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LIFE & Health Advisor

LIFE & Health Advisor, P.O. Box 613, Walpole, MA 02081 The Journal for the Financial Services Industry

2006 in review: EIAs

The Hidden Distribution Story:

Why demographics and the web-browser will drive indexed-annuity sales to $100 billion within the next five years

by David Macchia

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PART I of a two part series

When indexed annuity sales hit $27 billion in 2005, many in the annuity industry were surely pleased. Satisfaction over the sales growth of indexed annuities was understandable. Looking back over the 10-year history of the product, it appeared that the indexed annuity had become nothing less than a great success.

But a deeper look into indexed annuity product sales offers a different analysis, an “inside story” that is fascinating in its own right. It’s this inside story which leads me to believe that indexed annuity sales will rise to levels well beyond what we saw in 2005.

The inside story begins to reveal itself when we look at the source of indexed annuity sales. It’s a story notable for who didn’t sell the product, as well as who did.

TO SELL OR NOT TO SELL

Indexed annuity sales have been dominated by the independent agency channel which has produced more than 90 percent of all premiums written. Moreover, roughly one out of every three indexed annuity contracts sold have been issued by just one carrier, a level of market domination seen in no other major financial product.

Characteristics of some of the most popular indexed annuity contracts including long surrender charge periods, two-tiered annuitization, high commissions and complex contract designs were viewed by many producers, producers who might have sold indexed annuities but didn’t, as being less than friendly to consumers’ interests. Over time, indexed annuity products developed something of a stigma within certain channels of distribution as evidenced by the refusal of banks and other non-agency distribution channels to push them.

This created a very unusual marketplace dynamic as illustrated by this example: Imagine a conservative, 65-year-old saver seeking financial guidance and meeting separately with a bank financial advisor and an independent life agent. Both professionals might have emphasized the value of maintaining upside interest growth potential combined with a downside guarantee. But how each would deliver this value might differ. The bank rep would almost certainly not have chosen an indexed annuity as the way to accomplish it, while the agent would likely have concluded that an indexed annuity is the ideal way.

Why did the two distributors view the product’s appropriateness so differently? In part, the bank viewed the indexed annuity as being too complex, with too long a surrender charge period and with too high a commission. In other words, the bank might have believed that selling an indexed annuity would effectively result in a disservice to its customer. The independent agent, on the other hand, could rationalize the contract’s attributes, and its commission, by focusing the consumer on the long-term, tax-advantaged nature of the annuity’s benefits and the personal service being provided.

In essence, therefore, the inability of indexed annuity sales to grow to their full potential was pre-ordained by the opposing views of various distribution channels. If large segments of financial products distribution took the position that the product was to be shunned by definition, how could it possibly reach its full sales potential?

THE IMPACT OF NTM 05-50

Through 2005 we saw little interest in indexed annuities among large broker-dealers, wire houses or banks. What we did see was a startling move by the NASD to involve itself deeply in the indexed annuity business via its issuance of Notice to Members 05-50. By publishing this NTM, an action hugely unpopular with many insurance carriers, marketing organizations and agents, the NASD, in all likelihood unintentionally, set the stage for dynamic growth in indexed annuity sales.

Was that the NASD's intention in issuing 05-50? My guess, although I can't know for sure, is that it was driven by the perceived dual need to protect the interests of consumers as well as the firms themselves from liability potential arising out of sales of indexed annuities under the terms of registered reps' outside business activities. I don't know if the NASD foresaw that its action would stimulate growth in indexed annuity sales over the long-term. However, I do know that one result of the NASD's action has been to motivate indexed annuity providers to re-think contract designs, lower compensation, shorten surrender charge periods and boost consumer value.

A number of indexed annuity providers which historically have not sought out relationships with broker-dealers are now vitally interested in fomenting those relationships. The "ten-ten" rule, a de facto broker-dealer standard governing the minimum level of perceived consumer value built into an indexed annuity in terms of its maximum surrender charge percentage and surrender charge duration has become generally accepted by all parties. Yet, "ten-ten" isn't an end point, in my judgment. Arguably, it's only the first in an evolving, yet informal standard which will eventually progress to "nine-none", "eight-eight" or "seven-seven."

The indexed annuity business will know that its path is clear to full broker-dealer acceptance when indexed annuity products' surrender charges and commission levels are in parity with or even less than the surrender charges and commissions associated with variable annuities. This is inevitable in my view.

The improvements we've seen thus far to indexed annuity contract designs are only the beginning in what will become a revolution in indexed annuity product design destined to benefit both traditional and non-traditional distributors alike. We'll see indexed annuities designed for "wrap" accounts, indexed annuities with no surrender charge period, and others yet with very short duration surrender charge periods. Woven into these new contract designs will be new interest crediting methods and novel provisions for the payment of lifetime retirement income. All of these developments will, I predict, set the stage for indexed annuity growth that will ultimately see sales approach the $100 billion mark on an annual basis.

Predicting a 400 percent increase in indexed annuity sales may seem startling. But two major forces, demographics and improving web browser experiences will lead to a surge in growth in annuity sales, generally, and of indexed annuity sales, specifically.▲

NEXT MONTH: From accumulation to distribution.