

## YEAR IN REVIEW ▼

## Annuity Forecast: Shaking Off 2005's Uncertainty

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The climate in 2005 for annuity sales and marketing might best be described as uncertain. The factors contributing to this include rising interest rates, NASD encroachment on the equity-indexed annuity (EIA) marketplace, and the ever growing specter of compliance standards and suitability issues.

Overall, anxiety prevails, while the players, carriers, broker/dealers, banks, agents, brokers and planners – are looking for growth and stability while effectively managing these compliance and regulation issues, as well as increasingly compressed margins.

### RISING RATES AND A SHIFT TO EIAs

How have rising interest rates affected fixed annuity business? As interest rates on bank CDs increased over the last 20 months, the sales of declared-rate fixed annuities began to slow down. Increasingly, consumers are attracted to the roughly 4.0 percent rate they can obtain on one to two year CDs. They are making comparisons with fixed annuities and opting for the superior liquidity offered by CDs. In a rising interest rate environment, the traditional fixed annuity loses some of its appeal.

Distributors facing this shift have migrated to Equity-Indexed Annuities (EIA) when working with clients who want annuities as part of their retirement planning, but who are not willing to lock in a fixed rate or take on the investment risks of variable annuities. EIAs have settled into the middle ground between traditional fixed annuities and variable annuities. EIAs offer greater risk but more interest growth potential than traditional annuities, but less risk

and less growth potential than variable annuities.

A major selling point advisors highlight with EIAs is the minimum guaranteed interest rate credited to a portion of the original premium, combined with interest crediting potential linked to a stock index. Less well understood is the fact that customers can actually lose money on EIAs which are not held until the end of the surrender penalty period. Therefore, customers must understand the necessity to keep the contract for its full term, or longer.

### THE NASD ENCROACHMENT ON EIA REGULATION

The sale of EIAs exploded over the past few years, from \$14 billion in 2003 to \$24 billion in 2004, and it can be expected that 2005 will post strong sales. But there is an ominous storm brewing: the NASD's encroachment on the sales and marketing of EIAs. Make no mistake, the NASD wants to regulate this product line and has spent 2005

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alerting us to that fact. Practically speaking, the NASD has already wrested what resembles regulatory control.

In January, the NASD sent a letter to its member firms asking them for all the communications they have used in relation to EIAs, including the marketing materials and advertising by registered representatives. In June, the NASD issued an Investor Alert, “Equity-Indexed Annuities – A Complex Choice,” which covered the facts about the risks, potential rewards, and complexities of the product in simple, pro-consumer language. Then, in August, a Notice to Members (05-50) was published to provide guidance on member firm responsibilities for supervising sales of unregistered EIAs.

Clearly, the NASD is concerned about the way these products are being marketed and sold. They are particularly disturbed about certain claims in marketing and sales materials, especially those with such messages that flaunt the product as an investment such as:

*What if the market goes down and you would lose nothing?*

*The market goes up, you gain!*

*A Win/Win Investment Vehicle!*

*Growth Potential without Market Risk!*

*If you're looking for upside potential and no market downside look no further than this EIA!*

In addition to concerns over marketing claims, the NASD is equally disturbed by the complexity of the product and registered representatives' uncertain ability to clearly communicate and educate potential buyers about product features and suitability. Specifically, the NASD has cited complexities such as minimum guarantees and fees and expenses, including surrender charges, premium bonuses, and multiple premium payment arrangements. Other design components, such as interest crediting methods and participation rates with varying cap rates, have clouded the best way to educate clients about the product. Complexity and communications issues result in another key factor contributing to the increased anxiety throughout the industry: suitability.

#### **COMPLEXITY, COMMUNICATION AND SUITABILITY**

Earlier this year, the State of Florida instituted suitability rules for seniors considering the purchase of fixed annuities including EIAs. In July of 2004, a lawsuit was filed by a California contract holder seeking class action status for 150,000 contract owners of American Investors Life. The suit alleges that the company improperly targeted seniors for the sale of "profitable annuities." In addition, the California Department of Insurance received numerous complaints about problems resulting from annuities sold to seniors, particularly the practice of selling products that provide less than full benefits until after the purchaser's life expectancy. Is it a coincidence then that the California Insurance Commissioner, John Garamendi, recently called on insurers to adopt "suitability standards" for the sale of annuities to seniors?

All this heightened scrutiny of annuity sales practices has placed an additional burden on insurance carriers, broker-dealers, agents and planners to ensure that they are fairly representing annuity products to consumers. Just as important, distributors of EIAs need to set clear client expectations for the realistic performance potential of this product or run the risk that negative consequences will come back

to haunt them in the coming years in the form of class action lawsuits and litigation.

#### **MARKETING AND TRAINING SOLUTIONS**

The best and most productive way to handle these concerns is through solid training and compliance-approved marketing and sales presentation packages. Adherence to vigorous compliance standards and creating sales materials that stimulate buying interest are not mutually exclusive.

Some carriers are already using sophisticated marketing packages designed to boost "quality" sales and provide a shield against market related conduct liability, such as the growing use of compliance-approved multimedia presentations ("mini-movies") which fairly represent the EIA contract's growth potential and downside. That the delivery of these presentations can be made via the internet through advisor-branded websites only serves to make the advisor a partner in an effort to grow quality, sustainable new business.

#### **INCREASING SALES AND IMPROVING SUPERVISION**

The NASD's interest in EIAs and how they are sold, particularly through broker-dealers, is not going to go away. In fact, it will most likely increase to encompass not only EIAs but all fixed products, including fixed annuities and life insurance, sold through broker-dealers and their registered representatives. At some point in the near future, the most forward-thinking broker-dealers will instruct their registered representatives that any and all selling away of fixed products will not be allowed.

How would reps view a directive banning selling away? That will depend on how well-prepared the broker-dealer is in developing the marketing infrastructure that shows registered representatives how they will gain a significant competitive advantage. By instituting a fully developed marketing program for variable and fixed products that helps reps cross-sell and up-sell, broker-dealers can enhance registered representative productivity, grow top-line gross dealer concessions, and improve net margins. At the same time, the broker-dealer can improve compliance, supervision and sales practices to limit any potential liability from increased regulations and NASD scrutiny.

It is safe to predict that more change is coming for the annuity marketplace, particularly EIAs. For carriers, broker-dealers, and registered representatives who anticipate that change and begin now to prepare, the future will give birth to immense growth opportunities and transform the existing broker-dealer business to a new "marketing-driven" business personality. The result will be a winning strategy to gain market share, increase margins and enhance compliance.▲