

## Realistic annuity replacement scenarios for seniors age 65 and older

1. Agree with the need to stop the abuses. Not here to defend the practices.
2. My own background as an expert witness dealing primarily with annuity cases, representing the Department of Insurance.
3. Asked to speak on replacements of annuities. Would encourage their focus to include all inappropriate annuity sales. Example of savings bond case I consulted on while witnessing.
4. Working definition of a justifiable replacement:

**Replacement is warranted when the client is gaining a desired policy benefit that they do not now have, and cannot get, with their current annuity, at a cost that is fully disclosed and acceptable to the client and suitable for the client given their financial situation.**

5. The elements of that definition:
  - a. The client is gaining a desired policy benefit
  - b. The current annuity does not have the benefit
  - c. The current policy does not allow the benefit to be added post-issue
  - d. The advantages and disadvantages of the switch are fully disclosed
  - e. These are understood by and acceptable to the client and appropriate given the client's financial position.

6. What are examples of a “desired policy benefit”?
  - a. Better guaranteed or immediate annuitization factors
    - i. Original purpose of annuities: an income that the client could not outlive, a promise that no other financial product offers
    - ii. Either immediate annuity rates or annuity factors in another deferred annuity contract could be higher than in the current contract
    - iii. A replacement of an existing annuity contract, where annuitization factors are not as favorable, would clearly benefit a client looking for guaranteed lifetime income.
  - b. Higher interest rates being applied to the policy’s accumulation value
    - i. Many existing annuity contracts have crediting rates significantly below those offered to new purchases.
    - ii. While being wary of “teaser rates” or bonus approaches, significant long-term (3 to 10 year) guaranteed crediting rates are being offered in the market place.
    - iii. A replacement of an existing annuity contract, where the policy crediting rates appear to be significantly higher than the client is currently enjoying, would be warranted as long as all costs associated with the switch are disclosed and acceptable to the client given their financial position.

c. Guaranteed policy death benefits

- i. Most variable annuities now offer some type of death benefit guarantee, either the amount of the original investment, that sum compounded annually by an interest factor, or to the point of best performance, a “high water mark”.
- ii. Clients who have enjoyed gains are assured that their beneficiaries will receive some guaranteed benefit, even if some or all of those gains are subsequently lost due to poor market performance or excess policy withdrawals.
- iii. Many existing annuity contracts do not include this benefit. For a client who wants to participate in market-based returns, but also wants the assurance of some minimum amount left to his or her heirs, a replacement to a contract including this benefit would seem justified. In fact, one could argue that it is a disservice to clients who have enjoyed market gains in recent years to have not allowed them to lock in their gains by exchanging their annuities, almost a “duty to replace”.
- iv. However, given today’s recent market performance, the case for non-replacement of existing contracts where this benefit is already owned is also significant. If an annuity with an existing death benefit considerably higher than its cash value is suggested for replacement, it is mandatory that the client realize that the new company will be basing its guarantee

only on the amount of cash value being transferred, not on the prior policy's death benefit.

- d. Variable annuities also offer riders that will assure a client that regardless of market performance the client will enjoy a minimum income or withdrawal amount from that annuity or principal protection.
  - i. Too complicated to cover in detail here, but they are charged-for riders that effectively allow the client to insure their future income.
  - ii. The cost of the rider varies by the amount of the "insurance" provided, but usually is somewhere between 50 and 100 basis points. They also sometimes carry restrictions on the allocation of invested funds or their holding period when this type of rider is attached to the contract.
  - iii. Recent market performance has shown how valuable these benefits are, whether the client, is currently receiving the income or merely waiting to exercise it. I have clients who have already exercised the rider, and are receiving a level income from the insurance company even though their policy values have dropped sharply in the past year. Other clients who have yet to exercise the rider are comfortable knowing that whenever they do start to draw an income it will be based on an amount higher than their current annuity values would warrant.
  - iv. Many existing annuity contracts do not include this benefit. If the client values this "insurance", and the current carrier does not allow it to be

added to an existing contract, the replacement of that contract may be justified.

- v. Contra: Again, the replacement of one of these contracts, especially after a period of poor market performance, would likely cost the client since the new company's income or withdrawal benefit would be based only on the amount of cash transferred to it.
- e. Equity-indexed annuities offer a unique benefit
- i. Ironic: The product involved in so many abuse situations has actually more than vindicated its approach in the last year.
  - ii. Developed to offer some of the benefits of market participation while offering protection against downside risk (give a current example of the numbers involved)
  - iii. Part of their bad reputation is based on the number of "moving parts" involved in these contracts, and the difficulty of explaining these to any client, much less senior citizens. They must be carefully explained so that they can be distinguished from other financial products.
  - iv. When used properly, they can be an effective tool for part of a client's portfolio. Many people, including senior citizens, are or will be receiving their annual statements from these insurers soon. Even though their returns were market-based, these clients will learn that while their return for the year was zero, their principal was undiminished. I know of many variable annuity and mutual fund owners, perhaps many in this room,

who would like to know that their end-of-October 2008 policy values were exactly the same as their end-of-October 2007 values. For clients hoping to participate in a market recovery, but not willing to accept any more losses, the switch to an equity-indexed annuity may be suitable today.

- f. (Returning to the definition elements) A benefit that is not found in the current annuity, and **that is not available with the current contract**. Replacement normally would not be warranted if the same or similar policy benefit can be added to the current contract at a reasonable cost. Lacking other relevant factors, to do otherwise would just be a commission grab. However, I would encourage the Department to make certain that companies do their part. They should always be encouraged, when feasible, to offer newly-developed benefits to existing policyholders. Further, I strongly believe that a company's practice of suspending the writing agent's servicing abilities due to a lack of new production should be examined. Policies which are then re-assigned to a new agent, one receiving no compensation but saddled with servicing responsibility, ultimately can be viewed as inviting replacement. All costs and disadvantages involved in the transaction have been disclosed to and understood and accepted by the client, and are suitable given the client's financial position. This is likely the area where most abuses take place. Many agents will not fully disclose the

negatives involved with the transaction, and company review of the switch is jaundiced by a “management-by-the scoreboard” approach. Incentives are in place for new business volume, with few disincentives for lack of new business quality.

7. Even when great pains are taken to fully disclose and explain the transaction to a client, client understanding and recall of the details might cloud very quickly. In many cases this happens regardless of the client’s age, but is certainly exacerbated by age.