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Annuities

Getting Down and Dirty in the Financial Services War: The Attack on EIAs

by Robert W. MacDonald

For almost a year, the big-money players have been in a heated battle to dominate the financial services industry. The real issue is whether banks, insurance companies, or investment firms will control the distribution of financial products involving trillions of dollars.

It's not the normal competitive jockeying between companies and opposing sectors of the financial services industry. It is a "down-in-the-dirt, lie if you have to, deceive when you can, and misrepresent always" type of activity that has not been seen in these parts for over a quarter of a century.

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. No lesser scribes than The Wall Street Journal and The New York Times have offered running accounts of the battle.

This activity has so clouded reality that even politicians can sense an opening. Secretary of the Commonwealth of Massachusetts, William Francis Galvin, has inserted himself into the fray under the guise of consumer protection. But, more likely he's in search of publicity and higher office.

The flash point for this battle is a single insurance product that was not even on the market a decade ago – the equity-indexed annuity (EIA). In the past five years, the EIA has become the fastest growing product in financial services.

In the interest of full disclosure, I admit to being involved in the early development and introduction of the EIA product and I serve on the board of the largest seller of the equity-indexed annuity. This experience enables me to better offer observations about the product and the battle being waged.

A simple definition of a fixed annuity and the equity-indexed annuity is in order. A fixed annuity is an insurance product that enables people to accumulate funds on a tax-deferred basis for later payout as income. Since there is no risk of loss of principal, it is an insurance product, not an investment. The funds deposited in a fixed annuity increase in value based on a minimum guaranteed interest rate and an excess interest rate, which may be declared by the company.

The equity-indexed annuity is a fixed annuity that offers the potential of higher values because future effective interest rates are tied to the performance of a particular index – most often the S&P 500. As with traditional fixed annuities, all funds deposited in the EIA annuity are guaranteed against loss.

Historical Background

During the 1990s, traditional fixed annuities experienced exceptional growth and consumer acceptance as a way to help preserve and accumulate funds. But, the increase in fixed annuity sales attracted criticism, mainly from the same people who have attacked the EIA today. They complained that interest rates that were credited to the funds deposited were too low. Critics also said that the policyholder was at the mercy of the insurance company that could capriciously lower the credited interest rates once the funds were deposited.

The insurance industry developed the EIA to counter this criticism. The EIA is like fixed annuities, but with a creative twist. Instead of the company deciding on the amount of excess interest credited to the value, an independent index would be used to determine the effective interest rate.

Unlike investments or variable annuities, no principal is ever invested directly in equities or put at risk with the EIA policy. Rather, a small fee is charged against the funds, which is 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 EIA also increases. If the index goes down, the policyholder is out the cost of the option (since it had no value). However, unlike an investment, there is no loss of principal when markets decline.

Introduced in the late 1990s, the EIA started slowly. However, with the stock market crash of 2000 investment advisors who had rarely offered fixed annuities began to offer them to clients as an alternative to poorly performing investments. Sales soared as consumers saw the potential benefits of the product.

Since the EIA is an insurance product, investment advisors sold it through insurance companies rather than through their broker dealer organizations. When investment advisors sell insurance products rather than investments, the insurance companies compensate the advisor and not the investment firms. That takes money from the investment company's pockets. The investment muckety-mucks had no problems with the EIA when the stock market was flying high and the EIA was just a blip on the radar. But, as the EIA became increasingly popular with investment advisors and consumers, broker dealers began their efforts to recapture that lost revenue.

NASD broker dealers took a creative approach to fighting EIAs. They wanted to preserve future sales if they gained control of the product, so they did not say that the EIA was a bad product. They argued that the EIA was so complicated that only they — the broker dealers — could supervise the sale of the product and protect the consumer from misrepresentation. If any group can recognize misrepresentation, it's the leaders of our investment community. After all, they have done a great job of clouding the real issue and convincing regulators, the media, and even some insurance companies (the ones that missed out on the EIA boom), to jump on the bandwagon in attacking the EIA product.

The Insurance Industry Gave Them the Sword

The real problem with the EIA is not in its inherent structure, as many critics would have us believe, but in how some may have misused it. Shortsightedness among some insurance companies has helped open the door for the investment community and the media to attack the product.

The problems start with the name "equity-indexed annuity." Early sellers of the product came up with the EIA name because it was an alternative to investment products. An "equity-indexed annuity" sounded like a sophisticated investment product. Next, by positioning the EIA 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 as if it is something it isn't is a mistake that can come back to haunt you.

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." The real value of the EIA is that it provides an alternative to traditional fixed annuities and investments; it should be marketed and positioned as such. The insurance industry needs to do a better job explaining the details, benefits, and uses of the EIA product. It is called "disclosure and suitability."

As with most financial products, the EIA is complicated. The insurance industry should have made a concerted effort to fully disclose the workings, fees, and expenses of the policy. If you have nothing to hide, there should be no problem with full disclosure. When some companies failed to position and disclose the facts properly, critics and competition got an opening to misrepresent and attack the product.

Like most insurance and investments products, the EIA is long term in nature. This puts the onus on the company and salesperson to properly disclose the facts and determine the product's suitability for the buyer. When it comes to suitability issues, the insurance industry needs to do a better job of disclosing, training, and supervising. Failing to provide a product that is suitable to the consumer's needs is not the product's the fault, but the issuer's fault.

If the insurance industry cleans up its act in positioning and marketing the EIA product, critics will be neutralized and the EIA can play its proper role as a valuable alternative to the traditional fixed annuity and full-fledged investment products.

Getting Down to Specifics

Attacks against the EIA usually take the following form: the products are too complicated for the salesperson and consumer to understand; they are not good investments; the consumer does not know what return they will receive; and there are exorbitant fees, commissions, and surrender charges.

The heart of the criticism is that the EIA is complicated and difficult to understand. Of course it is. If that were the criteria for damning the product, virtually all financial products would have to be pulled off the market by now.

Name one financial product that's not complicated and difficult to understand – from free checking accounts, to homeowners policies, to hedge funds. Why do you think the disclosure material for the sale of a mutual fund is longer than the New Testament? Do you know anyone who can adequately explain the limits and benefits of their homeowners' policy? If they can, is that the type of fun person you want to be around?

The issue is not that the EIA is complicated. The issue is disclosing the nature of the product so the consumer can make an intelligent decision. Many in the insurance industry have not done the best job of proper disclosure. Since the EIA is an insurance product, insurance companies logically (if there is any logic left in this battle) should be the best source of disclosure. It is on the far side of disingenuous for broker dealers and investment firms to claim that they are best suited to supervise the sale of the EIA when they say they have experience with the proper disclosure of complicated products. It is a little like arguing that criminals should be the ones to guard other criminals because they know how criminals think. There must be some reason why each security sale is subject to mandatory arbitration.

The Critics Are Right – the EIA Is Not a Good Investment

Another common criticism is that the EIA is not a good investment. Critics are quick to point out that the EIA does not come close to keeping pace with the S&P 500, true indexed funds, or even run-of-the-mill mutual funds. For this reason alone, they say the product is bad and should not be sold or purchased.

However, the reason the EIA is not a good investment is that it is not an investment, but an insurance product. It is blatantly dishonest to compare the EIA to a mutual fund or the S&P 500. The EIA is not a mutual fund and it is not designed to track the S&P 500. The S&P is only used as an index for interest rate options, not where funds are invested. Comparing an EIA to a mutual fund, which media and critics like to do, is about as appropriate as comparing a race horse to a race car. Both of them are racers, but they are designed for different types of races. It is more rational to compare the EIA to the traditional fixed annuity; the EIA does quite well under such a comparison.

The insurance industry has only itself to blame for these misleading comparisons. Some companies have had marketing materials that inappropriately positioned the EIA as offering the benefits of an investment product without the risk.

Another complaint is that the consumer does not know what return they will receive. Are you kidding me? It is amazing how the investment types have convinced media and regulators to buy into this. Only members of an industry that sells products in which the buyer has no idea what the return will be can get away with criticizing another product for not guaranteeing the return.

One return the buyer of an EIA knows is a guarantee that they will get all their money back. No investment product can make that claim. It's true that the buyer does not know what the rate of return on the principal will be with the EIA, but that is only because future interest rates, to which the product is indexed, are not known.

Critics also say that rates, fees, commissions, and surrender charges are exorbitant for EIAs. How do you define exorbitant? Is it exorbitant to have a 200% markup on jewelry, a 7% commission on the sale of a home, a 3% commission on the trading of stock, or a 10% commission on a homeowner's policy? If we believe a salesperson's commission is exorbitant, we can shop around for a better deal.

Criticizing the sale of the EIA on the basis of fees and commissions is a classic, misleading attack. It is like trying to prove that all men are abusive to their spouses by interviewing women living in a halfway home for abused spouses. Critics overwhelmingly cite two companies in order to prove that all EIA fees and commissions are exorbitant. These companies have the highest fees in the industry, but they are far from the majority. Neither of these companies ranked in the top 10 of best selling fixed annuities in 2005. There are scores of other companies offering the product with lower commissions and fees. The consumer has options and should do a little shopping or work with an independent agent who will to find the best deal.

Another favorite target involves policy surrender charges. Bear in mind that the critics only cite the highest company surrender charges. Surrender charges are tied to the long-term nature of the policy -- much the same as a penalty for early withdrawal from long-term bank CDs. If insurers guarantee a long-term return, the investments backing the policy must be invested long-term. Without surrender charges, the funds become short-term demand deposits. That would require the insurance company to invest in short-term funds to meet unknown potential demand for funds, thus reducing the return to long-term policyholders.

In the event of emergencies or other financial needs, most companies give policyholders a number of options to use the funds without triggering surrender charges. Some companies even waive surrender charges completely if the funds are taken as income or upon death. It is vital to reiterate the importance of disclosing all fees or charges so the consumer can compare them to make an intelligent decision.

Another criticism is in caps and participation rates. A cap is a limit to how high interest rates will go up based on the growth of the S&P 500. Let's say the policy has a cap of 7%. The growth of the S&P up to that cap is fully credited, but nothing above that amount. A participation rate is the percentage of the S&P index growth that is credited to the EIA. For example, a 50% participation rate means that 50% of the index growth is used to determine the credited rate to the EIA no matter how much it grows.

EIA critics say the insurance company is free to change these complicated and confusing caps and participation rates anytime, so the consumer doesn't know what they will receive in values. This criticism is misleading. These caps and participation rates are in place to reduce and control the fees charged against the EIA.

It is not possible to predict movements in interest rates. In order to sell an annuity product that tracks interest rates, the insurance company must purchase hedges or options on future interest rate movements. Like all options, they have a cost. The cost increases or decreases depending on the likelihood of the options being in the money at the time they are purchased. For example, if interest rates are on a rising trend, then hedges or options purchased to participate in rising rates are more expensive because the likelihood of payout is higher. Conversely, options purchased in a declining interest rate environment would be less expensive.

A fixed percentage fee is allocated for purchasing these options. The fee is fixed while the price of the options is moving constantly. So, the benefits that the options provide become variable. This indeterminate future price of interest options causes the caps and participation rates to change. The alternative would be to constantly change the fees charged to the EIA, which would really create a firestorm from the critics.

The EIA has proven to be an attractive consumer alternative to traditional fixed annuities and some investments. The investment sector and insurance companies that are not selling the EIA are attacking it rather than developing a viable alternative. It is a little like trying to win a race by shooting the other competitors! Unfortunately, the real loser in this strategy is the consumer who can become confused by such approaches and may have fewer financial solutions from which to choose.

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