



Ethics

ETHICAL ISSUES WITH ANNUITIES: SOME SITUATIONS FOR REFLECTION

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The growth of the annuities market has been a boon for insurance companies accounting for more than half of their sales. According to the ACLI fact book:

The mix of premiums from life insurance and annuity considerations has changed markedly over the last 25 years. In 1978 the share of premium receipts from life policies (46%) was more than double the 21 percent from annuities. By 2002, this trend had reversed: Life policies accounted for only one-quarter of premium receipts (26%) while annuity considerations contributed more than half (53%).¹

But the growth of the annuities market has the potential to bring forth a set of problems and ethical scandals for the industry that could be as devastating as the scandals in the early 90s. There are challenges to the worth of annuities, serious challenges to some of the marketing techniques that are used, and, finally, concerns about the ability of companies to meet the demands of their guaranteed payouts.

Almost weekly there is a story in the *New York Times* or *Wall Street Journal* about supposed ethical misbehavior in selling annuities, usually variable annuities. Some of this misbehavior was highlighted by Mary Schapiro, NASD President of Regulatory Policy and

Oversight in her remarks to the Spring 2004 Securities Conference where she listed recent actions of the NASD:²

- Prudential Securities was fined \$2 million and ordered to pay customers \$9.5 million for sales and switches of annuities that violated New York State regulations.
- A Louisiana broker was permanently barred from the industry and ordered to pay more than \$1.5 million in restitution for making unsuitable annuity sales to older, conservative investors.
- A suit was filed against Waddell & Reed charging the firm with recommending 6,700 annuity exchanges to its customers—generating \$37 million in new commissions and costing the customers \$10 million in surrender fees—without determining whether the transactions were suitable. One Waddell & Reed adviser was quoted in a *Wall Street Journal* article as saying, “I have no problem selling an annuity that may cost [0.45 percentage point] more...because I have to support my family and pay my assistant and other business overhead.”³

Shapiro noted that those are just three of over 80 disciplinary actions taken against unacceptable sales practices in the past two years.

Sales to Seniors

Most concern centers around potentially unsuitable sales of variable annuities to seniors. In one of its alerts the NASD stated the following:

The marketing efforts used by some variable annuity sellers deserve scrutiny—

especially when seniors are the targeted investors. Sales pitches for these products might attempt to scare or confuse investors. One scare tactic used with seniors is to claim that a variable annuity will protect them from lawsuits or seizures of their assets. Many such claims are not based on facts, but nevertheless help land a sale.⁴

Also, in her conference remarks, Shapiro mentions the following ad as an example: “Sell *Annuities* to Seniors Who Don’t Have Money! Most Have Equity in their Homes. Help Your Agents Tap into It.”

Along those lines, The *Wall Street Journal* reported about training sessions on selling annuities to senior citizens, which used the following language:

- “Treat them like they’re children.”
- “Don’t be sophisticated.”
- “They buy based upon emotions! Emotions of fear, anger and greed.”
- “Show them their finances are all screwed up so that they think, ‘Oh, no, I’ve done it all wrong.’”
- “This will make you money, and it’s probably a product they need.”
- “Tell them you can protect their life savings from nursing home and Medicaid seizure of assets. They don’t know what that is, but it sounds scary. It’s about putting a pitchfork in their chest.”
- “What’s an annuity? There’s the technical answer, and there’s the senior answer. Tell them it’s like a CD—it’s safe, it’s guaranteed.”⁵

As a final example, on June 27, 2002, the SEC filed civil fraud charges against a California broker who allegedly defrauded approximately 60 retired customers by recommending they replace

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existing investments in variable annuities with new investments in similar variable annuities. This enabled the broker to reap approximately \$275,000 in commissions for the unsuitable switches. He told clients they needed to switch in order to stem investment losses caused by declines in the stock market. The switching did not halt their losses and they could have achieved the same objective by simply electing another investment option within the original variable annuity. The customers either received no economic benefit or lost money in the switch transactions and together incurred more than \$200,000 in needless transaction costs.

Simultaneously, the SEC proceeded against the broker's supervisor for failing to reasonably supervise him and for not investigating red flags raised by certain switches when the transactions were reviewed.

Multiple Pricing/ Compensation Structures in Variable Annuities

Beyond the problem of bilking seniors by selling them products they don't understand and/or need, there are issues with the size of commissions, which are generally higher than commissions on mutual fund sales, and commission structures. Consider the following account of an insurance agent:⁶

"The most common dilemma that I have faced over and over again in my professional career is that of multiple pricing and compensation structures for identical products. A good example of this is a variable annuity product. Typical pricing schemes are as follows [see table] (assume a \$500,000 deposit)":

	Up-front cost to the client	First year comp to the rep	Annual cost to the client	Annual comp to the rep
Option A	2%	1.5%	.7%	.25%
Option B	0%	5%	1.25%	.25%
Option C	0%	4%	1.4%	.4%
Option D	1%	1%	1.75%	1%

"Let's assume that the client intends to keep the contract for 10 years or more, as most deferred payment VAs are a long-term proposition. Clearly Option A is in the client's best interest as it has the lowest annual costs which are only moderately offset by a one-time annual fee. However, the rep would like to see one of the other options, as it clearly will pay considerably more commission."

NASD's Proposed New Rule

Situations like these have arisen all too frequently and caused heightened awareness on the part of the SEC and NASD. NASD's Board of Governors, in April, proposed a new rule⁸ that would impose a wide range of new requirements tailored specifically to transactions in deferred variable annuities—from new sales practice standards and supervisory requirements to increased disclosure and sales force training.

The key requirements of the rule proposal include: 1) suitability, which requires that the client has been informed about "the unique features of the deferred variable annuity," 2) a long-term investment objective on the part of the client, and 3) an annuity that fits the client's

needs regarding risk and liquidity.

The proposal also requires a prospectus and "plain English" risk disclosure that lays out surrender charges and IRS penalties as well as sales charges, fees (including mortality and administrative fees, investment advisory fees and charges for riders or special features), federal tax treatment, applicable state and local government premium taxes, and market risk, while letting the client know if there is a "free-look" period.

Further, the new rule states that "before a registered representative completes a recommended transaction, the registered principal would be required to review and approve, in writing, the suitability analysis document and a separate exchange or replacement document, if the transaction involved an exchange or replacement of an existing variable annuity."

Finally, the new rule puts a burden on registered principals and their firms. Before a registered representative could effect any transaction in a deferred variable annuity, a registered principal would be required to review and approve the transaction. The registered principal would be required to consider specific factors, for instance, whether the customer's age or liquidity needs made a

long-term investment inappropriate.

The rule proposal also requires registered firms to establish and maintain specific, written supervisory procedures reasonably designed to achieve compliance with the rule's standards and to develop and document specific training policies or programs designed to ensure that registered representatives and registered principals comply with the rule's requirements and that they understand the unique features of deferred variable annuities.

In short, the NASD proposed rules are establishing a checklist to make sure that the buyer of a deferred variable annuity gives informed consent and is not exploited as were the clients in the examples above. Clearly, there are ethical responsibilities that fall to the registered representative as well as to the company.

The Bonus Credit Feature

Leaving consideration of agents' or brokers' suspect marketing practices, we turn to consider areas where companies' marketing practices bear watching. Paul Roye, director of the Investment Management Division of the SEC, has expressed a number of concerns about potential problems with annuity sales that have ethical implications that companies need to face.

According to Roye, "The bonus credit feature offers the investor an immediate credit equal to a percentage of purchase payments, typically in the range of 1% to 5%. From a marketing perspective, these products have substantial appeal. They offer an investor the opportunity to put his or

her entire investment—and then some—to work immediately."⁹

But, according to Roye, "that is not the full story. Investors generally pay for bonus credits one way or another; whether in the form of higher surrender charges, longer surrender charge periods, or higher asset-based charges."

Hence, the SEC, says Roye, "is concerned by the fact that these charges can more than offset the amount of the bonus." Roye goes on to say that the SEC is:

...also concerned with the potential for sales practice abuses because the cost of the bonus may be less visible than the bonus itself. And our concerns are heightened in cases when a bonus is paid to an investor transferring funds from one variable annuity to another in an exchange. Often in these cases, an investor at or near the end of a surrender charge period takes on a new surrender charge schedule as a result of the exchange. Depending on the time horizon for the new investment, the impact of the new surrender charge could outweigh the value of the bonus. We have been paying close attention to disclosure regarding bonus programs.

Substitution Applications

Another area of company behavior of concern to Roye deals with applications requesting Section 26(b) approval for the substitution of underlying funds supporting variable annuity and variable life contracts. According to Roye, a company can have a number of good reasons to substitute underlying

funds, such as "eliminating funds with poor performance, compliance issues, and high expense ratios or to add funds which are more attractive from a marketing standpoint."¹⁰ But in some cases a company is replacing a fund unaffiliated with the company with one managed by an affiliate of the company or with a fund with which the company has "substantial revenue sharing arrangements." The overall question in these cases is whether a proposed substitution is designed to benefit contract owners in some tangible way or is mainly focused on benefiting the company. Roye continues, "Under Section 26(b), we can only grant a substitution order if we find it to be consistent with the protection of contract owners and the policies of the statute."¹¹

Fixed Annuities and Rate Guarantees

One last problem is how the companies are going to handle the guaranteed rates on their fixed annuities. Fixed annuities enjoyed a competitive edge over CDs, which led to a boom in fixed annuity sales. But as Bob Wick of Cramer, Wick and Associates says:

That advantage is diminishing. Many insurance companies, held hostage by the contractual minimum interest rate guarantees, 3% on average, are looking to refile a 1.5% minimum.

The looming issue is being driven by the portfolio yields that the insurance companies are experiencing. These portfolios, primarily intermediate duration bonds, are generating gross yields

approaching 5%, perhaps less. The typical insurance company distributing fixed annuities through banks needs a 225-275 basis point spread between the gross portfolio yield and the “new” money-crediting rate. This is the spread required so they can realize their target return on capital requirements.... So what are the options...that insurance companies will be facing as they approach their new budgets? How will they grow net operating revenues...in this ever-tightening rate environment?¹²

Problems

The preceding situations raise a host of problems that surround the sales and servicing of what has become insurance companies' largest product, some of which are caused by the greed of individual rogue agents, and others by the pressures put on honest agents by commission systems, sales quotas and other factors that companies put in place.

How serious is the misbehavior of the rogue agents? One optimistic way to look at the situation is to note that in this \$985 billion market, the NASD has only taken 80 disciplinary actions in response to troublesome sales practices. Even granting that quite a few unethical practices go undetected or unreported, 80 seems a small number. So one might surmise that the majority of annuity sales are done properly and aboveboard.

Even so, the question remains how to respond to industry critics such as Barry Perlman, who maintains a consumer Web site devoted to investments, and others who insist that annuities in

general, either fixed or variable, are not a good buy. Their claim is that when the purchase of an annuity doesn't meet the original purposes of annuities—to secure an income stream while living a long life with certain tax advantages—there are probably other financial instruments that meet other financial planning needs just as well, if not better. For example, if one's objective is a steady return on investment, they suggest that an instrument such as a ladder of high-grade bonds, where one keeps the principal with minimal restrictions on accessing the money, will bring better return than annuities. Further, if one buys an annuity because one is worried about others taking over one's money or capital, a decent trust can meet the need as well as or better than an insurance company.

Perlman, in questioning the worth of a variable annuity, claims that because of the high costs of annuities most people are better off in an equity index fund. As he says, “Tax considerations aside, the index fund is a better investment. Try to find some annuities that outperformed the S&P 500 index over the past ten or twenty years...do you think you can pick which one(s) will outperform the index over the next twenty years?”¹³

Of course this applies only if we focus exclusively on the accumulation period without taking into account the annuitization benefits. An annuity, after all, is a hybrid product with a risk-pooling aspect, which means there must be a compromise on the yield.

In short, the nature and worth of annuities and their suitability are issues that need to be addressed seriously.

Annuities, particularly deferred variable annuities, can be extremely complex products, and financial service professionals have the responsibility to know thoroughly the products they are recommending and an obligation to serve the best interest of their clients, offering those clients sufficient disclosure to enable the client to give adequately informed consent. Absent meeting those demands the adviser is not doing his or her job.

There is yet another group of questions that must be faced by the companies selling the annuities. What are the ramifications of having multiple pricing and commission structures available on identical products? Some companies have looked at their commission structures and leveled them out, removing the pressure or temptation that such structures cause their agents.

Further, given the latest NASD and SEC warnings to principals and firms, how confident is the company that the agent is selling annuity products that are suitable for each client? The companies need to face the following issues:

- Should companies be encouraging the use of bonus credits, and if so, what disclosure is appropriate at point of sale?
- What suitability review is necessary in the corporate office?
- What underlies the increasing use by the companies of substitution applications? Are they used to benefit consumers or simply to generate higher fees?
- How serious are the solvency issues arising from minimum guaranteed rates on fixed annuities? Is there a

serious insolvency risk for some companies, or is the risk limited to revenue and profit growth?

- Is a company too concerned about sales and not enough about suitability? What are their ethical responsibilities in attempting to strike this balance?
- What are the ramifications of having an intermediary—such as a broker/dealer or bank—involved in the sale of annuities?
- How much influence can the industry exert on companies that encourage or at least tolerate unsuitable practices? Do we need more regulation to protect consumers? If so, what kind and by whom?

Let us conclude with this comment. For the right person in the right circumstances, annuities are a good product. However, given the negative press, the existence of shady marketing practices, and the pushing of sometimes overpriced products, the industry is faced with a serious problem regarding the sale of its biggest product.

In one sense, most of these problems will probably be settled by the forces of the financial marketplace. If the prices and worth of annuities and

their benefits are too high, consumers will eventually discover that fact and gravitate toward less expensive products that deliver the same benefits. Given that, it behooves companies and agents to look at the product they offer to make sure it is the most beneficial for their clients. Part of what is needed is to take a clear look at the issues and engage in a thoroughgoing discussion and airing of those issues and how they are affecting the long-term future of the industry. ■

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(1) *Life Insurers Fact Book* (Washington, DC: American Council of Life Insurers, 2003): p. 53.

(2) Mary L. Schapiro, "NASD: Spring Securities Conference Remarks" May 12, 2004, Baltimore, MD, http://www.nasd.com/media/speeches/schapiro_2004_03.asp.

(3) Theo Francis, "NASD Charges Waddell & Reed Over Annuities," *The Wall Street Journal*, 15 January 2004.

(4) "Variable Annuities: Beyond the Hard Sell," *NASD Investor Alert*, May 27, 2003. This Alert

focuses solely on deferred variable annuities and the unique issues they raise for investors.

(5) Based on an article by Ellen E. Schultz and Jeff D. Opdyke, "At Annuity University, Agents Learn How to Pitch to Seniors," *The Wall Street Journal*, 2 July 2002.

(6) Used with permission by a student in The American College MSFS Ethics course who wished to remain anonymous, November 2003.

(7) Numbers are fictitious to illustrate the point and do not represent any one product.

(8) See "NASD Proposes Specific Requirements for Deferred Variable Annuity Sales," April 26, 2004, www.nasd.com. In 1999, the National Association of Insurance Commissioners (NAIC) created a model regulation for fixed deferred annuities that it offered for adoption by the states called "The Annuity Disclosure Model Regulation" and proposed in 2003 the Senior Protection in Annuity Transactions Model Regulation to take effect in 2005.

(9) "Understanding the Securities Products of Insurance Companies," address of Paul Royce, Director, Division of Investment Management, U.S. Securities & Exchange Commission, before the Practicing Law Institute on January 9, 2001.

(10) *Ibid.*

(11) *Ibid.*

(12) Bob Wick, "Bank Annuity Sales in 2003...Trouble in Paradise...and the good news is that your money will double in 24 years!" (<http://www.insurance-portal.com/102302bankannuity.pdf>).

(13) Barry Perlman, Chris Lott, Ed Zollars, "Annuities," The Investment FAQ, January 20, 2003, available at <http://invest-faq.com/articles/ins-annuities.html>.