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Variable Annuities: Sadly, Not Much Has Changed in Six Years

I wrote about variable annuities (VAs) for an article that first appeared in the July 2007 issue of The Briefs. At the time, there was rampant misinformation and omission (read fraud) surrounding the sale of these products to elderly retirees. Guess what? There still is. And why? Elderly retirees were then and still are ripe for the picking and the local "financial advisor" (read insurance salesman) knows just what buttons to push.

Back when I wrote the first article, the financial markets were at the tail end of a dramatic run up following the infamous tech bubble burst in 2000. Interest rates were low and retirees who depend on their investments for income could not get by on the traditional FDIC-insured certificates of deposit offered through the local bank. Well, here we are in 2013, at what I believe to be the tail end of another dramatic run up following the more infamous "Great Depression" of 2008. Sadly for investors, much of what happened in 2000 happened again in 2008...only worse. It makes me think of that often misquoted saying by George Santayana who said: "Those who ignore history are doomed to repeat it." Actually he said: "Those who cannot remember the past are condemned to repeat it," but you get the idea. Financial markets and economies, in general, are cyclical. Those same folks who owned equity-based variable products watched almost half their investment disappear in 2000 and did so again in 2008. The market cycles are so eerily similar and the products, although arguably improved in terms of features, benefits, and disclosure requirements, are still grossly inappropriate for most elderly retirees. Since most of what I wrote in 2007 sadly still applies today, the remainder of this article is a slightly edited version of the July 2007 article with updates where needed.

Like many investors, elderly retirees got burned when the unprecedented rise in the stock market during the 1990s gave way to dramatic declines in early 2000. Elderly investors who typically invested in FDIC-insured bank certificates of deposit had been lured into the equities markets with dreams of wealth and a better retirement. Sadly, when the markets corrected, those dreams became a nightmare, forcing many retirees back into the workplace or into a greatly reduced quality of life. As such, many will never again invest directly in the stock market and for good reason – they don't have time to recoup their losses.

Retirees represent a large portion of investible assets, a fact not lost on the investment industry. Realizing that retirees, many of whom reside in Florida, had lost their faith in the stock market, brokerages and insurance companies needed a new way to access the retiree market and their money. In response, the two industries joined forces to create and market products that would accomplish two goals: 1) be palatable to retirees and 2) generate fee and commission income for the firms and their sales force. One such product is the tax-deferred variable annuity (VA).

As the remainder of this article will discuss, VAs are rarely suitable for elderly retirees. VAs are contracts with insurance companies sold through broker-dealers that permit the individual to invest in stocks, bonds, or mutual funds. Most VAs are extremely complex and expensive products that are sold by brokers who receive high commissions. In fact, VAs are some of the highest paying products a broker can offer (as much as 10% of the principal investment). However, because of the complexity of the product, the brokers often know more about their commission payout than they do about the product's features. This has led to widespread abuse, particularly among the elderly population.

In many respects, VAs function like traditional investments only with an added insurance feature. The purchase amount is allocated to subaccounts that closely resemble mutual funds. The value of the annuity appreciates or depreciates depending on the performance of the underlying subaccounts. Management fees are assessed against the subaccounts much like mutual fund expense ratios. However, the insurance company also charges a Mortality and Expense risk charge (M&E), which is typically around 1.25% per year. This fee is used almost exclusively to pay broker commissions and provide profit to the insurance companies. Combined with other administration fees and subaccount management fees, the expense associated with a VA can cost the owner upwards of 2.5% annually as compared to approximately 1.5% for a comparable mutual fund.

So why are retirees so susceptible to being sold VAs? For one thing, they are marketed by touting the "guaranteed" return feature. This is particularly appealing to elderly retirees who previously lost money in the market or who are looking to preserve their retirement nest egg. Unfortunately, the salesperson often fails to disclose that the owner or third-party annuitant must die before receiving the guaranteed return of principal. This "guarantee" is of little use for those in need of their funds while they are still living.

Another of the common sales practice abuses occurs when a customer is persuaded to exchange one VA for another. This is an all too common practice, particularly among the elderly, who often blindly follow the advice of their financial advisor. Approximately 70% of annuity purchases are the reinvestment of proceeds from the sale of existing annuities. Annuity switching, much like "swapping" of mutual funds or the "twisting" of insurance policies, is typically of greater benefit to the salesperson than to the investor. When the VA is switched, the broker receives the high commission. Meanwhile, the investor is subject to starting over with the maximum declining sales charge period and surrender charges with no appreciable increase in benefits. This can become a recurring nightmare for those individuals who need access to their money and can't afford to pay large redemption fees.

Abuse also occurs any time an investor is persuaded to purchase a VA within a qualified plan or tax-advantaged account. For obvious reasons, there is little justification for placing tax-deferred funds in a tax-deferred vehicle such as a VA. The higher costs and disadvantages associated with the VA make it a highly suspect choice for tax-deferred funds held in IRAs or ERISA accounts. Broker commission is usually the primary motivator, and any such transaction should be highly scrutinized.

Many retirees are persuaded to purchase a variable product because they want to avoid losses, but because VA subaccounts operate like mutual funds, their use and recommendation by salespeople are subject to the same suitability requirements as any other investment. In most cases, elderly retirees need conservative investments as they cannot afford to lose their principal. Unfortunately, many brokers ignore this basic rule and invest the subaccounts in aggressive growth funds, subjecting the retiree to market risk and potential investment losses. The suitability issue is further aggravated by the fact the insurers often do not supervise the representatives who ultimately sell their products. The supervision is left to independent broker-dealers and insurance agencies, and history has shown that type of supervisory system is wholly inadequate to protect the elderly investor.

Widespread abuse in the sale of VAs has led to a litany of investor complaints. A search of the internet will reveal countless articles about annuity fraud, many of which deal with the impact on the elderly. In response to investor complaints, the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (formally NASD, before the merger of the NASD and the NYSE) examined broker-dealers who sell variable insurance products. A summary of their findings was published on June 9, 2004, and can be found on the Financial Industry Regulatory Association website (http://www.finra.org/newsroom/newsreleases/2004/p002822)[1]

The joint report covered five areas: 1) Suitability, Sales Practices, and Conflicts of Interest; 2) Supervision; 3) Disclosure; 4) Books and Records; and 5) Training. A thorough discussion of this report is beyond the scope of this article, but it's worth noting that the report found that recommendations to purchase variable insurance products are often made without the broker-dealer taking into account several factors which, if they had been considered, would have made the products unsuitable. Those factors include the customer's age, financial or tax status, investment objectives, investment sophistication and ability to understand the complexity of the products, risk tolerance, need for liquidity, and lack of need or desire for life insurance.

After the report was released, the financial services industry had no choice but to address sales practice abuses. The industry also realized it needed to create more investor-friendly products to attract

Editors' Note:

The November 2013 edition of *The Briefs* will be devoted to **veterans and military service issues**. The editors welcome submissions on topics including the laws and institutions that affect service men and women and their families, and personal stories about the military and civilian services undertaken by OCBA members. If you are interested in submitting an article, topic idea, or photos, please contact communications manager Peggy Storch at peggys@ocbanet.org.

The submission deadline for final articles is September 15, 2013.

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new capital. Accordingly, many of the newer VAs have shorter early redemption periods, increased benefits, and pay lower commissions. Unfortunately, abuses such as non-disclosure and switching still occur. Also, realizing there was a stigma attached to VAs, the industry came up with another product, the indexed annuity. Unfortunately, indexed annuities have many of the same negative characteristics and, thus, should not be sold to retirees. Further, depending on the mix of features, an indexed annuity may or may not be a security, and the typical indexed annuity is not registered with the SEC and is outside the jurisdiction of the securities regulators. This provides greater freedom for the unscrupulous salesperson, which means abuse is sure to follow. Additional index annuity information can be found on the SEC website at http://www.sec.gov/investor/alerts/secindexedannuities.pdf.

In conclusion, while VAs are not unsuitable for everyone, the complexity of the product, the high costs, the questionable or limited benefits, and the lack of liquidity clearly make the product unsuitable for the majority of elderly retirees. If an attorney has an elderly client who was sold a VA, the attorney should ask the following questions to determine suitability: 1) What is the age of purchaser? (over 70 is almost always suspect); 2) Does the client need current income? (if so, the product is probably unsuitable); 3) Was the product purchased in a qualified plan? (if so, it is unsuitable per se); 4) Was one annuity switched for another? (if there was no appreciable improvement in product benefits, unsuitable); and 5) Was the client told the return was guaranteed or the client could not lose the principal? If the answer to any of these questions is yes, the client may have a viable claim for rescissionary and/or compensatory damages.

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[1] *See*, Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products (June 2004).