The Fight to Control Fixed Index Annuities

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For the past year, insurance and investment big-money players have been involved in a heated battle as part of the ongoing war to see who will dominate the financial services industry. All the big guns have been pulled out for this battle. Special interest groups, industry associations, regulatory agencies, the media, lobbyists and public relations armies have been deployed.

Under the guise of consumer protection, but, more likely, in search of publicity and higher office, Massachusetts Secretary of the Commonwealth **William Galvin**, inserted himself into the fray.

What's all the fuss about? Thirty billion in annual sales of fixed index annuities (FIAs), also known as equity index annuities (EIAs). This product wasn't even on the market a decade ago, yet has become the flashpoint for a much larger conflict.

The real issue is an effort to determine which sector of the financial services industry—be it banks, insurance companies or investment firms—will control the distribution of these financial products. And, that involves trillions of dollars.

If consumers understand how the game is truly played, they can make more informed decisions as to how and where to spend their money. Unfortunately, how this battle has unfolded thus far can only result in consumer confusion, and under that scenario, everyone loses.

I have been there since the beginning; I was involved in the early development and introduction of the FIA and now serve on the board of the largest manufacturer of FIAs.

During the 1990s, traditional fixed annuities experienced exceptional growth and consumer acceptance to help preserve and accumulate funds. The increase in sales of fixed annuities attracted criticism, mainly from the same people attacking the FIA today. They argued that interest rates credited to the funds deposited were too low and that policyholders were at the mercy of the insurance company, because once the funds were deposited, the insurance company could capriciously lower the credited interest rates.

To counter this criticism, in the late 1990s, the insurance industry developed the FIA, which is akin to existing fixed annuities, albeit with a creative twist. Instead of the company deciding on the amount of any "excess" interest credited to the value, FIAs track a specific independent index in order to determine the effective interest rate.

And, unlike investments or variable annuities, with the FIA policy, no principal is ever invested directly in equities or put at risk. Rather, a small fee is charged against the funds and used to purchase "interest rate hedge options" tied to a specific index such as the S&P 500. If the index goes up, interest credited to the FIA also increases; however, if the index declines, the policyholder is out the cost of the option. However, unlike an investment, there is no loss of principal when markets decline.

Following the stock market crash of 2000 and as consumers were exposed to the potential benefits of FIAs, sales soared. A key ingredient to this story—in reality the core of all the commotion—is that, due to the market crash of 2000, investment advisers who had rarely if ever offered fixed annuities to clients began to offer the FIA as an alternative to poorly performing invest-

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ments. This may have been prudent action on the part of the investment adviser to protect the assets of their clients, but it created a problem.

Since the FIA is an insurance product, registered reps sold the product through insurance companies rather than their broker/dealer organization. Moreover, when investment advisers sell insurance products rather than investments, then the insurance companies or independent marketing organizations compensate the advisers. That takes money out of the pockets of the broker/dealers.

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Investment firms had no problems with the FIA when the stock market was flying high and the FIA was but a blip in the radar. However, as the FIA became increasingly popular with registered reps and consumers, broker/dealers began efforts to recapture that lost revenue.

NASD broker/dealers took a creative approach to accomplish this objective. In simple terms, they didn't argue that the FIA was a bad product, presumably to preserve future sales if they gained control of the product. Their strategy was to argue that the FIA was so complicated that only they could supervise FIA sales and protect the consumer from misrepresentation.

It's a potent argument. Give credit to the investment community. After all, it has done a great job clouding the real issue and convincing regulators, the media and even some insurance companies (the ones who missed out on the FIA boom), to jump on the bandwagon attacking the FIA.

Insurers are far from innocent when it comes to how the FIA has been developed and disclosed. Shortsightedness on the part of some insurance companies in selling FIAs has helped open the door for the investment community and the media to attack the product. But, that is the point: The real problem with the FIA is how some may have misused it, not, as many critics would have us believe, the inherent structure of the product itself.

To be honest, the problems started with the name equity index annuity. Early sellers of the product came up with that moniker because the product was designed as an alternative to investment products. Further, the name itself hearkens to a sophisticated investment product. Next, in positioning the FIA as an alternative to investments, some insurance companies made the mistake of marketing the product almost as if it were an investment. Trying to make and market a product to look or act like something it isn't is a mistake that can come back to haunt you. For the insurance industry, it has.

The insurance industry and the consumer would have been better served if the product had been called what it is: an interest indexed fixed annuity. Now, most companies have recognized the error of their ways and refer to it either as an FIA or index annuity.

The real value of the FIA is as an alternative to both the traditional fixed annuity and investments, and it should be marketed and positioned as such. The insurance industry needs to do a better job of explaining the details, benefits and uses of the FIA. In simple terms, it boils down to disclosure and suitability.

As with most financial products, the FIA is complicated. The insurance industry should have recognized the complexity of the product and made a concerted, clear and detailed effort to fully disclose the workings, fees and expenses of the policy. If you have nothing to hide, then there should be no problem with full and transparent disclosure. The failure on the part of some companies to properly position and disclose the facts of their FIAs has provided critics and competition alike with an opening to misrepresent and attack them.

The FIA, like most insurance and investments products, is long-term in nature. This puts the onus on the company and salesperson to properly disclose and determine the suitability of the product for the buyer's circumstances and needs. The insurance industry needs to do a better job of disclosing,

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training and supervising suitability issues regarding the FIA. Failure to fit suitability with the needs of the consumer is not the fault of the product, but the responsibility and fault of the issuer.

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