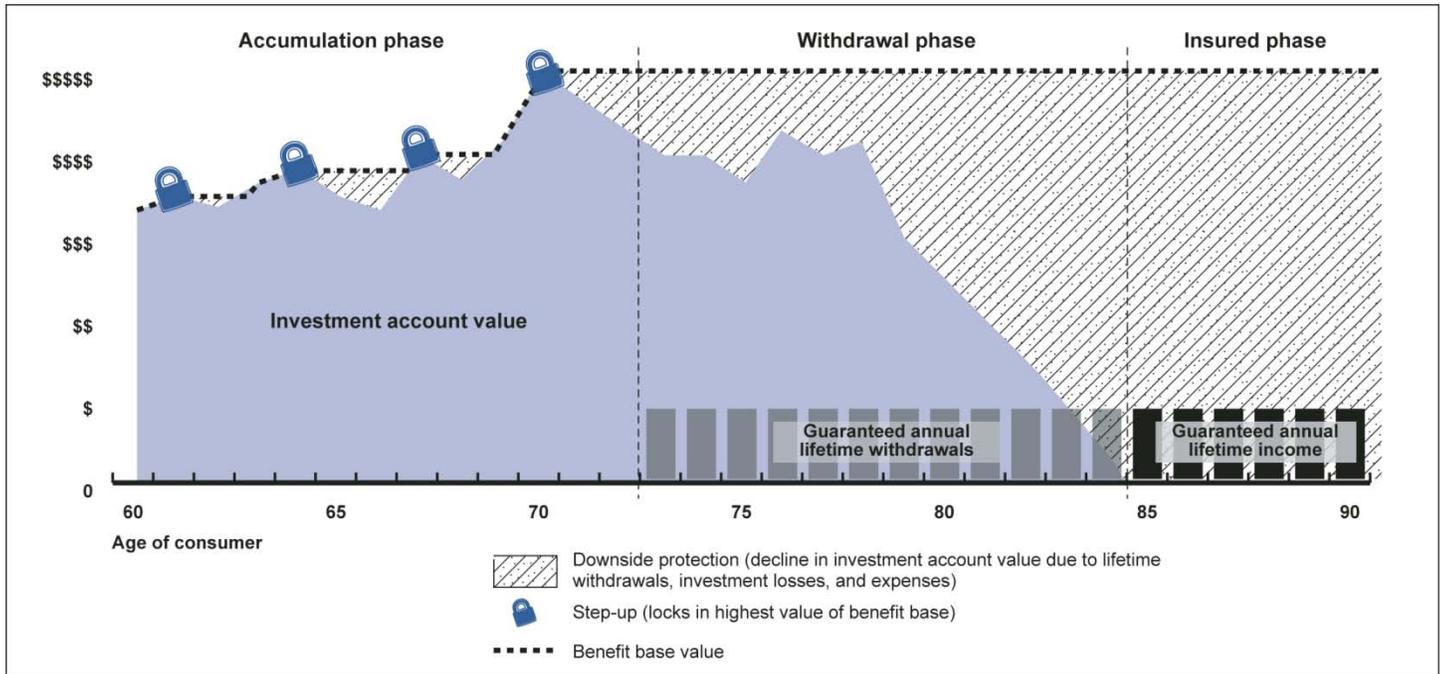
VA/GLWBs and CDAs share a number of features, but they also have some important structural differences. For example, both provide consumers with access to investment assets and the guarantee of lifetime income, but while VA/GLWB assets are held in a separate account of the insurer for the benefit of the annuity purchaser, the assets covered by a CDA are generally held in an investment account owned by the CDA purchaser. In part because of their shared features, these products can provide similar benefits to consumers. Yet as complex instruments that require consumers to make multiple important decisions, they also present certain risks to consumers. VA/GLWBs and CDAs may also involve risks for insurers, who must manage these risks in order to make promised payments to consumers.

VA/GLWBs and CDAs Share Some Features

VA/GLWBs and CDAs share a number of product features. In general, both allow consumers to take lifetime withdrawals from their assets at a rate that the insurance company guarantees even if such withdrawals and investment losses deplete the consumer's assets. VA/GLWBs and CDAs generally have three distinct phases of ownership: an accumulation phase, a withdrawal phase, and an insured phase (see fig. 1).⁸

⁸One insurance company whose products we reviewed referred to the insured phase as the "settlement phase." The American Council of Life Insurers and the Insured Retirement Institute refer to it as the "annuity payments phase."

Figure 1: Accumulation, Withdrawal, and Insured Phases of a VA/GLWB or CDA



Source: GAO analysis of VA/GLWB and CDA product information provided by insurers.

Note: This figure is a hypothetical illustration of the phases and features of a VA/GLWB or CDA and may not represent the actual results of any product we reviewed. The actual results for each consumer will depend on the particular product's features and costs, as well as factors such as the amount invested, the consumer's age when the guarantee was purchased, the actual return on investments, the timing and amount of withdrawals, and how long the consumer lives.

Accumulation Phase

The accumulation phase begins when a consumer purchases a VA/GLWB or CDA contract.⁹ The initial premium paid under a VA contract with a GLWB rider or the value of assets covered by a CDA contract establishes the initial withdrawal value, or benefit base, on which the

⁹The VA/GLWBs we reviewed are allowed to be added either when annuity contracts are first purchased, on a contract's first anniversary, or anytime after the contract's issue date subject to availability and the consumer's eligibility. The CDAs we reviewed can be purchased when eligible investment funds are purchased. While some products we reviewed had no minimum eligibility age for purchasing the VA/GLWB or CDA, others had established minimums that ranged from ages 35 to 50. According to LIMRA, consumers initially purchase VA/GLWB contracts at about age 61.

amount of lifetime withdrawals are based.¹⁰ This benefit base is not a cash value that can be withdrawn, but rather is the amount to which lifetime withdrawal percentages will be applied during the withdrawal phase. The investment account value, on the other hand, represents the total value of the consumer's investments, which is increased by investment gains and decreased by fees, withdrawals, and any investment losses.¹¹ During this phase the consumer decides how to allocate investment assets among various options, including funds made available by an insurance company for investment under its VA/GLWB products and funds that an insurance company has agreed to cover under its CDA products.¹² Also during this phase, the insurance company monitors each consumer's account value and automatically adjusts the benefit base periodically should investment gains increase the value of this account. This feature, which exists for the VA/GLWBs and CDAs we reviewed, is referred to as a step-up or ratchet.¹³ Once a consumer's benefit base is stepped up, it cannot later decline because of investment losses that reduce the consumer's investment account value.

Some VA/GLWBs have an additional feature that guarantees that, no matter how the investments perform, the benefit base will grow each year by a set percentage. This guaranteed percentage, alternatively referred to as a roll-up rate, growth credit, or bonus, is added to the benefit base, as adjusted for any prior step-ups. For example, some of the VA/GLWBs we reviewed included annual roll-up rates that ranged from 5 to 7 percent. The amount of the roll-up rate and the frequency, duration, and manner of

¹⁰The minimum initial premium or investment in the VA/GLWBs and CDAs we reviewed ranged from no minimum to \$100,000 with maximums that ranged from \$500,000 to \$5 million. According to LIMRA, the average initial premium paid for a variable annuity with a GLWB rider is about \$100,000.

¹¹The investment account value may be greater or less than the benefit base.

¹²The number of investment options available under the VA/GLWBs and CDAs we reviewed ranged from 1 to over 100 different funds.

¹³The VA/GLWBs and CDAs we reviewed stepped up benefit base values to either the highest daily, monthly, or annual account value. For example, on each contract anniversary an insurer may compare the benefit base to the account value at the end of each of the past 12 months and step up the benefit base to the highest of those 12 values. A more frequent step-up may increase the chances of locking in investment gains, but the level of these gains, and thus the value of a more frequent step-up, may be affected by the nature of the funds and any investment limitations, restrictions, and nondiscretionary asset reallocation formulas used by the insurance company to manage market risks and volatility.

Withdrawal Phase

calculation can affect the value of a consumer's benefit base and thus the amount that can be taken as lifetime withdrawals. While such features can increase a consumer's benefit base on which lifetime withdrawals are determined, annuities with higher roll-up rates can have higher fees.

The withdrawal phase starts when a consumer begins taking annual lifetime withdrawals. The maximum amount of lifetime withdrawals that a consumer can take each year (without incurring a reduction in their benefit base) is calculated as a percentage of the consumer's benefit base at the time of the first lifetime withdrawal. The VA/GLWBs and CDAs we reviewed had withdrawal percentages for a single life that ranged from 3 percent to over 8 percent of the benefit base, and the percentages were generally lower for younger consumers and higher for older consumers.¹⁴ Some products also have a joint life option where, if the consumer dies, the guarantee of lifetime income passes to their spouse. When such an option is elected, withdrawal amounts are typically one-half a percent less than they would be otherwise.¹⁵

Step-ups, like those during the accumulation phase, can increase the benefit base after lifetime withdrawals have begun, increasing the amount of annual lifetime withdrawals. Typically, the insurance company will increase the benefit base if a consumer's account value, net of withdrawals and fees, has increased above this amount. After a step-up during the withdrawal phase, the base and the lifetime maximum withdrawals cannot decline because of investment losses that reduce the consumer's account value. Step-ups that occur after lifetime withdrawals

¹⁴Two products we reviewed (one VA/GLWB and a CDA) set withdrawal rates based on a combination of age and the 10-year Treasury bond yield at the time of the owner's first withdrawal. The older the owner and the higher the 10-year bond yield results, the higher the withdrawal rates.

¹⁵The joint life withdrawal rates for one of the VA/GLWB products we reviewed were the same as for a single life, except that the withdrawal percentage was based on the younger of the two lives. Another VA/GLWB product we reviewed, whose withdrawal rates were based on the 10-year Treasury bond yield, set the joint life withdrawal rates at 90 percent of the single life rates.

begin allow consumers to benefit from investment gains that can offset the effects of inflation.¹⁶

Insured Phase

A consumer enters the insured phase only if their investment account value has been reduced to zero as a result of lifetime withdrawals; investment losses; or any expenses, fees, or other charges. In such cases, the consumer's benefit base on which lifetime withdrawals are determined (the amount to which the withdrawal percentage is applied) remains unchanged but the consumer's investment account value, which was the source for the funds previously withdrawn, is zero. Consequently, the funds needed to continue paying the same level of benefits to the consumer (and spouse, if a joint life option is elected) would then come from the insurance company's own assets, and consumers receive payments from the insurance company that are equal to their prior lifetime withdrawal amount. Once the insurance company begins paying the agreed-upon withdrawal payment, the fees that the consumer had been paying for that protection would cease, as would any investment management and other fees paid for other benefits. Once the insured phase begins, all rights and benefits under a VA/GLWB or CDA contract, except those related to continuing benefits, terminate.¹⁷ In addition, all lifetime withdrawal benefits will continue to be paid to the consumer on the established schedule and generally cannot be changed.

Structural Differences Exist between VA/GLWBs and CDAs

Although VA/GLWBs and CDAs have some common features and function in similar ways, the contractual, product, and cost structures differ in terms of where the underlying investment assets are held and what benefits are offered, and the amount of fees charged for those benefits. With variable annuity contracts, including those with GLWB riders, consumers can direct premium payments into a range of investment options, typically mutual funds made available by and held in

¹⁶The withdrawal percentages for some VA/GLWB and CDA products we reviewed can increase when an owner enters a new age band preceding a step-up of the benefit base. VA/GLWB and CDA products that base the withdrawal percentage on the 10-year Treasury bond yield and recalculate the owner's withdrawal amount based on the current bond yield potentially provide a more direct connection between increases in future withdrawal amounts and long-term inflation to the extent that 10-year Treasury bond yields vary with inflation or inflationary expectations.

¹⁷For example, the right to make additional contributions and receive the benefit of future step-ups in the withdrawal amount would no longer be available to an owner once the account is depleted.

a separate account of the insurance company. The mutual funds may be managed by outside advisers, but the insurance company holds these assets for the benefit of consumers. By comparison, the investment assets covered by a CDA are held by the consumer in his or her own brokerage or investment advisory account and invested in investment funds, such as mutual funds, that the insurance company has agreed to cover under a CDA. The investment assets are not owned—nominally or otherwise—by the insurance company issuing the guarantee. Like the investment options available under a VA/GLWB, the investment assets covered by a CDA may or may not be managed by the insurance company or an affiliate. In this way, consumers can accumulate retirement assets in a personal account, such as an individual retirement account (IRA), and obtain lifetime withdrawal guarantees without having to transfer those assets to an insurance company.

Further, the base variable annuity contracts to which GLWB riders are attached provide additional benefits not available under CDAs. For example, a VA/GLWB contract permits the consumer to annuitize an account balance in the future and receive benefit payments from the insurance company for life at rates set forth in the annuity contract.¹⁸ Also, with a VA/GLWB, if a consumer dies before annuitizing the account balance or taking lifetime withdrawals, the death benefit payable to beneficiaries is typically the greater of the sum of premiums paid or the investment account value.¹⁹ The additional VA/GLWB benefits come with additional costs, however. For example, in addition to the guarantee fee, variable annuity contracts with death benefits entail additional fees to cover the cost to the insurer. For the CDAs we reviewed, the assets covered by the CDA could not be annuitized in the future. The assets

¹⁸Guaranteed lifetime withdrawal benefits terminate upon annuitization of the base contract's account value. Further, the VA/GLWBs we reviewed had maximum annuity commencement ages of either 91 or 95. At those ages, annuitants are typically required to annuitize their remaining account balance or take a lump sum distribution. For all but one of the products we reviewed, in cases where an owner starts taking lifetime withdrawals and later reaches the maximum annuity commencement age, the lifetime withdrawal payments cease and the annuity payments would be calculated as the greater of the lifetime withdrawal amount or the annuity amount for the selected payment option under the contract.

¹⁹To illustrate, if an owner who paid \$200,000 in premiums had investments that had declined in value to \$190,000 at the time of their death, and had not annuitized their account balance or begun taking lifetime withdrawals, the insurance company would pay the owner's beneficiaries \$200,000.

would first have to be sold and the proceeds used to purchase a separate annuity. In addition, unlike a variable annuity contract, a CDA does not have a death benefit.²⁰

VA/GLWBs and CDAs Can Provide Consumers with Similar Benefits

Similar to other annuity products, VA/GLWBs and CDAs can provide consumers with the benefit of a guaranteed stream of income for life. That is, for a fee, they can ensure that consumers receive a minimum annual payment until they die, regardless of how long they live or how their investment assets might perform. These products may also lock investment gains into the benefit base on which future lifetime withdrawals are determined and, in the case of variable annuities, also offer other potentially beneficial features such as death benefits, which pass on certain guaranteed amounts to a spouse or other beneficiaries. Further, VA/GLWBs and CDAs typically offer consumers the ability to invest their assets in a variety of investment funds.

A unique benefit of these products is that they allow consumers to receive income guarantees while still maintaining ownership of and access to their funds during the accumulation and withdrawal phases. With traditional annuity products, in order to receive lifetime income consumers must transfer assets to the insurer, who holds them in their own general account and uses them to fund an annuity (they are annuitized). Consequently, once these assets are annuitized the consumer does not have access to these assets. With VA/GLWBs and CDAs, however, the consumers' assets are not annuitized. As a result, consumers can withdraw any or all of their funds at any time. This can benefit consumers should they need funds for unexpected uses, such as medical or other expenses.

One benefit specific to CDAs is that the guarantee of lifetime withdrawals can, in certain cases, be applied to existing investment assets. That is, consumers who have existing investment assets may be able to purchase a CDA to cover those assets, if an insurer agrees to cover those assets under a CDA. If the same consumers wanted to use those assets to obtain a guaranteed stream of income through a traditional annuity, they would have to first sell the investment assets and then use the proceeds to purchase the annuity.

²⁰For the VA/GLWB and CDA products we reviewed, if the consumer elects a joint life withdrawal option, upon their death during the accumulation phase surviving spouses typically could elect to continue the guarantee and maintain the benefit base.

Consumers Face Risks When Purchasing and Withdrawing Funds from VA/GLWBs and CDAs

Several insurers and regulators we spoke with said that VA/GLWBs and CDAs are complex products, and emphasized the importance of obtaining professional financial advice before purchasing these products and making key decisions. Consumers that purchase VA/GLWBs and CDAs can face risks similar to those they may face with the purchase of other financial products. These risks include purchasing an unsuitable product, paying too much, making withdrawal decisions that decrease benefits, and having an insurer become insolvent before benefits are received.

First, consumers face the risk of purchasing an unsuitable product if they do not understand how a particular product functions and meets their own needs, including how much might be appropriate to invest in a particular product. Insurers with whom we spoke said that VA/GLWBs and CDAs are generally attractive to middle-income consumers who want more control and flexibility over the investments they are relying on to provide retirement income. In addition, one insurer with whom we spoke said that consumers investing in such products have generally had around \$500,000 in retirement savings and invested around 20 percent of that amount.

Second, consumers may face the risk of being unable to determine if they are obtaining the best price for similar benefits provided by different insurers. Several insurers and regulators told us that because of the uniqueness of VA/GLWB and CDA products, it would be difficult to compare one insurer's product to that of another insurer. For example, products can function in slightly different ways, have different combinations of features, and charge different amounts for the guarantees. As a result, consumers would find it difficult to take a price quoted to them from one insurer for a specific product with specific features, then compare that to a product from another insurer to determine if they could receive similar benefits at a lower price.

Third, VA/GLWBs and CDAs pose a risk that certain decisions by consumers in withdrawing their assets, such as the timing and size of the withdrawals, could affect them negatively. For example, these decisions can reduce or even eliminate guaranteed benefits and result in additional fees that further reduce their assets. The investment assets underlying VA/GLWB and CDA guarantees are typically available for withdrawal before guaranteed lifetime withdrawals begin, but taking withdrawals too early or above certain thresholds can result in financial penalties and deplete assets, as the following examples illustrate,

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- Variable annuities are frequently sold without any up front sales charges but impose contingent deferred sales charges, or “surrender” charges, on withdrawals taken during the early years of the contract (for example, the first 7 years) that are above a “free” withdrawal limit.²¹ Surrender charges on variable annuities are expressed as a series of percentages that decline over time and are applied to annual withdrawals that are typically greater than either accumulated earnings or 10 percent of premiums paid.²² Because CDAs split insurance and investment elements of the guarantee, there are no surrender charges on the CDA contract. However, a surrender charge may apply when a consumer sells shares of mutual funds covered by the CDA contract.²³ In addition to sales charges, income taxes and an additional 10 percent penalty tax on withdrawals taken before age 59½ may apply.²⁴
 - With some VA/GLWB products, taking withdrawals of any amount after reaching a minimum age can trigger the beginning of lifetime withdrawals (at a specified percentage) and stop all future roll-ups of the benefit base.²⁵ In addition, a consumer who takes withdrawals sooner than initially planned can experience a permanent reduction of the lifetime withdrawal amount. For example, for one of the products we reviewed a withdrawal at age 64 triggers the establishment of a 4 percent lifetime withdrawal percentage, but waiting for a year would raise the percentage to 5 percent. Further, starting lifetime withdrawals during a downturn in the market can have a negative

²¹A “free” withdrawal limit is an amount below which consumers may take withdrawals without penalty.

²²The period during which surrender charges are assessed typically varies from 3-7 years according to the variable annuity share class. For example, some variable annuities we reviewed had 7-year surrender charge periods with first-year surrender charges of between 7 and 8.5 percent that declined to 0 percent over 7 years. The free withdrawal limit for the annuities of this type that we reviewed was either 10 percent of premiums paid or the greater of either accumulated earnings or 10 percent of premiums paid.

²³Surrender charges are a form of sales charges that are levied on annuities and mutual funds and are used to pay commission expenses.

²⁴Some of the products we reviewed established age 59½ as the minimum age when guaranteed lifetime withdrawals could begin. Withdrawals made earlier than the minimum age may reduce the benefit base on which lifetime withdrawals are calculated.

²⁵Owners of the VA/GLWB and CDA products we reviewed that did not have a roll-up feature could not trigger the lifetime withdrawal percentage merely by taking withdrawals but had to affirmatively elect to take lifetime withdrawals before they became effective.

effect on lifetime income because the investment account balance will be that much lower than the benefit base, making the possibility of a step-up, and a possible increase in the withdrawal percentage and amount, less likely.

- The age at which lifetime withdrawals begin can have an impact on the value of other benefits and guarantees. For example, withdrawals and the related charges can reduce the cash value and death benefits under a variable annuity contract, leaving fewer assets available for surviving spouses and other beneficiaries. On the other hand, waiting too long to withdraw benefits can result in not living long enough to benefit from the product's guarantees or receiving enough income to offset the amount of fees paid. For example, a person who first purchases a VA/GLWB or CDA at age 60 and waits until age 85 to begin taking lifetime withdrawals will be able to take a higher amount, but likely for a shorter period of time. Further, the purchaser will have paid fees for 25 years to protect against outliving his assets, a possibility that becomes less likely over time.

In addition to deciding when to begin taking lifetime withdrawals, consumers need to decide how much to withdraw and need to be aware of certain product features when doing so. For example, lifetime withdrawals above the maximum annual amount specified in the withdrawal guarantee are permitted and are referred to as "excess withdrawals." However, such withdrawals typically reduce the benefit base to which withdrawal percentages are applied, thus reducing future annual withdrawal amounts. Further, guarantee fees and other charges are typically not counted as withdrawals for purposes of calculating the maximum for a given year, but some VA/GLWB and CDA products we reviewed counted certain fees and charges or those above a certain threshold toward the annual lifetime withdrawal maximum.

Finally, as with the purchase of any long-term insurance product, consumers can face some level of risk that by the time the consumer needs the benefit promised by the insurer, the insurer may not be able to provide it. However, insurers and insurance regulators take a number of steps to ensure that insurers remain financially solvent. In addition, in the event of an insurer's insolvency, state insurance guaranty funds can help pay consumers what was promised by insurers, up to any coverage limits of those guaranty funds. According to officials from the National Organization for Life and Health Guaranty Associations (NOLHGA), while promises made under GLWBs, which are distinct from the investment portion of a variable annuity, are generally covered by state guaranty

funds, such certainty does not exist with respect to CDAs. As a result, a risk exists that if an insurer who sold a CDA became insolvent, consumers owning those CDAs might not collect any promised benefits.

Insurers Must Also Manage Risks Associated with VA/GLWBs and CDAs

As with the sale of life insurance products in general, insurers must manage the financial risks associated with VA/GLWBs and CDAs in order to ensure their ability to make promised payments and, depending on the amount of such products they sell, their financial solvency. Risks to insurers can arise when investment returns, interest rates, consumer longevity, and consumer behavior are different from what they expected. While a number of insurers and NAIC officials said that VA/GLWBs and CDAs do not pose undue risk to insurers, as we noted, at least one major insurer has decided not to sell CDAs because of the potential risk involved, and another insurer told us that they do not sell VA/GLWBs because they do not fit with the company's risk profile.

Insurance company officials with whom we spoke told us that in designing their products they consider not only the features that will help to meet consumer needs, but also the company's own appetite for certain risks, the methods for managing those risks, and the price charged for the products' guarantees. According to insurers with whom we spoke, ways in which insurers can use product design to help manage their risk can include the following.

- Establishing the minimum age at which consumers can begin taking withdrawals and the extent to which consumers can benefit from growth in the investments protected by the guarantee.
- Specifying which investments consumers may have covered by the products' guarantees. For example, one CDA product we reviewed limited a consumer's investments in equity funds to no more than 80 percent of the consumer's total investment account value. Another insurer that sells CDAs told us that they were only willing to cover index funds for major, highly traded indices, such as the Standard and Poor's 500.²⁶

²⁶The Standard and Poor's 500 is an index of 500 U.S. company stocks from various industries that meet certain criteria for inclusion in the index, including a market capitalization in excess of \$4 billion.

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- Determining the formulas used to rebalance consumers' investments into and out of fixed-income funds to mitigate some of the financial risks associated with providing lifetime withdrawal guarantees.²⁷ Prospectuses for these VA/GLWB products disclose that the automatic rebalancing feature may limit the consumer's participation in future market gains and, therefore, the potential for future increases in their annual lifetime income.

Insurers will also price their products to ensure they have sufficient revenue and capital to pay for the expenses they expect to incur related to the products they sell. That is, they will charge more for products that they deem to be more risky or on which they expect to incur greater costs. With respect to VA/GLWBs and CDAs, for example, insurers may charge higher fees for products with features that can result in a higher guaranteed benefit base. Insurers also use hedging programs to help further manage the investment risks of the assets underlying the VA/GLWB and CDA. Hedging involves buying financial instruments, such as options, to offset the potential loss on an investment.

To the extent that product design and hedging is not sufficient, insurers can also manage financial risks by modifying their products after they have been purchased by consumers to the extent permitted by their contracts, their prior disclosure, and applicable law. For the VA/GLWB and CDA products we reviewed, insurers sometimes reserve certain rights, such as the right to determine which investment funds will be covered by a GLWB rider or CDA guarantee and the conditions surrounding the allocation of a consumer's investment assets, change the frequency and amount of a guarantee fee, or reject additional contributions or transfers. Some insurers have recently raised fees on VA/GLWB guarantees or stopped accepting additional contributions to existing contracts in response to changing market conditions. Insurers generally cannot change the roll-up, step-up, or withdrawal rates for existing contract holders, but can make these changes prospectively for new customers.

²⁷There are various factors that determine the amount and timing of transfers, including the difference between an owner's account value and benefit base. Insurance company officials told us that owners who invest more aggressively can expect more frequent rebalancing than those who invest more conservatively.

Federal and State Oversight Varies by Type of Product and Is Currently under Industry Review

Federal disclosure and suitability regulations apply to the offer, recommendation, and sale of securities products such as variable annuities, including variable annuities with GLWB riders. While it has long been accepted that variable annuities constitute securities under the federal laws, because CDAs are a relatively new product, analysis under the federal securities law is less developed. However, SEC officials have said that CDAs currently being offered in the retail market are being registered as securities and are therefore covered by federal securities law and state insurance regulations. In addition, NAIC has developed annuity disclosure and suitability regulations for use at the state level, but state adoption and protection levels vary, so CDA consumers may not be uniformly protected. Further, questions about the adequacy of existing annuity regulation and the applicability of state insurance guaranty funds for CDA consumers if insurers become insolvent have prompted industry oversight reviews, which were ongoing as of October 2012.

Federal Disclosure and Suitability Regulations Apply to Registered Annuity Products

Federal disclosure and suitability regulations apply to the offer, recommendation, and sale of securities products such as variable annuities, including variable annuities with GLWB riders. These requirements aim to inform consumers about products and ensure that the products themselves are reasonably appropriate for consumers before they are purchased. As previously noted, while it has long been accepted that variable annuities constitute securities under federal law, CDAs are a relatively new product and analysis under the federal securities law is less developed.²⁸ To our knowledge, no court has addressed the securities law treatment of CDAs, and SEC has not provided written guidance with respect to the status of CDAs under the federal securities laws. However, according to SEC officials, existing CDAs have been registered under the Securities Act of 1933, absent specific exemptions from registration such as the exemption for contracts sold to certain types of tax-qualified retirement plans, and are therefore covered by federal securities law and state insurance regulations.

The 1933 Act generally requires issuers of securities that are offered to the public to register them with SEC and make certain disclosures through a prospectus that has been filed with SEC. The 1940 Act

²⁸ See *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967); *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) (variable annuities are securities).

generally requires investment companies, including separate accounts that fund variable annuities, to be registered under the Act. Pursuant to these requirements, SEC has issued rules and standards for prospectuses offering registered variable annuities. The purpose of these requirements is to ensure that investors receive descriptive information on basic product features, fees, benefits, and risks that can help inform their investment decisions.²⁹ Disclosures made through prospectuses filed with SEC under the federal securities laws are subject to the anti-fraud provisions of the 1933 Act, which prohibit material misrepresentations or omissions and provide a general anti-fraud remedy for purchasers and sellers of securities.³⁰

Since variable annuities, including those with guaranteed benefits, are securities, they must be offered and sold through registered broker-dealers. On the basis of anti-fraud provisions of the federal securities laws and FINRA rules, broker-dealers are required to deal fairly with their customers and only recommend securities to an investor that are appropriate for the investor based on his or her individual facts and circumstances. The suitability obligation is part of a broker-dealer's duty of fair dealing.³¹ SEC and FINRA rules also require communications used with investors to promote the offer and sale of variable annuities to be fair and balanced, not misleading, and to include certain disclosures regarding the risks and fees associated with these products. These rules include the following:

²⁹SEC Form N-4, the form used to register variable annuities with the SEC, is filed under the Investment Company Act of 1940 and the Securities Act of 1933 and subject to review by SEC staff. Part A of the form, the product prospectus, must present clearly written information about the contract and its costs, including information about annuity payments and death benefits. Part B includes information about premiums and underwriters, as well as insurance company and separate account financial statements. Part C contains information about directors and officers of the insurance company and indemnification, and a representation regarding contract fees.

³⁰See §17 of the Securities Act of 1933 (15 U.S.C. §77q); §10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)).

³¹SEC staff has recommended consideration of rulemakings that would apply a fiduciary standard to both broker-dealers and investment advisers no less stringent than that applied currently to investment advisers. The SEC staff also identified certain areas where laws and regulations that apply to broker-dealers and investment advisers differ, and recommended the Commission consider whether these areas should be harmonized for the benefit of retail investors. SEC Staff Study on Investment Advisers and Broker-Dealers As Required By Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2011), (Washington, D.C. January, 2011).

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- FINRA Rule 2090, which requires broker-dealers to ask about and retain essential information on each customer (“Know Your Customer”) and concerning the authority of each person acting on behalf of the customer.
 - FINRA Rule 2111, which requires broker-dealers to have a reasonable basis to believe that a recommended securities transaction or investment strategy is suitable for the customer based on information obtained through reasonable diligence of the broker-dealer or its associated person to ascertain the customer’s investment profile. This profile includes, but is not limited to the customer’s other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the broker-dealer or associated person in connection with the recommendation.
 - National Association of Securities Dealers (NASD) Rule 2210, which regulates broker-dealers’ communications with the public and applies to, among other things, variable annuity advertisements. Broker-dealers must file retail communications concerning variable annuities with FINRA and respond to comments provided by FINRA staff on such communications.³²
 - FINRA Rule 2330, specific to deferred variable annuities, which governs member broker-dealers’ compliance and supervisory responsibilities with respect to the recommendation of the initial purchase or exchange of deferred variable annuities, and initial subaccount allocations.

These requirements apply to the recommendation and sale of variable annuity products, including those with guaranteed lifetime withdrawal benefits. According to SEC officials, issuers of CDAs have been registering offerings of their CDA products with SEC, and SEC is reviewing the disclosures associated with these products. While we did not observe and were not told of any such instances, if CDAs were sold without being registered as securities, SEC could take action if it

³²FINRA, which formed in 2007, is in the process of converting the older NASD rules into its own rule book. Some rules have not yet been converted, and therefore retain the NASD label. FINRA rule 2210 replaces NASD Rule 2210 effective February 4, 2013.

determined that securities laws were being violated. If it were determined that federal securities laws did not apply to CDA offerings, relevant state regulations would still apply. In addition, FINRA officials said that they regulate member broker-dealers that offer variable annuity products, including variable annuities with GLWB riders. If a broker-dealer offers a CDA that is registered under the federal securities laws, FINRA also regulates the sale of such a CDA. If state insurance law issues arise in connection with a firm's sale of a CDA, FINRA staff may refer these issues to relevant state insurance regulators.

NAIC Has Developed Annuity Disclosure and Suitability Regulations, but State Adoption and Protection Levels Vary

The NAIC committee responsible for life insurance and annuities issues considers CDAs to be insurance products and has developed annuity disclosure and suitability model regulations for use by state insurance regulators. NAIC has developed these model disclosure and suitability regulations for annuity products in collaboration with consumer advocates and industry experts. However, unlike federal standards that are consistently applied to variable annuities regardless of where consumers live, state adoption of these model regulations varies, so protections may be stronger in some states than in others. In 2011, NAIC developed a model disclosure regulation for annuity products that serves several functions for consumers and insurers, including:

- helping ensure that consumers understand annuity products by explaining basic features, benefits, and fees;
- suggesting that annuity products with guaranteed income or benefit provisions are intended to be longer-term investment products;
- providing guidance for insurers when they choose to develop product illustrations intended to help consumers better understand how a particular annuity product works. In particular, the guidance provides illustration formats and specifies what kinds of illustration disclosures must be made when an insurer chooses to develop them; and
- requiring that annuity customers be provided or referred to NAIC's Annuity Buyer's Guide that also contains general product information and provides answers to basic questions about risks and investing that consumers can use to decide whether these products are right for them.

In addition to its model disclosure regulation, NAIC developed a model suitability regulation in 2003 to help ensure that insurers consider the financial needs and objectives of consumers and that these needs are appropriately addressed at the time annuity sales or exchanges occur. More specifically, the model suitability regulation requires insurers and insurance agents to inquire about consumers' suitability information and ensure that they have reasonable grounds to believe that annuity products would benefit consumers before recommending purchases or exchanges.³³ In 2006, NAIC revised the model regulation to expand its scope to consumers of all ages, and in 2010 the model regulation was again revised to further strengthen a number of annuity suitability protections. Among other changes, the 2010 revision requires insurers to

- be responsible for compliance with the model regulation whether or not they contract suitability functions out to a third party;
- maintain procedures for reviewing each investment recommendation made to consumers and helping ensure that the product is suitable for the particular purchaser and that the purchaser understands the annuity product recommended;
- ensure that insurance agents, or producers, complete general annuity training before selling annuity products; and
- provide product-specific annuity training and training materials to the agent or producer before an agent or producer can solicit the sale of a product.

In addition to these changes, NAIC adopted the revised the model regulation to set standards and procedures for suitable annuity recommendations and to require insurers to establish a system to supervise recommendations so that the insurance needs and financial objectives of consumers are appropriately addressed. The revised NAIC model regulation includes a "safe harbor" provision that is intended to prevent duplicative suitability standards from being applied to sales of

³³According to NAIC's model regulation, suitability information refers to information that is reasonably appropriate to determine the suitability of an annuity recommendation for a consumer, including the following: age, annual income, financial situation and needs, financial experience and objectives, intended use of the annuity, financial time horizon, existing assets, liquidity needs, liquid net worth, risk tolerance, and tax status.

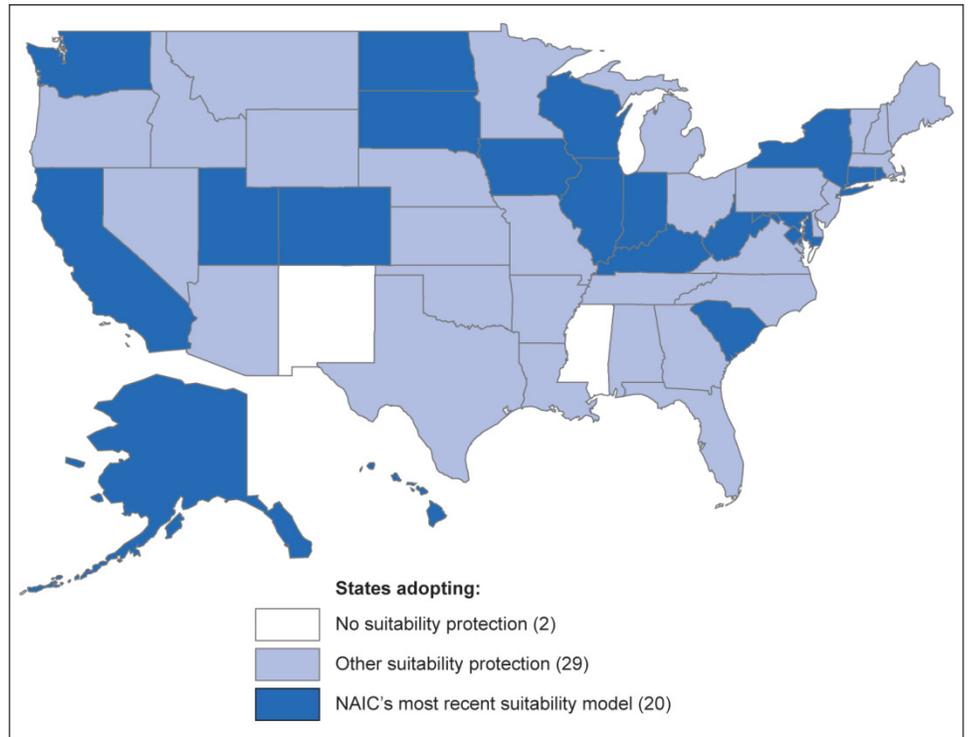
annuities through FINRA member broker-dealers. Annuity sales made in compliance with FINRA requirements are deemed to comply with the suitability requirements outlined in NAIC's model regulation. Violations of state law developed from the model regulation can result in remedies for consumers and penalties for insurers and agents. Under the model regulation, state insurance commissioners can require reasonably appropriate corrective action for violations that have harmed consumers.

NAIC information shows that, as of October 2012, state adoption of NAIC's disclosure and suitability regulations varied significantly, meaning that consumers in some states may not be protected as well as those in other states.³⁴ According to NAIC, many states have adopted some form of annuity disclosure regulation, although some states and the District of Columbia do not have disclosure protections in place. As of October 2012, officials are working to determine which states had adopted the revised model disclosure regulation.³⁵ In terms of the suitability model regulation, 19 states plus the District of Columbia have adopted NAIC's most recent model regulation that incorporates the added protections noted above, and another 29 states have adopted other suitability protections for annuity consumers. The remaining 2 states do not have suitability regulations in place. According to NAIC officials, model disclosure and suitability standards are not required as part of NAIC's accreditation program. Figure 2 summarizes the state adoption of suitability regulations.

³⁴According to NAIC officials, NAIC has not collected nationwide data on which states allow the sale of CDA sales, so we were unable to determine which states allow CDA sales but have not adopted disclosure and suitability regulations.

³⁵According to NAIC officials, "other suitability protection" includes but is not limited to adopting earlier versions of the NAIC model suitability regulation, or developing legislation or regulations derived from other sources such as bulletins and administrative rulings. For the purpose of this study, we reviewed NAIC's model disclosure and suitability regulations, but did not review states' other disclosure or suitability protections.

Figure 2: State Adoption of Suitability Regulations as of October 2012



Sources: GAO analysis of NAIC data; MapInfo.

Whether or not states have adopted NAIC disclosure and suitability regulation is important for CDA consumers. Unlike federal regulations that apply to the sale of VA/GLWBs nationwide, disclosure and suitability regulations for CDAs may depend on the actions of individual states and the extent to which they have implemented these protections. According to NAIC, regulatory action by states can time to occur and depends on legislative cycles and the political environment of states. As the

information in figure 2 shows, consumers across states are subject to different suitability protection and in some cases to no protection at all.³⁶

The different regulatory approaches among the sample of seven states we reviewed also show the variation in regulation of CDAs across states. Although most states in our sample have not specifically approved CDA sales, most have adopted some form of disclosure and suitability regulation for annuity products. Among these seven states, three have adopted NAIC's model disclosure regulation and three have adopted NAIC's most recent suitability regulation. For the states that allow CDA sales, the consumer protections found in the model regulations are critical. Of the two states that allow CDA sales—Iowa and Ohio—both have adopted NAIC's model disclosure regulation, but only Iowa has adopted its most recent model suitability regulation. Ohio, according to NAIC information, has passed a previous version of NAIC's model suitability regulation, and therefore has not adopted added protections found in the revised model regulation as outlined above. Consumers in states that have not adopted NAIC's model regulations may not be benefitting from available disclosure and suitability protections. More specifically, states that have not adopted the most recent model suitability regulations may not be extending to consumers protections developed through NAIC's 2010 suitability revision. Table 1 shows the variation in the disclosure and suitability protections across our seven sample states.

³⁶In prior work that was designed to provide insights for the development of a federal financial services regulatory framework, we highlighted the importance of, among other things, providing consistent consumer protections for similar financial products and services. See GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, [GAO-09-216](#) (Washington, D.C.: Jan. 8, 2009). In a report looking at regulation of the insurance industry, a function carried out by the states, we pointed out the importance of state regulation supporting the goals of this framework. See GAO, *Insurance Reciprocity and Uniformity: NAIC and State Regulators Have Made Progress in Producer Licensing, Product Approval, and Market Conduct Regulation, but Challenges Remain*, [GAO-09-372](#) (Washington, D.C.: Apr. 6, 2009).

Table 1: CDA Consumer Regulations in Sample States, as of October 2012

Sample state	CDA sales approved	Model disclosure regulation adopted	Other disclosure protection adopted	Most recent model suitability regulation adopted	Other suitability protection adopted
California				X	
Florida			X		X
Iowa	X	X		X	
New Jersey			X		
New York			X		
Ohio	X	X			X
Utah ^a		X		X	

Sources: GAO and NAIC.

Note: According to NAIC, “other disclosure protection” and “other suitability protection” used in this table include but are not limited to adopting earlier versions of the NAIC model regulation, or legislation or regulation derived from other sources such as bulletins and administrative rulings.

^aState insurance officials with whom we spoke from Utah were unsure whether CDAs had been sold there because Utah is a “file and use” state that does not require state review of insurance products before they are sold. However, Utah officials said that they did not believe that CDAs were being sold in their state.

Regulatory Uncertainty and Concerns about CDA Regulation Have Prompted Industry Oversight Reviews

Some industry participants suggest state insurance regulation and existing actuarial guidance may adequately address risks to insurers offering CDAs and to consumers. Others said that CDAs may pose solvency risks for both because insurers offer consumers an income guarantee but do not maintain the assets on which the guarantees are made. One major insurer has said that CDAs pose significant enough pricing and reserving challenges that it does not offer CDAs. In addition, two consumer advocates with whom we spoke highlighted the solvency risks CDAs pose for insurers. One advocate suggested that reasonable and appropriate insurer reserving and capital requirements do not currently exist for CDAs and that considerable NAIC and state regulatory work would be needed to develop them. The same advocate said selling CDA products before key issues concerning the regulatory framework are finalized might expose consumers to risks that might result from an insurer’s potential insolvency. The advocate concluded that the potential for insurers to increase the marketing and sale of CDAs, given the growing needs of retirees, makes having consumer and insurer protections in place important.

Potential risks to CDA consumers and insurers have prompted industry oversight reviews of these products and their regulation. Although NAIC has determined that CDAs are a life insurance product, it is working with state regulators, insurers, and consumer advocates through its CDA Working Group, formed in March 2012, to build greater consensus around the classification of CDAs and to determine whether any adjustments to state regulation might be appropriate. In particular, NAIC is evaluating the adequacy of existing state annuity laws and regulations for CDA sales, including those on insurer solvency such as capital adequacy and reserve requirements. According to NAIC officials, both NAIC and state insurance regulators recognize the complexity of CDA products for consumers and are also working to revise disclosure and suitability practices where appropriate.

Another industry review by the NOHLGA, NAIC, and state insurance regulators aims to address whether CDA consumers are protected by state insurance guaranty funds in the event of an insurer's insolvency. According to NOLHGA officials, variable annuities are not covered by guaranty funds because they are indistinguishable from equity products. That is, they are not supported by assets in an insurer's general account, but by specific assets in separate accounts dedicated to the particular fund or funds chosen for the variable annuity. However, the officials said that guaranteed lifetime withdrawal benefits, which are now part of most variable annuity contracts, are distinct from the equity portion of a variable annuity and are generally covered by state guaranty funds. The officials said that while CDAs would also appear to have an equity portion and a guarantee portion, they have a committee studying the extent to which CDAs might be covered by state guaranty funds. Officials noted that even when the committee has reached a determination on guaranty fund protections, each state will have to reach its own conclusion about whether their particular guaranty fund laws allow for CDA coverage.

Agency Comments

We provided a draft of the report to SEC and NAIC and relevant excerpts to FINRA. Each provided technical comments that were incorporated as appropriate.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Chairman of the Securities and Exchange Commission, the Chief Executive Officer of the National Association of Insurance Commissioners, and other interested parties. In addition, the report will be available at no charge on the GAO website at <http://www.gao.gov>. If you or your staff have any questions about this report, please contact Alicia Puente Cackley (202) 512-8678 or cackleya@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix III.



Alicia Puente Cackley
Director
Financial Markets
and Community Investment

Appendix I: Objectives, Scope, and Methodology

To compare the features of variable annuities with guaranteed lifetime withdrawal benefits (VA/GLWB) and contingent deferred annuities (CDA), we analyzed specific insurance company products to obtain information on how the products function, including how investment gains and losses are treated, how withdrawal amounts are determined, and what happens when a consumer's investment account is depleted. We also interviewed insurance company officials to verify our understanding of their products, and VA/GLWBs and CDAs in general. We judgmentally selected the companies based on criteria that included their market share of variable annuity sales and their decisions to sell or not to sell CDAs. To identify potential benefits and risks to consumers, we analyzed the product information we obtained and also interviewed insurers, consumer advocates, and state insurance regulators. To understand the potential risks these products pose to insurers and how they manage these risks, we also interviewed NAIC officials and reviewed information from insurers and stakeholder groups. We also obtained data from industry organizations on the sale of annuity products with guaranteed lifetime withdrawals. We discussed the sources and reliability of the data with officials from these organizations and found the data sufficiently reliable for the purposes of this report.

To determine how VA/GLWBs and CDAs are regulated and the extent to which regulation addresses identified concerns, we identified regulations and processes used by federal and state regulators, as well as any proposed regulations, and compared them with the risks to consumers that we identified as part of the work under the previous objective. Our review of state regulation included model laws developed by the National Association of Insurance Commissioners (NAIC), specific state regulations, and Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) rules. We selected the sample of states for our analysis based on the volume of sales of VA/GLWBs and CDAs in the state, whether the state allowed the sale of CDAs, and the state's population. We interviewed NAIC, state, SEC, and FINRA officials to determine how VA/GLWBs and CDAs are regulated. We also interviewed other stakeholder groups, such as consumer advocates and industry organizations, to gain their perspective on issues related to regulation of lifetime income products considered in our review.

We conducted this performance audit from February 2012 to November 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: GAO Contact and Staff Acknowledgments

GAO Contact

Alicia Puente Cackley, 202-512-8678 or cackleya@gao.gov

Staff Acknowledgments

In addition to the contact named above, Patrick A. Ward (Assistant Director), Emily R. Chalmers, Nima Patel Edwards, Scott E. McNulty, and Steve Ruszczyk made key contributions to this report. Also contributing to this report were Pamela Davidson, Marc Molino, Patricia Moye, and Frank Todisco.

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