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Elder Law Committee

Variable Annuities Are Not Elder Friendly

William B. Young, Jr.

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, which are sold by brokers who are paid 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 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.

Unfortunately, high expense ratios are not the worst features of VAs. Every VA has a Contingent Deferred Sales Charge, also known as an Early Redemption or Surrender Charge. To cover the upfront commission paid to the broker, the insurer includes a deferred sales charge in the contract. This charge covers the cost of the upfront commission should the purchaser wish to redeem the VA before the insurer has the opportunity to recoup the commission through M&E expenses. The deferral period can last decades and provides stiff penalties for early withdrawals. The penalty decreases each year until it completely disappears on a pre-determined date. This feature is often not disclosed by salespeople and can be very harmful to elderly retirees. For example, a retiree may purchase a VA, investing all or most of his liquid assets. Subsequently, the retiree incurs an unforeseen medical emergency or other major expense. He needs access to his money but discovers he can't get it without paying early redemption penalties. As he has no other option, the retiree redeems all or a portion of the annuity and loses a significant portion of his limited funds. This scenario occurs all over Florida on a regular basis.

The marketing of VAs is also suspect. VAs are pitched as a way for investors to accumulate wealth through tax deferral. However, regardless of whether the broker describes the VA as tax advantaged or tax deferred, this common sales practice is materially false for the majority of potential purchases by elderly investors. This is a false benefit for retirees as the tax impact is a function of the investor's age, time until retirement, and current and future marginal tax rates. The elderly purchaser does not have time to reap the benefits of the tax deferral.

VAs are also 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

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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.

As noted, many retirees are persuaded to purchase a variable product because they want to avoid losses. However, 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 can't 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 National Association of Securities Dealers (NASD) 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 NASD website (www.nasd.com).[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 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 equity-indexed annuity (EIA). Unfortunately, EIAs have many of the same negative characteristics and, thus, should not be sold to retirees. Further, depending on the mix of features, an equity-indexed annuity may or may not be a security. The typical equity-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 EIA information can be found on the SEC website at www.sec.gov/investor/pubs/equityidxannuity.htm.

In conclusion, while VAs are not unsuitable for everyone, the complexity of the product, the high costs, the questionable or limited benefits, and 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) ; 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).

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