GUEST COLUMN

A War Over Annuities

BY ROBERT W. MACDONALD

Big insurance and investment players are engaged in a heated battle as part of the ongoing war for domination of the financial services industry. But this is not just the normal competitive jockeying that goes on among companies and opposing sectors of the industry. All the big guns are out—special interest groups, industry associations, regulatory agencies—and lobbyists and public relations armies have been deployed. It's been covered in the *Wall Street Journal* and *New York Times*.

What's all the fuss about? It's simple: big bucks, numbering $30 billion a year and growing. But there's more. What's really at stake is determining which sector of the financial services industry—be it banks, insurance companies or investment firms—will control the distribution of financial products. And that means trillions of dollars.The flash point for this battle, however, is a single insurance product that was not even on the market a decade ago. It is the equity-indexed annuity (EIA), which in the past five years has become the fastest-growing product in financial services. (Full disclosure: I was involved in the early development and introduction of the EIA and currently serve on the board of the largest seller of the product, and I offer my observations from that vantage point.)

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With a nod to Carl von Clausewitz, the Prussian whose *Principles of War* is a classic in military strategy, exploring the battle over the EIA can provide an interesting insight into how the big boys battle for big bucks. 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, the way this battle has unfolded thus far can only result in marketplace confusion, and under that scenario everyone loses.

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A fixed annuity is designed to enable individuals to accumulate funds on a tax-deferred basis for later payout as income. It is an insurance product—not an investment—because there is no risk of loss of principal. Funds deposited in a fixed annuity increase in value based upon a minimum guaranteed interest rate and an additional "excess" interest rate that may be declared by the company.

The equity-indexed annuity is a form of fixed annuity that offers potentially 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 are still guaranteed against loss.

During the 1990s, traditional fixed annuities experienced exceptional growth. The increase in sales attracted criticism that interest rates were too low and the policyholder was at the mercy of the insurance company, which had the power to lower the credited interest rates. The EIA was developed to counter these concerns. Instead of the company deciding on the amount of any excess interest credited to the value, a specific independent index would be tracked in order to determine the effective interest rate.

Unlike investments or variable annuities, no EIA principal is ever invested directly in equities or put at risk. Rather, a small fee is charged against the funds and is used to purchase "interest rate hedge options" tied to a specific index. If the index goes up, interest credited to the EIA also increases. If the index declines, the policyholder is out the cost of the option (since it had no value). There is no loss of principal when markets decline.

Introduced in the late 1990s, the EIA started slowly. With the stock market crash of 2000, and as consumers were exposed to the potential benefits of the product, sales soared. The reason for the ensuing conflict is that investment advisers who had rarely offered fixed annuities to their clients began to offer the EIA. This may have been prudent action on the part of the advisers to protect client assets in the face of poor market performance, but it created a problem. As an insurance product, the EIA was sold through insurance companies rather than broker-dealers. The advisers got compensated by the insurance companies, and money was taken out of the pockets of the investment companies, which didn't like it.

The equity-indexed annuity is the flash point in a battle to determine which sector of the financial services industry will control the distribution of financial products.

The securities industry had no problems with the EIA when the stock market was flying high and the EIA was but a blip on the radar. However, as the EIA became increasingly popular with investment advisers and consumers, broker-dealers began efforts to recapture that lost revenue.

Opening Shots

NASD-regulated broker-dealers took a creative approach. They did not argue that the EIA was a bad product. Their strategy was to argue that the EIA was so complicated that only they could supervise its sale and protect the consumer from misrepresentation.

It was a good argument. Based on what we have witnessed over the past few years, if any group should be able to recognize misrepresentation it's the leaders of our investment community. And give them credit for clouding the real issue and convincing regulators, the media and even some insurance companies (those that missed out on the EIA boom) to jump on the anti-EIA bandwagon.

Insurers, too, are far from pure when it comes to how the EIA has been developed and disclosed. Shortsightedness on the part of some insurance companies in selling the EIA product has given the investment community and the media an opening to attack the product. The real problem with the EIA 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 start with the name. Early sellers came up with the EIA name because the product was designed as an alternative to investment products. Further, "equity indexed annuity" sounded like a sophisticated investment product. Positioning it as an alternative to investments, some insurance companies made the mistake of marketing the EIA 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. 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 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 explaining the details, benefits and uses of the EIA. In simple terms, it is called disclosure and suitability.

As with many financial products, the EIA is complicated. The insurance industry should have recognized the complexity 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 the EIA has provided critics and competition alike with an opening to misrepresent and attack the product.

The EIA, being long-term in nature, puts the onus on companies and salespeople 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 supervising suitability issues. Failure to fit suitability with the needs of the consumer is not the fault of the product, but of the issuer. If the insurance industry cleans up its act regarding the positioning and marketing of the EIA, critics will be neutralized and the EIA can play its proper and valuable role as an alternative to both the traditional fixed annuity and full-fledged investment products.

Specific Attacks

The general arguments against the EIA, revolving around its complexity, are that: (1) it is too complicated for the salesperson and consumer to understand; (2) it is not a good investment; (3) the consumer does not know the return they will receive; and (4) the fees, commissions and surrender charges are exorbitant.

Let's take these one at a time. Of course it is complicated, but name one financial product that is not, whether it's a "free" checking account, homeowners insurance or hedge fund. If that were the criteria for damning a product or limiting its availability, then virtually all financial products would have to be pulled off the market.

The issue is not that the EIA is hard to understand; the issue is who best can properly disclose the nature of the product so that the consumer can make an intelligent decision. Many in the insurance industry have not done well at disclosure.

Not a good investment? Critics are quick to point out that the EIA does not even come close to keeping pace with the S&P 500, true index funds or even run-of-the-mill mutual funds. The critics are right—but the reason the EIA is not a good investment is that it is an insurance product that should not be compared with a mutual fund and 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.) That would be like comparing a racehorse to a racecar: Both are racers, but they are designed for different races.

The appropriate and more rational comparison for the EIA is to the traditional fixed annuity, against which the EIA actually does quite well.

Complaining that the consumer doesn't know the anticipated return falls into the category of the bigger the story you tell, the more it will be believed. It is amazing how the investment types have convinced media and regulators to buy into this line of criticism. Only members of an industry that only sells products where the buyer has no idea what the return will be can get away with criticizing another product for not guaranteeing what return the buyer will receive.

One assurance that the buyer of an EIA has—and no investment product can make the same claim—is the guarantee that they will get all their money back. True, the buyer does not know the rate of return on the EIA principal, but that is only because future interest rates, to which the product is indexed, are not known.

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As for pricing, what is the definition of exorbitant—a 200 percent markup on jewelry, a 7 percent commission on the sale of a home, a 10 percent commission on a homeowner's policy, a 3 percent commission on a stock trade? There are options; we can shop around for a better deal. The same is true with the purchase of an EIA.

Another favorite target of critics involves policy surrender charges. These are tied to the long-term nature of the policy—much the same as early-withdrawal penalties on bank certificates of deposit. If insurers are to guarantee a long-term return, then the investments backing the policy have to be invested long-term. Without surrender charges, the funds become, in essence, short-term "demand deposits," requiring the insurance company to invest in short-term funds and reducing the return to long-term holders.

In the event of emergencies or other financial needs, most companies afford the policyholder with a number of options to obtain use of the funds without triggering the surrender charges. Some companies even waive surrender charges if the funds are taken as income or at death. An important point to reiterate is that complete and open disclosure of any and all fees or charges enables the consumer to compare and make an intelligent decision.

Predicting future movements in interest rates is not possible, so 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, which increases or decreases depending on the likelihood of the options being in the money at the time they are purchased. Insurance companies use a fixed percentage fee that is allocated to the purchase of these options. With the fee charged for the purchase of the options fixed, and the price of the options constantly moving, the benefits provided by the options becomes variable. It is this indeterminate future price of interest options that causes the caps and participation rates to change. The alternative would be to constantly change the fees charged to the EIA, and that would really cause a firestorm from the critics.

The Real Battle

In most criticisms of the EIA, only part of the story is being told. It takes a full story, balancing all the issues, to make a truly informed decision.

We can keep circling the wagons to debate the good and bad points of the EIA. But that is not the real issue in this battle. It's really big bucks that are at stake here.

The EIA has proven to be an attractive consumer alternative to both traditional fixed annuities and some investments. The investment sector and those insurance companies not selling the EIA are responding by attacking the product rather than developing a viable alternative. That's a little like trying to win a race by shooting the other competitors.

Unfortunately, the real loser in the application of this strategy is the investor who not only can become confused by such approaches, but who potentially has fewer options from which to choose optimum financial solutions. ■