

Re: EIAs: Behind the Hype by Joan Warner

NAFA is responding to your article referencing indexed annuities. NAFA was created in 1998 to foster an unbiased understanding by consumers, producers, consultants, and insurance companies of the appropriate uses of all fixed annuities. Today, NAFA is the only independent, non-profit organization dedicated solely to these unique products.

The author immediately reveals her conclusions: “the beauty of EIAs, the pitch goes, lies in the seductive combination of safety with the siren lure of potential stock market gains”. She goes on to lament the growing popularity of indexed annuities as evidenced by 2001-2004 sales statistics. However, NAFA would like to add a little perspective. The \$13.8 billion of indexed annuities sold in the first half of 2005 represent 8% of the total \$109 billion of annuities sold during the same period (\$67 billion in variable annuities and \$42 billion in traditional fixed annuities). Does this increase from nothing 10 years ago make the product worthy of pejorative treatment? What is it that stimulates the wrath of the author and her securities industry sources? It is more than coincidence that the increase in index annuity sales follows the tech sector collapse, the flood of baby boomers nearing retirement, and the tepid performance of the market since 2003. People value safety and they tend to value it more as they near retirement and develop a greater need to insure their savings against loss. Indexed annuities have principal guarantees these people need. We believe indexed annuities, like all fixed annuities are a safe place for money when a safe place makes sense.

The article discusses the “regulatory controversy”, quoting the NASD’s concern that multiple regulatory regimes create a real risk for brokers. At this time, the NASD, wanting to be a “new kid” on the fixed annuity regulatory block, is the only organization creating the controversy as a result of their Notice to Members 05-50. The National Association of Insurance Commissioners has not acted nor has the Securities and Exchange Commission contrary to the article that seems to confuse the SEC with the NASD. The NASD has issued a Notice not a “Rule” as it would be beyond their purview to declare indexed annuities to be securities. What the SEC determines is the status of indexed annuities as a class or any particular design will be based on precedent and will be well reasoned and, thus likely to be positive. The NASD’s Notice is only a suggestion to broker dealers asking them to consider supervising the indexed annuity sales of their registered reps for fear those reps when talking to clients are making them sound like securities. This would seem a desirable goal. At this time the state insurance departments are increasing regulation of annuity products through the Producer Licensing Disclosure Model Law and the Senior Protection in Annuity Transactions Model Law. State departments already regulate disclosure and advertising of all fixed annuities through advertising and fair trade regulation. Indexed annuities should and will remain fixed annuities regulated by the state insurance departments.

The author states that “these insurance contracts share some characteristics with other deferred annuities,” but that since “total interest is partially pegged to stock market fluctuations...insurers can’t rely on actuarial tables to calculate returns that will yield them a profit.” We wish the author had checked with some actual pricing actuaries (NAFA would be happy to provide a number of actuaries expert in the field of indexed annuities) where she would have found that actuarial tables have nothing to do with calculating equity linked investment returns for any fixed annuity product including indexed annuities. The only reason to make this point would be to assert a danger of insurance company insolvency and therefore a threat to clients’ money if the stock market fluctuates or loses too much. Since insurance companies are required by state laws to invest appropriately and reserve for all insurance products there is no chance of insolvency resulting from stock market fluctuations. However, the author is effectively conceding the argument that these products *are* substantially different than securities because of their strong guarantees to clients. No company “goes bare” in providing for indexed annuity interest credit. All companies *hedge* these risks, paying dollars generated from bond income, up front to a counterparty or reinsurer in exchange for receiving the appropriate indexed linked interest at the appropriate time.

The article often refers to the annuity owner as “the investor” effectively making its proof that indexed annuities must be securities because we define everyone who buys them as “investors”. The securities industry has co-opted

the terms “security” and “investor” among others. To them, they no longer hold their broader Webster definition. According to the NASD, they represent just the set of financial products that the SEC regulates, ironically enough, products which provide very little “security” and which transfer risk to their purchaser. Some have opined that since these new indexed products have interest credits based on an index, they should be securities since the index if purchased separately would be a security. Presenting such a product and talking about the equity index on which it is based should make it a security with all of the appropriate SEC protections. By this logic though, there are no non-security insurance products. After all, every declared rate annuity has funds invested in bonds, mortgages, etc., which if sold separately would be a security. Indexed annuities are insurance contracts that provide **guaranteed** protection of principal and **guaranteed** payout options as even the U.S. Supreme Court has held.

The article states that “people can and do lose money with EIAs” and that insurers “write their guarantees very, very carefully.” It notes the “increasingly common” guarantee of “90% of the premium plus 3% simple interest [would] ...take nearly seven years for the investor just to breakeven.” First, no product of which we are aware (and we are familiar with over 200) uses simple interest for its minimum guarantee since the state insurance law with which it must comply uses compound interest. Whoever did the math for the article needs to recalculate. Simple interest returns principal in 3.7 years and compound interest in 3.57 years. The author states “if the annuity is held to maturity they could wind up with \$9,270.” This is wrong again. The minimum guarantee at the end of one year would be \$9,270. If the product matured in 10 years, the client is guaranteed a 21% increase in value by that time. There is, however, a high probability that indexed interest credits will exceed the guarantee. Annuity contracts do carry surrender charges for a fixed period as do most financial products. Surrender charges are a way for any financial company to assure that it recoups its up front expenses even if the owner decides to terminate the contract early. We suppose the author’s point was that guarantees are “written carefully” to give the policyholder poor value. In fact these guarantees ARE intentionally designed lower than declared rate annuities (while still complying with state laws) in order to make more funds available for hedging a higher indexed interest credit.

The author incorrectly states that “although some contracts allow investors to dip into 10% of principal a year with no penalty, most do not.” All indexed annuities provide some form of free partial withdrawal; over 90% offer at least a 10% penalty-free withdrawal every year. At the end of the surrender charge period, all funds are available penalty-free.

The article quotes a CFP from Minnesota: “if the index does 30% and you’re capped at 12%, you’ve given the insurance company money to pay for a big spread”. This is patently false and makes one wonder why the author would have consulted who from the ignorance of his quote obviously (and hopefully) has never sold an indexed annuity. In reality the company is simply exchanging the interest it otherwise would have credited in the policy for a specific option on the index. The insurance company does not own stocks or funds underlying the index and they certainly don’t just gamble on the outcome. Following is the simple value proposition of a typical indexed annuity.

*Ms. Client, do have safe, conservative money on which you would like a no-risk, conservative rate for a period of time with potential tax benefits. If so I can provide a quality annuity for you. Would you like an annual option in that annuity to move your funds to an index-linked interest bucket? Why would you want that? In this bucket the company will take the money they otherwise would have credited you in the fixed bucket and invest in such a way as to provide you a credit which will be based on how an independent index like the S&P500 changes.*

*You could put money in this bucket, at your discretion. This will produce more interest than you would get in the fixed bucket, but rarely will you ever get as much interest as there would be gain in the full index, in fact, as an estimate, you might be trading off half the upside in the index in exchange for a protection from any index downside. You also might also get zero interest in a year, but your account will never go backwards and any prior interest credits are locked in never to be lost. Any money in the indexed buckets can always be switched back to a fixed interest rate annually. Do you have any money you’d like to have that option now or in the future to earn higher interest with no downside risk?*

These products are *not* designed to provide any participation in the markets and related investment risks and most agents are not presenting them that way. This is why it is so misleading when Scott Butterworth states “if inflation picks up and the market drops, you lose purchasing power and opportunity cost.” This product is not for money whose profile is all the risk and all the upside. Is he suggesting that it would be better to “own the equities market” “so that the retiree’s entire nest egg which must last them a lifetime plummets with the market decline? If so, he is indulging in the fantasy that the investment rep is smart enough to time the market and that their clients can sleep nights while the representative presides over perhaps a 20% decline in their life’s savings targeted for investment.

Sheryl Garrett’s “zero coupon bond plus indexed mutual fund idea” as an alternative to indexed annuities is a straw man. It is designed to inoculate a client’s conservative money against an indexed annuity purchase through its ostensibly superior performance, though it is rarely every actually proposed or executed for a client. It may theoretically perform better if a client holds the assets to bond maturity, however it lacks true principal protection. Where is protection from asset loss at death? Where is the emergency partial liquidation feature without loss of value? Taxes must be paid by the client every year even though the zero coupon bond gives you no cash flow to pay it with. This approach is like trying to set a screw with a hammer because it is the only tool in your toolbox. More importantly, most people are ill-equipped to watch the values of this approach decline 20% during an interest rate rise and not feel forced to make the bad economic decision of realizing the loss by selling.

Declared rate and indexed fixed annuities are responsible for protecting billions of dollars worth of retirement assets and have saved many a contract owner from losses in riskier vehicles. They provide tax deferred growth, solid return potential, minimum guarantees and eventually something no other financial product can provide, an income you can’t outlive. These benefits fulfill the conservative promises of safety and minimum guarantees for which many people are looking. In fact, fixed annuities can be the ideal foundation for a sound retirement portfolio.

If you have questions or would like more information on fixed annuities, please call NAFA, and we will be happy to provide additional information.

Sincerely,



Michael Tripses, Fellow, Society of Actuaries, Member, American Academy of Actuaries, FSA, MAAA, FLMI Board Member, NAFA