

## **NAFA Corrects and Clarifies Security Litigation Consulting Group's "Overview of Indexed Annuities"**

The authors, Craig McCann and Dengpan Luo from the Security Litigation Consulting Group, claim the paper is "an overview," which might suggest a measure of objectivity. Instead, it is a highly subjective paper that adds to the confusion of those who might be seeking a better understanding of fixed indexed annuities and their proper application in financial planning. NAFA finds it to be irresponsible and unfortunate in the degree of its inaccuracy.

The paper is replete with words like 'trivial', 'exorbitant', and 'unsophisticated', used to describe everything from insurance company motives to investor intelligence. The sheer volume of specious assertions and mistaken conclusions leads us to believe that the authors have a severe negative predisposition to the product which is not to be swayed by the facts. To correct the fourteen-page Security Litigation Consulting Group paper thoroughly would require a document of even greater length. We have chosen to focus on the core issues that, if understood properly, provide a more balanced view of the product and its appropriate uses.

Fixed indexed annuities offer these basic values -

1. minimum guaranteed interest rate,
2. excess interest determined by a formula linked to an independent index,
3. no loss of principal or interest previously credited due to market declines,
4. availability of an income you can't outlive, and
5. tax deferral advantages.

The SLCG paper makes an assumption that indexed annuities are designed to be equity substitutes. They are not.

The authors suggest that indexed annuities are hopelessly complex. At one point they claim the formulas are impenetrable. Instead of casting aspersions, it might be more useful to look at an example. One popular product issued last year credited interest based on the change in the S&P500 Index up to a cap of 10%. Based upon this product:

1. The March 2<sup>nd</sup>, 2005 and March 1, 2006 values of the S&P 500 were 1210 .08 and 1291.24, respectively.
2. The change between those two numbers was a 6.7% increase.
3. 6.7% is lower than the promised cap of 10%
4. 6.7% was credited as interest to the account value.

That doesn't seem complex. The interest calculation subject to a maximum or "cap" can be accomplished by most 6<sup>th</sup> graders. While there are different methods for determining the interest to

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credit, we believe these variations to be a reflection of innovation in a competitive and robust insurance market.

The authors also absolutely incorrectly state that insurance companies pay investors part of the capital appreciation in a stock index. They do not pay “capital appreciation.” They credit interest at a rate based on the positive change in the index during the crediting period.

The authors assert that index annuities guarantee a minimum return (meaning interest) if the contract is held to maturity, but neglect to note that companies also credit minimum interest each and every day just like all fixed annuities.

The authors equate indexed annuities to equity participation securities to which insurance companies have added “trivial insurance benefits.” This shows a fundamental lack of understanding of how indexed annuities work. Indexed annuities are obligations of the issuing insurer funded from the general accounts of the insurer. The vast majority of the general accounts' assets are comprised of high-quality bonds. Understandably, the insurers also match their obligations to pay the excess interest by using a small portion of the premium, 3-4%, to purchase equity options.

Also, we would also ask in whose estimation it is “trivial to guarantee a senior that they will not outlive their income?” Is it trivial to promise a 70-year old retiree that their assets will not decline in value due to market fluctuations? Would most people consider the following trivial?

- Full account value at death regardless if that death occurs 1 year or 5 years after purchase
- No surrender charges if you are confined to a nursing home
- No surrender charges if you become terminally ill
- Access to 10% of their account value per year with no surrender charge
- Potential for guaranteed lifetime income

The authors mention that industry trade groups, including NAFA, are behind an effort to “head off” regulation. Indexed annuities are currently heavily regulated by state statutory reserve guidelines, minimum non-forfeiture laws, GAAP reporting standards, and Actuarial Guideline 35. In addition to these accounting regulations, the marketing and sales of indexed annuities are already highly regulated by state insurance and actuarial laws; including, comprehensive insurance trade practices provisions covering misleading presentations, false advertising, full disclosure, etc. Of course, NAFA supports such laws and their ongoing enhancement (of which the authors appear unaware), which protect consumers from unethical and misleading sales practices.

In July 2003, the NAIC adopted the Consumer Protections in Annuity Transactions Model Law covering senior citizens and will soon adopt an expansion to include consumers of every age. NAFA has sponsored meetings and information on this consumer protection law and its Board of Directors voted unanimously on March 2<sup>nd</sup> to support adoption and passage of the latest model.

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Companies do not design agent commissions on indexed annuities differently than they do for non-indexed annuities. According to the Advantage Compendium less than 3.5% of all FIA products sold in 2005 paid over 10% commissions and almost 60% were less than 7%. If one compares asset fees of 1% or more charged each and every year for a mutual fund or an asset wrap account over the duration of financial plan against the 5% to 10% commission paid ONCE to the agent, a more realistic conclusion might be that the playing field of fees and commissions is remarkably level.

When it comes to Guaranteed Minimum Rates of “Return” the authors once again seem conflicted. They state that “indexed annuities do not guarantee that investors won’t lose money [but] they do guarantee a minimum rate of return – typically 3%.”

Fixed indexed annuities promise no loss of value if the referenced index decreases. The absolute worse they can do in *any* year is zero interest credited to their account value and, in fact, interest continues to be credited on the indexed annuities’ floor values. This is not insignificant when you consider that between September 2000 and September 2005 the S&P 500 went *down* 14%, the S&P 500 Index funds lost 11% and the Dow Jones Industrial lost 2% (source Wall Street Journal October 4, 2005) Meanwhile, all indexed annuities *credited interest* during the same period (see Advantage Compendium for a breakdown of the interest credited between September 2000 and September 2005).

When the authors compare annuities to US Treasury securities, they seem to conclude that a fixed indexed annuity is a suboptimal risk-free instrument. They ignore the product’s potential for additional excess interest, which is one of its core benefits. Beyond that they presume they can compare historical Treasury returns which include double digit returns of the 1980’s to Indexed Annuities issued today in a 4.75% 10-year treasury environment. The comparison is either incompetent or disingenuous.

Further in their analysis they make a similar mistake when drawing a parallel to index returns over a period of time. They ignore that decreases in the referenced index will not result in a decrease in the value of an indexed annuity, which again, is one of its core benefits. Consideration of the 0% floor would change the interest rate credited to indexed annuity as calculated by the authors from 5.5% to 8.50%. It is difficult to comprehend such a slipshod mistake in a presumably objective white paper analysis.

Average annual return of the S&P 500 from December 31, 1974 to December 31, 2004:

	Concluding Statement	
	No Floor	0% Annual Floor
S&P 500 Annualized Appreciation	10.0%	n/a
S&P 500 Annualized Appreciation capped at 14%	5.5%	8.5%

An objective analysis would have concluded very roughly, at the 50,000 foot level, that in exchange for a interest rate floor of zero, the interest credited to the account value of an indexed annuity is roughly ½

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of the index performance. This is an understandable trade off. This can of course vary significantly over time based on many factors, but this may be close to the long-term average for setting consumer expectations.

The section titled “A Simple Comparison” is a lengthy explanation of how to replicate the indexed annuity’s historical performance. There are three key problems with this analysis.

First, it ignores that interest credited to indexed annuity **cannot go below zero**. 40% of their model can lose significant money. Are the authors advocating putting 40% of a retiree’s portfolio at risk?

Secondly, it ignores the fact that US Treasury securities, which represent 60% of their model, are not federal tax deferred. This ignores the impact of tax deferred growth in the calculations.

Thirdly, it states accurately that there is no capital gains treatment for annuity interest, but neglects to note that 60% of their proposed alternative gets no capital gains treatment either. Interest on US Treasuries is ordinary income.

In the end, the paper seems to conclude (1) that fixed indexed annuities can’t outrun equity investments in terms of sheer return, and (2) can’t out-guarantee the risk-free rate. The companies that issue fixed indexed annuities, and the vast majority of agents who sell them, understand clearly that indexed annuities are not attempting to do either of these things. They are not designed to masquerade as some other financial instrument. They combine *some* potential for increased interest not available with other fixed interest alternatives and possess significant guarantees not provided by equity instruments. Sales are brisk because consumers appreciate this combination.

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