The Changing Face of Annuities Regulation: What Lies Ahead?

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Presentation Outline

I. Some Basic Annuity Categories

II. Currently, Who Regulates What?

III. Suitability: Focus on Consumer Protection

IV. What Lies Ahead: Regulation of Indexed Annuities

- Q & A

Some Basic Annuity Categories

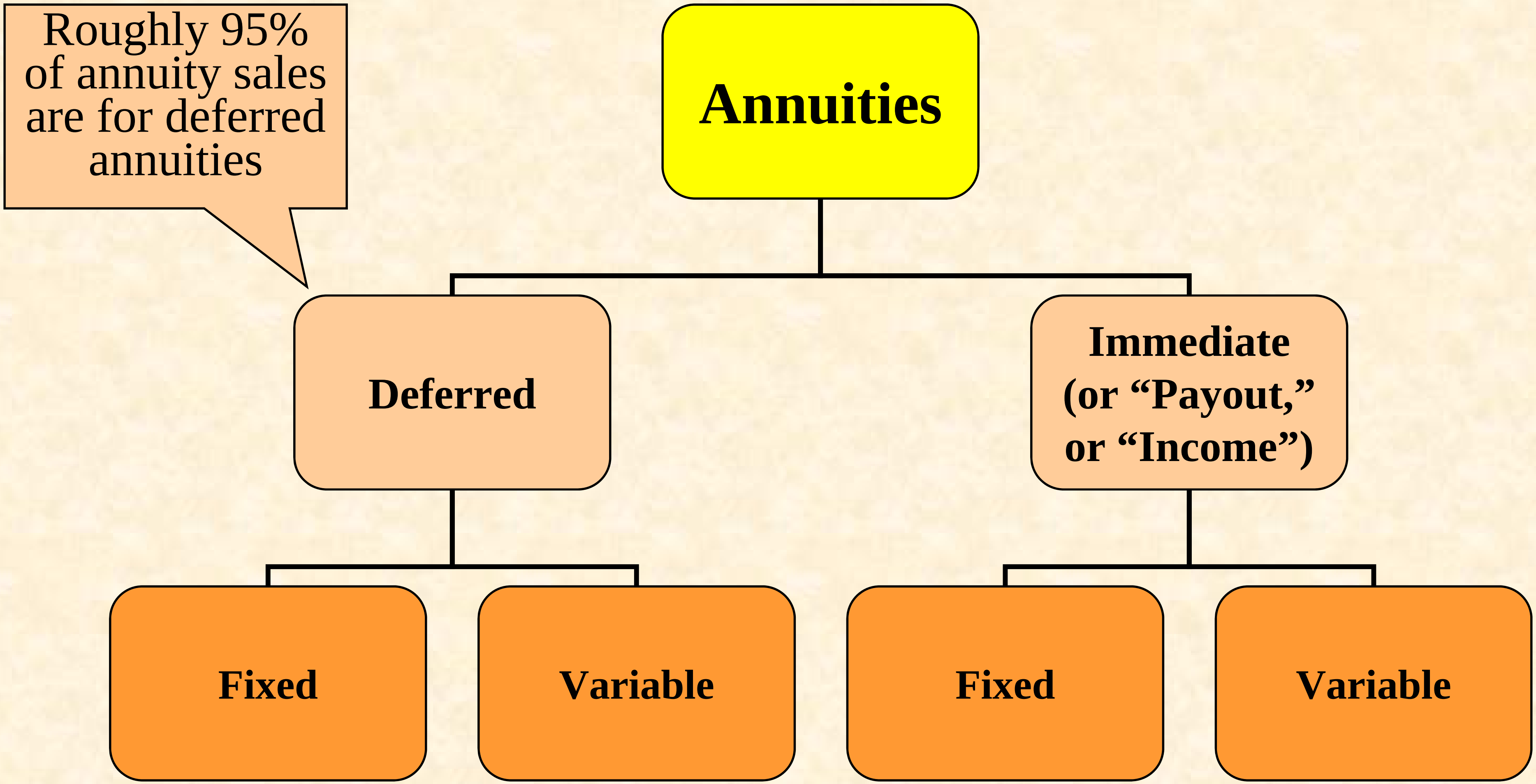
Deferred vs. Immediate
Fixed vs. Variable

People Are Hungry for Basic Information About Annuities

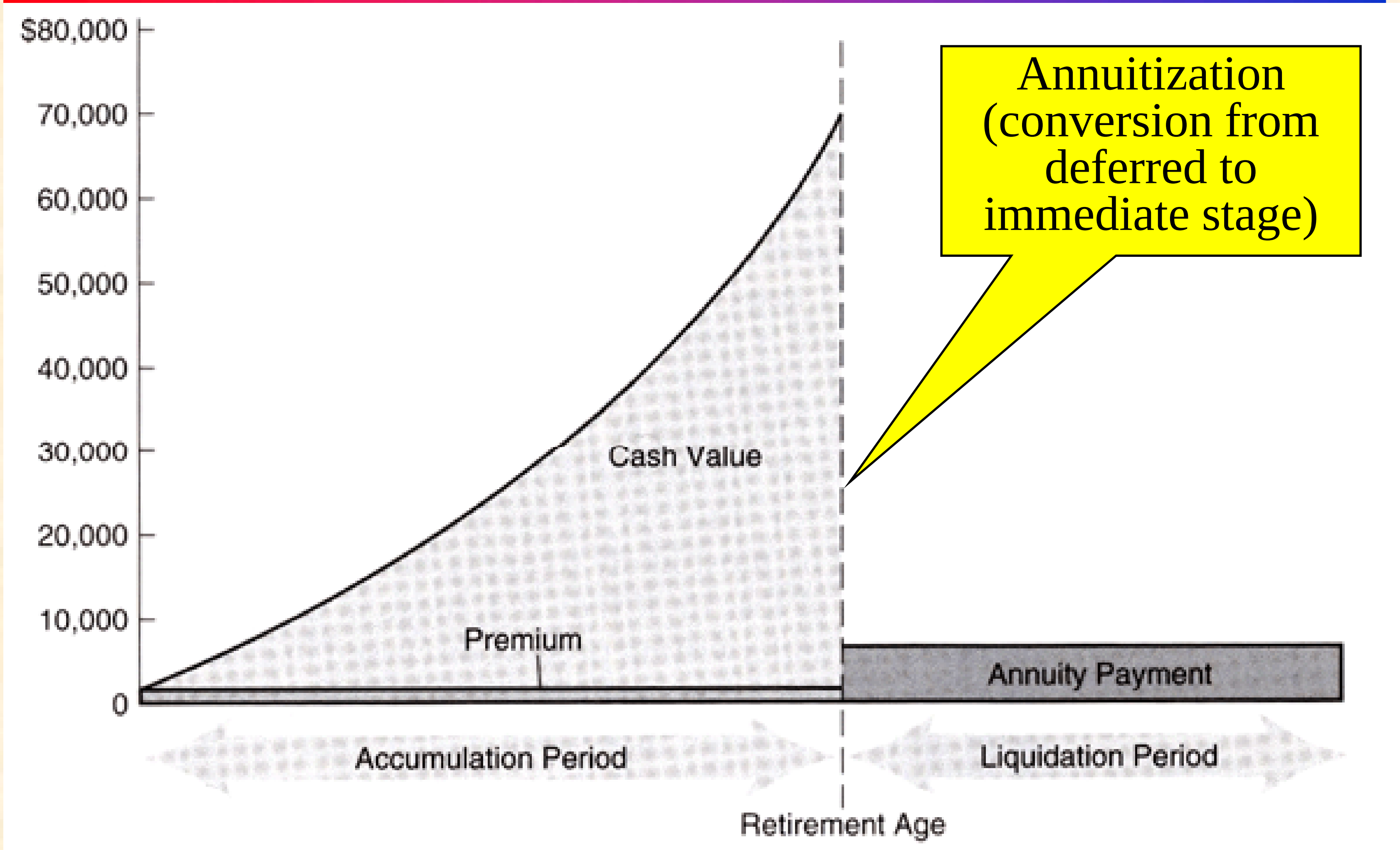
Rank	Top Keyword Search Categories	Search Terms	visits to I.I.I. web site in May 2008
1	Homeowners Insurance	Home insurance/home owners insurance/homeowners policy	6,927
2	Annuities	Annuity/what is an annuity/ what is annuity/ types of annuities	5,211
3	Insurance terms	Insurance glossary/insurance terminology/insurance terms dictionary	4,783
4	Disability Insurance	Disability	3,230

Source: I.I.I.

Types of Annuities, Classified by When Payments Begin, and Underlying Investment



One Product, Two Stages: A Deferred Stage, Then an Immediate Stage



Source: Black and Skipper, *Life & Health Insurance*, 13th edition, (Upper Saddle River, NJ: Prentice-Hall, 2000) p. 165.

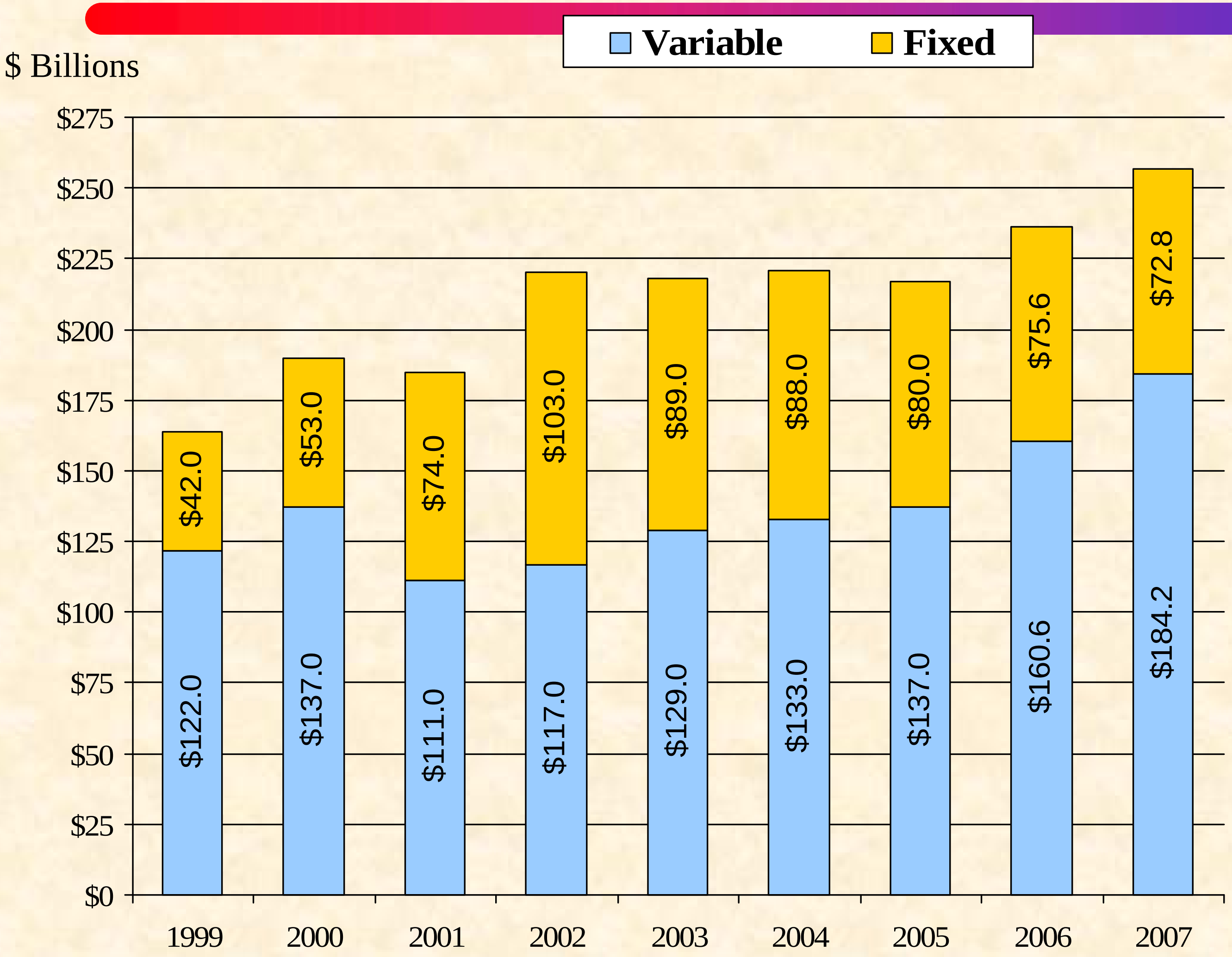
*Differences Between **Immediate** and **Deferred** Annuities*

Immediate Annuities	**Deferred Annuities**
Function: Paying out funds, usually for life	Function: Accumulating funds for future payout (mainly in a single sum, rarely as immediate annuity)
Usually funded by a single sum (can be from a deferred annuity)	Funded either by periodic contributions (premiums) that can be stopped or by a single sum
Once payout is started, cannot be stopped by annuity owner	Annuity can be surrendered, but this might trigger a withdrawal charge and/or income taxes

*Differences Between **Fixed** and **Variable** Annuities*

Fixed Annuities	**Variable Annuities**
Interest credited by insurer based on performance of its “general account,” mainly bonds	Investment results from performance of insurance company’s “sub accounts,” similar to mutual funds
Guarantees principal and a minimum interest rate	Original product: No investment guarantees Added feature: minimum investment guarantees
An insurance product, regulated by states	An insurance product ***and*** a security, regulated by states ***and*** SEC

Individual Annuity Sales, 1999-2007

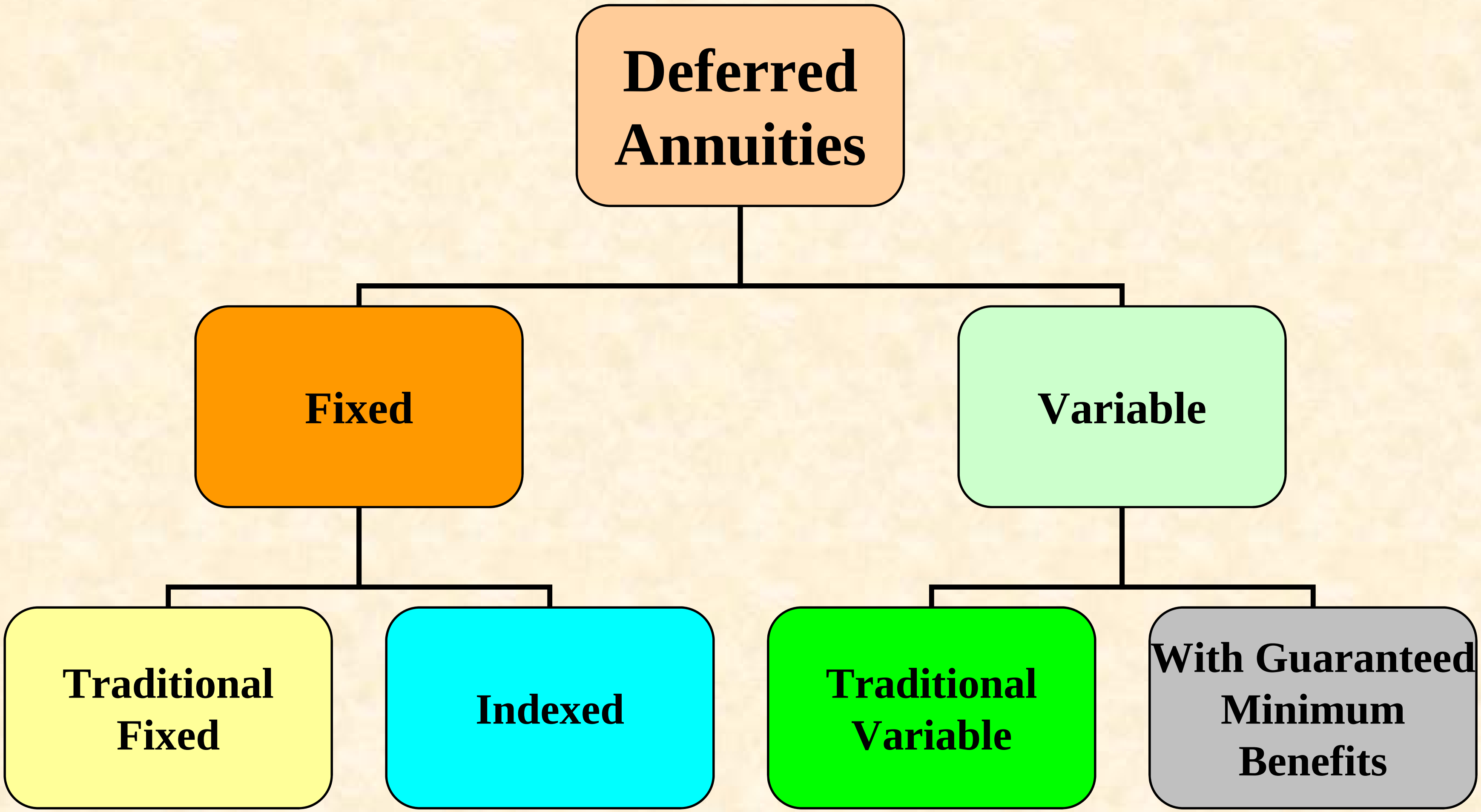


Fixed annuity sales doubled from 2000 to 2002 but have faded steadily since then.

Variable sales dropped after the stock market plunge in 2000 but recovered by 2004. **2006 was a record year, up 17%. 2007 was up 15% over 2006.**

Source: LIMRA International, as reported in *National Underwriter, L&H*, March 24, 2008, p. 8.

Deferred Annuities, Classified by Underlying Investment



Differences Between **Traditional Fixed** and **Indexed** Annuities

Traditional Fixed Annuities	Indexed Annuities
Interest credited by insurer based on performance of its “general account,” mainly bonds	Interest credited by insurer based on performance of an external index, typically S&P 500, subject to caps and floors
Guarantees principal and a minimum interest rate	Guarantees principal and a minimum interest rate
An insurance product, regulated by states	An insurance product, regulated by states, but SEC plans to regulate it also

Annuity Regulation

Currently,
Who Regulates What?

States Regulate Fixed and Variable Annuities

Annuities are insurance products because, in their immediate annuity stage, they involve "life contingencies"

- This means the benefit depends on how long someone lives
- As insurance products, they are regulated by the states
- State regulation of annuities covers
    - Minimum reserves
    - Contract provisions
    - Market conduct standards

Currently, the SEC Regulates Variable Annuities

- The SEC considers a variable annuity an *investment*, not an *insurance*, product
  - because the annuity owner retains the investment risk (unlike a fixed annuity, in which investment risk is transferred to the insurance/annuity company)
  - SEC regulation is in addition to state securities regulation, but states typically copy SEC requirements
  - SEC regulation of annuities covers
    - Market conduct standards

Who Regulates Indexed Annuities?

- Indexed annuities are fixed annuity products
  - When interest is credited, the credit is determined by the annuity company.
    - The determination uses a formula that the company can change.
    - The formula uses an external index, often the S&P 500
- As fixed annuity product, they're currently regulated by the states
- Even though indexed annuities
  - Determine investment growth by reference to a stock market index, and
  - May be sold partly on the "upside potential,"

they're *not* currently regulated by the SEC

Chart Shows Variation in Selected Indexed Annuity Features

Equity Indexed Annuities of the Month		
Midland National MNL Ten	**MarketPower Bonus Index Plus**	**Escalator 10**
10.00% Upfront Bonus	10.00% Upfront Bonus 100% Participation No Spread/Margin Fees	10.00% Bonus 100% Participation No Spread/Margin Fees
Retire X-Cel Rider Provides 7.50% Guaranteed Payment Balance Growth and Guaranteed Lifetime Income Payments	No Cap Rate Unlimited Upside Interest Potential	2.15% Monthly Cap Rate
10 Year Surrender Term	14 Year Surrender Term	10 Year Surrender Term
A+ (Superior) Rating from A.M. Best	A- (Excellent) Rating from A.M. Best	A (Excellent) Rating from A.M. Best
Product Profile	Product Profile	Product Profile
Request More Information	Request More Information	Request More Information
Agent Contracting	Agent Contracting	Agent Contracting

Source: www.annuityadvantage.com/eiabenefits.htm

Annuity Regulation

Suitability: Focus on Market Conduct (Consumer Protection)

What Does “Suitability” Mean?

It involves matching

- The customer’s characteristics, future plans for the policy and related financial matters, the customer’s circumstances, and
- A policy’s characteristics

Ideally, the policy should also be better suited for the customer’s needs than alternative financial products and/or arrangements.

Why Does Annuity Suitability Need to be Regulated?

- Annuities are products many people find hard to understand
  - Unlike other products that may entail large financial outlays (e.g., a car), people don’t repeatedly buy annuities over a lifetime and don’t gain buying experience
- Sales reps are generally compensated by commission, which is not required to be disclosed to the prospective buyer, creating a possible conflict of interest in the rep
- Once an annuity is bought, high and long-lasting withdrawal charges might make it costly to “unwind” the purchase

Why Does Annuity Suitability Need to be Regulated? (cont'd)

- Some annuities have quite high ongoing expense charges (just as some mutual funds and some other financial products do), but many buyers might not recognize that comparable products with lower charges are available
- Annuities have unique characteristics in the financial services world but they compete with products that don't have those unique characteristics

Who Decides What's Suitable? Two Philosophies

- Let the buyer decide what's suitable for him/herself
  - Provide full and clear disclosure of all relevant information related to an annuity

- Put the "burden" on the seller to sell only products that are suitable for the buyer
  - Specify types of information the seller must take into account
  - Require that the insurer review prospective sales for suitability

Implications of the Consumer-as-Decider Model

- An important—maybe critical—aspect of this model is the disclosure of information to consumers. For the model to be effective, disclosure must be
  - Easy to understand by people with little financial background
    - Avoid jargon; use plain English
    - Use clear, attractive format
  - Able to convey which elements of the annuity are changeable and which are unchangeable
  - Able to illustrate the effect of adverse scenarios

Implications of the Consumer-as-Decider Model (cont'd)

- Should consumers be "protected" from their own imprudent financial decisions?
  - For example, some people put all of their money into
    - a single type of investment
    - the care of a single advisor or money manager
    - investments with time horizons that don't match their current or likely future circumstances
  - If so, what form should this "protection" take?

5 Questions the I.I.I. Recommends for the Consumer-as-Decider Model

1. **Am I comfortable with the risks involved in this annuity**? Some are guaranteed and some are not.
2. **Do I have emergency funds?** If you don't have additional cash you can count on for an emergency, an annuity is not for you.
3. **What will I be charged if I want to withdraw my investment early?** That depends on the annuity. Shop around, because they all have different fees and different early withdrawal charges.
4. **What happens to the money if I die?** There are several different options out there. Some continue to pay to beneficiaries and some do not. You'll want to know before you buy.
5. **Am I sure that this annuity is good for someone of my age, health and financial situation**? There are many different financial products out there and what works best for you will be determined by your particular situation. Speak with your financial advisor to find the annuity that works for you.

Implications of the Consumer-as-Decider Model *(cont'd)*

- Not all consumers can be expected to make informed decisions "on their own"
  - Some are presumed to be vulnerable to pressure to buy unsuitable annuities
  - A decade ago, the NAIC promulgated a model regulation classifying "seniors" (age 65+) this way
  - More recently, the NAIC revised this model bill to address it to *all ages* — **effectively adopting the seller/protector model**

Implications of the Seller/Protector Model

- Realistically, some sellers, in some cases, will make suitability judgments that a regulator or judge could later consider "unsuitable"
  - If sellers carefully follow prescribed procedures to assure suitability,
    - Should sellers be shielded from penalties?
    - Should regulators/judges be limited to rectify only egregious cases?

What Must the Seller/Protector Know for a Suitability Judgment?

- The customer’s financial situation
- Characteristics of financial products that might suit the customer’s needs
  - Includes other types of annuities
  - Includes non-annuity products?

A two-way street? The SEC believes that a seller of indexed annuities must also be knowledgeable about (i.e., licensed to sell) variable annuities. By this logic, shouldn’t sellers of variable annuities be required also to be licensed to sell fixed annuities?

Current Events: Regulation of Indexed Annuities

Why Do Indexed Annuities Need Special Treatment?

- Some elements are not what they seem at first glance; for example,
  - The S&P Index that's used is only the capital gain portion—not the dividend portion—of the index
  - The index's capital gain portion is itself capped in different ways that change over time
  - A withdrawn accumulation may be subject to "surrender charges" and/or a "market value adjustment," providing the owner with less than he/she expected
- There are "moving parts" (features that change during the contract's lifetime)
- Features vary from one indexed annuity plan to another, even among products of a given annuity company, so comparisons between alternatives are difficult

Why Do Indexed Annuities Need Special Treatment? (cont'd)

- They're currently regulated as fixed annuities but marketed as having
  - the upside characteristics of variable annuities
  - with guarantees to protect against downside risk
- Many variable annuities today are sold with additional features that promise
  - the upside characteristics of variable annuities
  - with guarantees to protect against downside risk

The SEC's Rule 151a

- The SEC plans to declare indexed annuities an investment – like variable annuities – and to regulate them under Rule 151a
  - It contends that these products are sold primarily for their investment characteristics
  - The new rule would go into effect in January 12, 2011

Florida's SB 2082 and HB 141

- SB 2082 became law on two months ago.
  - Imposes new disclosure requirements on insurers
- HB 141 was introduced and referred to committee on six weeks ago
  - If enacted, it would apply SEC Regulation 151a to Florida indexed annuities on January 1, 2010–a little over a year ahead of 151a's effective date

What Suitability Standards Will the SEC Extend to Indexed Annuities?

Identify the customer's

- Financial status
- Tax status
- Investment objectives

- Use other information that the sales rep or broker believes reasonable for making recommendations to a customer

But no suitability regulation explains how to use the collected information, and there is no consistency regarding what products are suitable for what buyers.

Source: FINRA Rule 2310.

Annuity Suitability Standards: Other Tough Issues

Two More Suitability Issues

- What role should expense/compensation disclosure play?
  - Should sales reps be required to disclose their compensation for a sale?
  - Should they be requried to disclose what they'd receive for selling an alternate product?
- Suitability should include consideration of a customer's risk tolerance, but how should that be measured?

For Suitability Purposes, How Do We Measure a Person's Risk Tolerance?

Dimensions of Risk

- Psychological vs. Financial Effects
- Extent of loss or gain
  - In absolute (i.e., dollar) terms
  - In relative (i.e., percentage) terms
  - Vs. fixed financial commitments?
  - Vs. inflation?
- Duration of loss

IMSA's "Best Practice" Summits to Assure Compliance with NAIC Model Suitability Laws

- The Insurance Marketplace Standards Association (IMSA) is a nonprofit, life-insurance-industry-sponsored group to improve market conduct
  - Has sponsored several "Annuity Suitability Summit" meetings to gain consensus on what conduct meets regulators expectations
  - Next summit is Tuesday, March 3 at IMSA's offices in DC
    - One focus: possibly adding training requirements for sales reps to the Model Suitability Regulation

IMSA's Suitability Goals

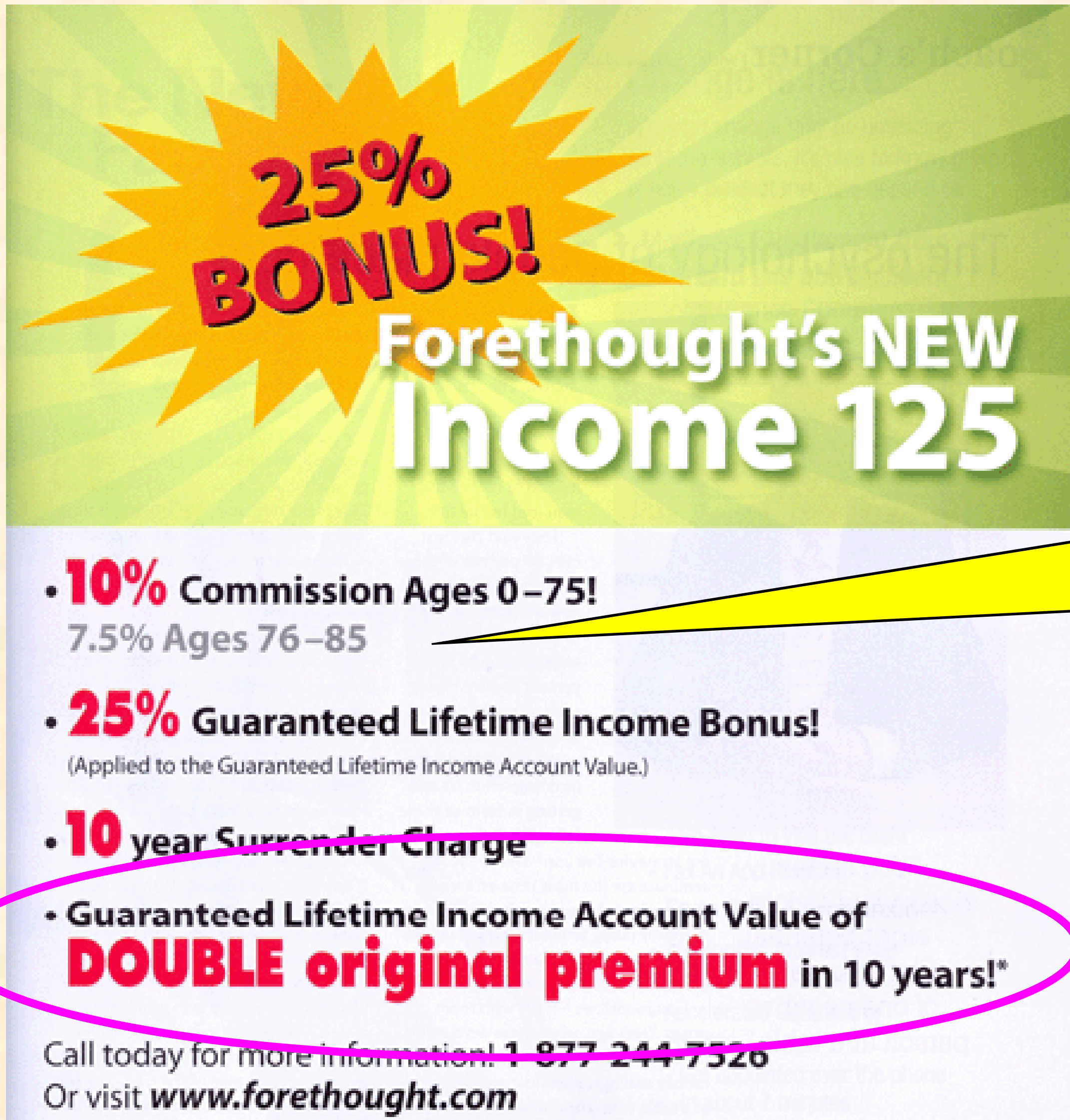
- A set of practices that
  - apply in every state
  - satisfy every state's laws and regulations regarding suitability of insurance-related financial products
    - Annuities
    - Life insurance
    - Long-term care insurance

Regulation of Guaranteed Minimum Benefits in Variable Annuities

What Are Guaranteed Benefits in Variable Annuities?

- Types: Guarantee, regardless of the performance of the underlying investments, a minimum
  - Accumulation,
  - Withdrawal amount,
  - Income amount for life, or
  - Death benefit
- Function
  - From the buyer's viewpoint: eliminate "downside risk" inherent in investing in a variable account
  - From the insurer's viewpoint:
    - A potential additional profit source
    - Product appeal to a broader range of risk preferences

More Lines Blurred: Indexed Annuities Offer Guaranteed Benefits, too



Is a sale of an annuity with a 10-year surrender charge to an 85-year-old suitable?

Some Questions for Legislators About Regulation Involving GLBs

1. The stock prices of a number of companies that sold variable annuities with GLBs have been "hammered" due to concerns about their ability to meet the guarantees.
   a. Should state regulation have seen this coming—*and prevented it*? Are capital requirements for this "bundle of promises" too low?
   b. One study shows that some insurers are charging less for the GLB feature than the cost of "put options" to "insure" this feature. Did they underinsure their GLBs?

More Questions for Legislators About Regulation Involving GLBs

2. The states have a post-event guaranty-fund apparatus for insolvent insurers.
   a. Should the guaranty fund reimburse unpaid GLBs?
   b. To bolster confidence in the safety net, should the guaranty fund be pre-event funded (as New York's is)?

Also Proposed: Overhauling Regulation of Consumer Credit

and Annuities?

Might This Regulatory Overhaul Proposal Include Annuities?

- “The Consumer Product Safety Commission (CPSC) ensures the basic safety of every type of product sold in the United States save one” [consumer credit].
- “A Consumer Credit Safety Commission would
  - Make financial products more transparent,
  - Get rid of tricks and traps, and
  - Give consumers the tools to make prudent financial decisions.”

Source: Elizabeth Warren and Amelia Tyagi, “Consumer Safety for Consumer Credit,” *Harvard Business Review*, February 2009, p. 22.

Summary

- Annuities are financial products that many people find hard to understand
- Regulators have been concerned that some people are buying annuities that are unsuitable for them
- Indexed annuities are now regulated by the states but soon will be regulated by the SEC as well
- Suitability standards are inconsistent from one jurisdiction to another
- Regulation will differ depending on which suitability model is relied on

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