NAFA Response: MONEY magazine article January/February 2011 “The Safety Trap”
DRAFT December 31, 2010

Dear Ms. Gibbs,

We received a copy of your article about indexed annuities entitled “The Safety Trap.”

We were pleased that the article does state some positive aspects of indexed annuities and offers a rebuttal by industry experts to many of the negative aspects. Unfortunately the conclusion clearly advises consumers to not purchase indexed annuities, which is unfortunate for retirees seeking safety and protection from market fluctuations.

Some of the negative assertions made about indexed annuities are:

The product itself

1. That the surrender penalties are onerous, both in duration and amount
2. That the bonuses provide no real value to consumers
3. That the products are overly complex
4. That the performance is inferior to a portfolio consisting of 85% bank CD’s and 15% an S&P 500 index fund, or taxable bond funds, or 5-year CD’s
5. That the performance is inadequate because the caps are low and can change every year, and because they exclude the dividend yield
6. That the lifetime income feature is inferior to (or at least no better than) an immediate annuity
7. That the tax deferral aspect is redundant for the 58% of buyers whose annuity is an IRA

   The sales practices

8. That they are sold in a deceptive manner
9. That they pay unusually high commissions to sales agents that lead to abuses in the sales process
10. That they are inadequately regulated by state insurance regulators

NAFA asks you to consider a more balanced perspective. NAFA is the National Association for Fixed Annuities, the only association whose sole purpose it to educate regulators, legislators, consumers, members of the media, industry personnel, and distributors about fixed annuities (including indexed annuities) and their benefits to retirees and those planning retirement. Here is our perspective:

1. Assertion: The surrender penalties are onerous, both in duration and amount.

Point of agreement: Annuities are relatively unique in terms of having a charge upon termination that may last for many years and, if invoked, may result in the principal not being fully returned.

But you should also consider: The surrender charges are necessary to allow the carriers to invest in long-term financial vehicles which can provide higher credited interest rates than

investments with shorter durations. It naturally follows that those customers who break the time commitment cost the carrier money, because the carrier has already credited bonuses or annual interest credits not possible without the lengthier time commitment. That loss could be recovered in a variety of aggregate ways, but the surrender charge method only asks those customers who break the time commitment to bear the loss. Surrender charges are necessary and fair.

And, most importantly for your readers is to tell them that they can choose from a wide variety of surrender periods. There are indexed annuities with low surrender charges and short surrender periods (as short as three years). However, because a longer, higher surrender charge typically provides higher interest potential and because the charge is completely avoidable if customers follow the annuity's liquidity rules, products with longer, higher surrender charges tend to be more popular with consumers. The most popular surrender charge duration selected by consumers is about 10 years.

2. Assertion: The bonuses provide no real value to consumers.

Point of agreement: All other things being equal, an annuity with a bonus interest credit at inception will have higher and longer surrender charges than a similar annuity without such a bonus interest credit to give the carrier time to accumulate the funds necessary to provide for the bonus.

But what else you should consider: Some carriers credit the same or similar annual interest rates to all of their indexed annuities. Products with lower and shorter surrender charges have no/ lower bonus interest credits, and products with higher and longer surrender charges have higher bonus interest credits. So, for a consumer who holds the annuity longer than the surrender charge period, the bonus annuity results in more interest earned.

3. Assertion: The products are overly complex.

Point of agreement: Indexed annuities are not standardized products. Carriers have innovated to differentiate their products from each other and to provide consumers with a wide variety of choices to meet the changing and variant needs of retirees and those planning retirement.

But you should also consider: We are reminded of Henry Ford's famous expression that consumers could have the 1909 Ford Model T painted in any color they like, as long as it is black. The reality is that having choices is good for consumers. We don't criticize the automobile industry for its variety when we struggle to find the headlight switch in every rental care.

But at the same time, all indexed annuities share the same basic chassis, which is very simple: in periods (typically one-year) where the index declines, they protect principal and all previously credited interest from loss – the annuity owner earns zero interest. In periods where the index increases, they credit an interest rate which is a simple calculation of the index increase. Each annuity owner can easily calculate their own interest or view their annual report

which is simple and easy to understand. Below is a real life annual report of one of the top-selling annuities which we happen to have owned.

CURRENT STATEMENT PERIOD PREMIUMS PAID		
Premium Number	**Net Premium* Amount**	**Date First Indexed**
1	199,610.93	10/06/2000

INTEREST RATE INDEX INTEREST RATE CALCULATION							
Start Date Of Index Period	**End Date Of Index Period**	**S & P 500 Value On Start Date**	**S & P 500 Value On End Date**	**(A) Gain in S&P 500**	**(B) Participation Rate**	**(C) Cap Rate**	**Index Interest Rate**
10/02/2003	10/02/2004	1029.85	1131.50	10.90%	100%	7.0%	7.0%

NEXT PERIOD INDEX INFORMATION		
Participation Rate Next Period	**Starting S&P Value**	**Next Period Cap Rate**
100%	**1131.50**	**6.5%**

PREMIUM ACCUMULATION FOR THE STATEMENT PERIOD					
Premium Number	**(A) Beginning Balance**	**(B) Withdrawal/ Transfer Amount**	**(C) Beginning Premium Value A + B**	**(D) Current Index Interest Rate**	**(E) Current Index Interest Ending Premium Accumulation C + E**
1	$225,320.82	$0.00	$225,320.82	7.0%	**$241,093.28**
*Premium Amount may include fixed interest until the first/renewal indexing date					

4. Assertion: The performance is inferior to a portfolio consisting of 85% bank CD's and 15% an S&P 500 index fund, or taxable bond funds, or 5-year CD's.

Point of Disagreement: Fixed indexed annuities should not be considered investments nor should they be compared to risk-based investments. Indexed annuities are not securities. Indexed annuity owners do not invest in underlying markets and do not own any securities. Indexed annuity owners do not lose principal – including previously credited interest - due to market fluctuations. This is the clear difference between indexed annuities and securities. However, since this assertion is a major point of your article, we will address the assertion as well.

Point of agreement: It is entirely possible to take a look at the past and find financial vehicles that historically have provided a superior return to indexed annuities or that have historically provided a satisfactory level of safety relative to indexed annuities.

But you should also consider: There were a number of favorable economic conditions in the past that may not necessarily hold true in the future. For example, bonds have benefited from the generally falling interest rate environment over the past few decades, as falling interest rates mean rising bond values and attractive bond returns. The stock market has also done very well, rising at a faster rate than any other major asset class.

However, it is entirely possible for the future to be very different from the past. As we all know, past performance is not a guarantee of future performance. Consider the example of

Japan. Twenty years ago, Japan's economic dominance – as epitomized by its successes in automobile and electronics manufacturing – appeared so inevitable that even popular culture was reacting. Remember the Ron Howard / Michael Keaton movie "Gung Ho" about an American automobile plant that was taken over by a Japanese company, and how differences between the American and Japanese work ethic threatened to close the plant?

But then over the last twenty years, Japan experienced the retirement of a massive portion of its population – much like the U.S. will experience over the next twenty years. During the twenty-year period from 12/31/1989 to 12/31/2009, the value of Japan's benchmark stock index – the Nikkei index – dropped 73%, and interest rates remained at historic lows for the entire period. If our experience mirrors Japan's, interest rates will remain at, near, or even below their current low levels, and the stock market will perform very poorly. This is the scenario that prominent economist Harry S. Dent warns is possible in his best-selling book *The Great Depression Ahead*.

Guess what product would perform very well in such an environment? An indexed annuity! Because, you see, even though the Nikkei index did drop 73% over that 20-year period, it actually increased in value 9 of the 20 calendar years, and in the years it increased, the average increase was above 16%. In such an environment, a Japanese citizen owning an indexed annuity with a 4.5% annual cap would have outperformed all of his fellow citizens' holdings of stocks, bonds, CD's, or virtually any combination of assets – all with contractual guarantees of safety.

In theory, consumers could replicate the performance of some indexed annuities, but only by buying what insurance carriers purchase to back indexed annuities: a combination of bonds and stock index options. The reality is that few consumers have the financial sophistication to actually do so, nor do they have the buying power that carriers have. Thus, insurance carriers are essentially making the benefits of this sophisticated strategy available to the average consumer, which is a wonderful service to the marketplace.

5. Assertion: The performance is inadequate because the caps are low and can change every year, and because they exclude the dividend yield.

<u>Point of agreement</u>: Over long periods of time, you would hope that stocks and stock mutual funds would outgain an indexed annuity – after all, stock purchasers are taking a lot more risk, and they expect to be rewarded for doing so.

<u>But you should also consider</u>: It is unfortunate that the article makes a direct comparison here between the potential returns offered by stocks versus indexed annuities. Because of the guaranteed safety features provided by indexed annuities, it is entirely unfair to compare them directly to holdings of stock. Indexed annuities – by protecting consumers from fluctuations in market value – are not only much safer than stocks, they are even safer than bonds and bond mutual funds.

The closest product available in terms of a risk/reward comparison is a bank CD. After all, both CD's and indexed annuities require a time commitment, penalize early withdrawals, yet

fully guarantee the customer's principal if the time commitment is satisfied. Both have interest rates that fluctuate over time, since most CD's are 6-month or 1-year CD's. Both naturally have interest rates that appear low compared to the returns people hope for when they put money in the stock market. Both are purchased by safe money, conservative savers. The biggest difference between CD's and indexed annuities is that indexed annuities require a longer time commitment, have higher penalties associated with breaking the time commitment, but correspondingly offer higher upside potential.

There is no financial product anywhere that provides stock returns, including dividends, yet fully guarantees that the effect of a down year in the stock market will be immediately eliminated.

6. Assertion: That the lifetime income feature is inferior to (or at least no better than) an immediate annuity.

Point of agreement: Immediate annuities have existed since our country started, are widely available, are easily understood, are easily compared with each other, and provide lifetime income.

But you should also consider: But many people don't know or can't predict when they will need income. While an immediate annuity is an excellent consideration for someone who needs income ***today*** a fixed deferred indexed annuity is the choice for someone who wants to DEFER that choice until they need it, if they need it. Meanwhile they enjoy peace of mind knowing that their deferred annuity guarantees an income for life if needed. In addition, if when income is needed immediate annuities offer a more competitive payout, they can simply exchange the deferred annuity for an immediate annuity.

Another appealing feature of fixed deferred indexed annuities is the promise of guaranteed lifetime income at a future date while providing accumulation potential and continued access to most if not all of their initial premium through a guaranteed lifetime withdrawal or income benefit that is a very common feature on indexed annuities today.

7. Assertion: The tax deferral aspect is redundant for the 58% of buyers whose annuity is an IRA.

Point of agreement: Tax deferral should not be a reason to put IRA money into an annuity.

But you should also consider: The fact that annuities are tax-deferred does not mean that they offer inferior returns to other safe financial products. For consumers who want to have all or a portion of their IRA in safe financial products, if an indexed annuity offers some appealing characteristic – such as the guaranteed lifetime withdrawal benefit or the index-based interest crediting with guaranteed safety features – then an indexed annuity can make sense in an IRA. The most important attraction of the fixed indexed annuity for both IRAs and non-qualified funds is the zero percent interest-rate floor that protects the money from market disasters or simple corrections.

8. Assertion: They are sold in a deceptive manner.

<u>Point of agreement</u>: It is not possible for any regulator or financial provider to absolutely guarantee that every consumer perfectly understands the financial product they have bought, or to assure that every agent or advisor always sells the product in the best manner possible.

<u>But you should also consider</u>: As indexed annuities have become more popular, insurance regulators and insurance carriers have consistently increased the effort that they put into ensuring that consumers are more likely than ever before to understand the financial product they have bought and that agents are more likely than ever to follow a process that prevents unsuitable sales.

One point to be emphasized is that the product itself has significant integrity. As a reporter in the financial press, you probably see reports of new Ponzi scheme convictions in the securities industry on seemingly a weekly basis. While investments and securities are risky and subject to widely variable returns, indexed annuities, on the other hand, are safe financial products that provide returns that stay within a relatively narrow band – and that are guaranteed not be negative as long as the time commitment is satisfied to avoid the early termination penalties.

Most importantly, the NAIC Suitability Model approved by the NAIC last March requires that all fixed annuity sales, including sales of indexed annuities, be sold using prescribed suitability determination criteria that was designed after the FINRA suitability standards. In addition each and every sale must be reviewed ***a second time*** by the insurance company to ensure that the standards have been addressed by the producer's review process and suitability determination.

9. Assertion: They pay unusually high commissions to sales agents that lead to abuses in the sales process.

<u>Point of agreement</u>: Annuities pay sales commissions, and agents are not paid unless they make a sale. Since annuities usually pay all their commissions just once when the annuity is issued the raw percentage number appears higher than when commissions are paid over time.

<u>But you should also consider</u>: All financial vehicles have to cover the provider's sales and marketing expenses. Over time, the margins built into an annuity to cover commissions are not necessarily higher than the sales and marketing expense margins built into competing financial vehicles.

Consider, for example, the typical fee-based financial advisor. Such an advisor will often charge a fee of around 1% of assets annually, in addition to the expenses and fees built into the product itself. Now compare this to one of the best-selling indexed annuity in the marketplace, which gives agents have a choice of being paid a 7% commission in year 1, or a 2.25% commission in year 1 followed by a 1% annual trail commission. The 7% commission is hardly egregious, as it is about the same as the present value of fees charged by security advisors.

Despite the fact that indexed annuities pay no more and no less than fee-based financial products over comparable time horizons, the state insurance departments' standards for suitability determination leave no room for abuses resulting from commission-driven sales. The regulation states that "an insurer shall not issue an annuity recommended to a consumer unless there is a reasonable basis to believe the annuity is suitable based on the consumer's suitability information."

10. Assertion: They are inadequately regulated by state insurance regulators.

Point of agreement: Agents and advisors who are banned from the securities industry should, in most cases, be banned from the insurance industry as well, and vice versa.

But you should also consider: State insurance regulators have a long history of protecting the public and responding to their concerns. Many annuity owners are very comforted knowing that if they have a problem with an insurance carrier or a producer, they can seek redress from a regulator who is charged with protecting all insurance customers in their home state and who holds the power to assess fines, revoke licenses and file criminal charges. And, unlike security regulation, they do not have to submit to a lengthy and costly mediation process.

State insurance regulators have also been quite proactive in responding to the growing popularity of indexed annuities. The fact that certain laws have not been adopted by every state is no longer relevant with the recently adopted Harkin Amendment (incorporated in the Dodd Frank Bill) which requires all indexed annuities and the carriers who issue them must comply with the 2010 NAIC Suitability model regulation to maintain their status as insurance products.

Thank you for your consideration. Please don't hesitate to contact NAFA if you would like additional perspective from the fixed annuity industry.

Sincerely,

Kim O'Brien
Executive Director
The National Association for Fixed Annuities

Cell 414-332-9312
Email kim@nafa.com