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WHERE WE STAND

a publication of

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VARIABLE AND FIXED ANNUITIES WHAT ATTORNEYS NEED TO KNOW

Frederick Rosenberg JD

Introduction

Once upon a time, the much-maligned Variable Annuity (“VA”) was limited to death benefits for beneficiaries to fight over. However, once VAs were permitted to add guaranteed Living Benefit Riders, much mischief followed. Attorneys representing parties to Variable Annuities should be apprised of the benefits and pitfalls of this problematic investment product. That is the focus of this article.

VAs are insurance products that promise safety, income, a death benefit, and guarantees of income, not an estate. Originally developed as a tax shelter in the 1970s when tax rates reached 70%, VAs and Fixed Income Annuities (“FIAs”) are now globally recommended for the portfolios of investors across all economic sectors. Investors select from a menu of features and riders promoted in sales brochures and often supplemented by broker forecasts and financial plans. In the end, investors pay an average of 3-4% annually for “benefits” and other features they often never use, which they didn’t understand, which impair returns, and restricts access to funds. Less than 2% of VAs are annuitized annually with investors instead paying for and electing costly lifetime benefits and notional guarantees.¹

According to the Insurance Information Institute (III) and LIMRA, an Insurance Industry Trade Association, by the end of 2017 there were \$2.547 trillion in Variable and Index Annuities increasing by upward of 200

1. Erick Halpern, *Ruark Releases Fall 2018 Variable Annuity Study Results*, Ruark (Nov. 28, 2018), <https://ruark.co/ruark-releases-fall-2018-variable-annuity-study-results/> (“Annuitization rates on policies with guaranteed minimum income benefit (GMIB) riders continue to decline. The overall exercise rate for the riders with a 10-year waiting period is below 2% for the full study period. Rates have been falling steadily since 2010, and quarterly observed rates have stayed at or below 2% since 2014...”).

Billion/year^{2,3}. Two and half trillion dollars at an average 3% per year would generate by my calculation \$75 billion/year in fees and expenses. Variable and Fixed Index Annuity annual commissions could exceed \$1.2 billion at 6%. Unfortunately for most investors, the failings of their VAs and accruing damages are often masked by rising markets over the long-term, resulting in delayed discovery and consequent statutes of limitation and FINRA arbitration eligibility issues.

Impairment Damages

Damages related to VAs are based on impairment of returns, not allocation or market losses. Even suitably allocated portfolios can be impaired through excessive costs. Impairments are structural and unrelated to profitability or market adjusted damages. The impact of impairments grows in direct proportion to market performance. A 3%+ drag over 10-15 years will diminish returns by an amount equal to the original investment. Impairment damages must be separately calculated based not on an index but upon actual performance adjusted for the drag.

What is certain is that with high front-end fees, 12(b) fees, mortality expenses, and rider fees, there is a substantial inducement for financial advisors to recommend VAs and FIAs. Do the features truly conform to an investor's financial condition, objectives, and needs under both FINRA Rule 2330 and state insurance regulations?

This article analyzes annuity benefits and costs. At the end of this article, I list twenty disciplinary actions over the last two years relating specifically to VA sales practice abuses like switching and share types that generate higher fees to financial advisors for no benefit to investors.

2. LIMRA Secure Retirement Institute, *LIMRA Secure Retirement Institute: Total Annuity Sales Have Best Quarter in Nearly 10 Years*, (Feb. 20, 2019), http://www.limra.com/Posts/PR/News_Releases/LIMRA_Secure_Retirement_Institute_Total_Annuity_Slaes_Have_Best_Quarter_in_Nearly_10_Years.aspx (last visited Feb. 22, 2019).

3. LIMRA Secure Retirement Institute, U.S. Individual Annuity Sales Survey (2018, 4th quarter).

State Insurance Laws Always Apply

All states regulate insurance contracts and claims arise primarily under state insurance laws in addition to any State or Federal securities laws and regulations, or the rules of self-regulatory organizations (“SROs”). Respondents in arbitrations frequently argue that some Annuity claims are not eligible for FINRA arbitration because “they are not securities” and because FINRA arbitration rules specifically exempt such claims from arbitration.⁴ Variable Annuities are securities registered under the 33 Act. While FIA’s are safe-harbored from Registration⁵, FINRA requires supervision of the sale when sold “as an investment.”

State insurance laws provide the strongest basis of any VA claim and should be pleaded specifically and most states have a searchable online database of regulatory actions that define violative conduct and standards including Variable Annuities. For example:

New Jersey Revised Statutes TITLE 17B – INSURANCE: (NJ Example)

- **17B:17-5. Annuity defined.** “Annuity” is a contract not coming within the definition of life insurance as set forth in section 17B:17-3, or health insurance as set forth in section 17B:17-4, under which an insurer obligates itself to make periodic payments for a specified period of time, such as for a number of years, or until the happening of an event, or for life, or for a period of time determined by any combination thereof....”
- **17B:25-42 - Violations, penalties.** A violation of this act shall be a violation of N.J.S.17B:30-1 et seq. . Pursuant to the authority provided to the commissioner under N.J.S.17B:30-1 et seq., the commissioner may, upon finding a violation occurred or is occurring, order: (1) an insurer to take reasonably appropriate corrective action regarding any consumer harmed by a violation relating to an annuity issued by the insurer;

4. See FINRA Rule 12200.

5. See NASD NTM 05-50, 3 Equity-Indexed Annuities Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities (August 2005) (marketing an FIA as an investment nullifies the Rule 151 insurance safe harbor from Registration under Section 3(a)(8) of the 33 Act. Selling FIAs imposes a supervisory responsibility under FINRA Rules). See also *Malone v Addison Ins. Marketing, Inc.*, 225 F. Supp. 2d, 743 (W.D. Ky. 2002) (guidance on FIA exemptions from Registration); See also SEC Release 33-7438 (discussion of the Section 3(a)(8) Rule 151 Safe-harbor.)

- **17B:30-2 - Practices prohibited** “No person shall engage in this State in any trade practice which is defined in this chapter as or determined pursuant to this chapter to be an unfair method of competition or an unfair or deceptive act or practice in the business of life insurance, health insurance or annuity. The practices described in sections 17B:30-3 to 17B:30-13 as modified by section 17B:30-14 are hereby defined to be such practices.”
- **17B:30-3. Misrepresentations and false advertising of policies or annuity contracts.** “No person shall make, issue, circulate or cause to be made, issued or circulated, any estimate, illustration, circular or statement misrepresenting the terms of any policy or annuity contract issued or to be issued or the benefits or advantages promised thereby ...”.
- **17B:30-4. False information and advertising** “No person shall make, publish, disseminate, circulate, or place before the public, or cause, directly or indirectly, to be made, published, disseminated, circulated, or placed before the public, in a newspaper, magazine or other publication, or in the form of a notice, circular, pamphlet, letter or poster, or over any radio or television station, or in any other way, an advertisement, announcement or statement containing any assertion, representation or statement with respect to the business of insurance and annuities or with respect to any person in the conduct of his insurance and annuity business, which is untrue, deceptive or misleading”.
- **17B:30-6 - "Twisting" prohibited** “No person shall make any misleading representations or incomplete or fraudulent comparison of any insurance policies or annuity contracts or insurers for the purpose of inducing, or tending to induce, any person to lapse, forfeit, surrender, terminate, retain, or convert any insurance policy or annuity contract, or to take out a policy of insurance or annuity contract in another insurer”.

No Death Benefit

Variable annuities are insurance products and, as such, must include an insurance component - a death benefit initially pegged to the value of the contribution, the “contract value.” On average, VAs charge 1.35% + 0.15% administration of the contract value each year to pay for the death benefit. Consistent with life policies, that charge is called a “mortality expense.” On a \$1 million VA, the initial mortality expense is \$13,500/year. This fee will increase if the portfolio appreciates under Riders in most VA policies providing for “step-up.”

So, if the portfolio appreciates to \$1.2 million, a paid rider - Guaranteed Minimum Death Benefit (“GMDB”) - allows the investor to *permanently* “step up” the guaranteed notional⁶ (theoretical) death benefit to \$1.2 million. GMDB riders that ratchet-up the notional death benefit increase the mortality charges by at least 0.5% to 1.85%, or \$18,500 a year.

The Death Benefit is a Put

The death benefit is a unique and prohibitively expensive form of portfolio insurance.⁷ If at death the portfolio is less than the Guaranteed Death Benefit, the put will be in-the-money and its value will be equal to the difference between the notional (theoretical) death benefit and the portfolio’s market value. The sub-accounts of the VA will be “put” to the annuity company in exchange for the death proceeds. If at death the sub-account value exceeds the Guaranteed Benefit, the put will be out-of-the-money and will be valueless. Assuming no step-up, the 10-year cost is \$135,000 on a \$1,000,000 investment.

Buying a put is a costly short-term hedge against market reversals and is never a long-term solution due to high costs that impair returns. Mortality expenses, on the other hand, are lifelong and increasing. With step-up, mortality costs grow by an additional 0.5% to 1.85% a year in addition to living benefits that add another 1.5%, bringing policy costs to over 3%+/- in many cases in addition to portfolio management costs and 12(b) fees.

Assume the investor dies after 10 years, having paid \$135,000 in mortality expense. Disregarding fee impact, growth and step-up, if the investor died during a severe recession and his portfolio declined to \$700,000, his heirs would exercise the put and take the \$1 million death benefit, surrendering the \$700,000 sub-account. Actual costs are \$1 million plus \$135,000 mortality

6. The insurance benefit is “notional” or theoretical. The actual insurance benefit is the value of the put at death and is calculated by subtracting the surrendered portfolio’s value from the notional death benefit upon death. On contract date, the death benefit value is zero, not a notional \$1 million. VA sponsors restrict risky investments, require income allocations and restrict investment choices. The probability of a VA portfolio ever going to zero from market activity is nil and real death benefits are typically a small fraction of the notional insurance benefit even when the investor dies during a market recession.

7. Portfolio Insurance is a hedge strategy using Puts that is employed sparingly by professional portfolio managers to hedge short term risk. It has been widely criticized for its cost and value on a long-term basis.

fees, a benefit cost of \$1,135,000 for a \$1 million Death Benefit after 10 years. The value of the put is \$300,000, the amount by which the put is in-the-money. Had the portfolio only declined to \$900,000, the put value would drop to \$100,000 at death. By comparison, a 20-year \$500,000 term policy on a 58-year-old male costs approximately \$5,200 a year⁸ and offers fixed protection at savings of \$328,000 over 12 years. The beneficiaries get to keep both the portfolio and policy proceeds of \$500,000 regardless of performance.

Two things are deeply troubling about this:

1. VAs are routinely sold and promoted as providing a “Death Benefit” especially to those unable to qualify for a life policy, when in actuality the investor is purchasing a put of uncertain value, not a \$1 million life insurance policy.
2. Unlike insurance, mortality expenses are not refunded when, upon death, the put is out-of-the-money and expires worthless, as would normally be the case with insurance policies that do not pay out on death for any reason.

Below is a Comparison of a Guaranteed Death Benefit vs. Average Market Returns coupled with a \$500,000 term policy for Life+20-year guaranteed. The results are these:

1. Regardless of the death year, the index/term policy resulted in substantially better outcomes.
2. The put was in-the-money in only six of the 12 years.
3. That fact, plus the impact of fees, resulted in a deficit after 12 years of over \$1million between the variable annuity and the index/term Insurance under identical market performance.
4. The total costs of the VA - \$432,850 over 12 years - compare with \$104,080 for an index (.25%) and term policy costing \$5,200 a year and over 12 years the excess VA cost still amounts to a \$327,700 drag on performance.

8. Average Based upon quotations obtained on-line ranging from <\$2800-\$7,600/yr depending on health and age.

Sex	Male
age	58
Invest	1,000,000
Fees and Costs	VA 3%
Withdrawal*	NO
20 yr Term Life	500,000
Ann Premium	5,200

Death Benefit Analysis and Comparison

Variable Annuity with Step Up										
	A	B	C	D	E	F	G	H	I	J
age	Death Year	Open Value Contract Val	Avg Return	New Value Sub Acct	Costs** -3%	End Value	Notional Death Benefit With Step-Up	Upon Death G or F	Put Value Death Bene. G - F	Death Delta VA vs.idx Term Life
58	1	1,000,000	14%	1,140,000	(34,200)	1,105,800	1,000,000	1,105,800	-	(526,150)
59	2	1,105,800	-5%	1,050,510	(31,515)	1,018,995	1,105,800	1,105,800	86,805	(461,664)
60	3	1,018,995	-25%	764,246	(22,927)	741,319	1,105,800	1,105,800	364,481	(187,597)
61	4	741,319	34%	993,367	(29,801)	963,566	1,105,800	1,105,800	142,234	(449,494)
62	5	963,566	12%	1,079,194	(32,376)	1,046,818	1,105,800	1,105,800	58,982	(567,974)
63	6	1,046,818	14%	1,193,373	(35,801)	1,157,571	1,157,571	1,157,571	-	(671,986)
64	7	1,157,571	2%	1,180,723	(35,422)	1,145,301	1,157,571	1,157,571	12,270	(689,986)
65	8	1,145,301	17%	1,340,002	(40,200)	1,299,802	1,299,802	1,299,802	-	(767,699)
66	9	1,299,802	-7%	1,208,816	(36,264)	1,172,552	1,299,802	1,299,802	127,251	(649,129)
67	10	1,172,552	18%	1,383,611	(41,508)	1,342,103	1,342,103	1,342,103	-	(858,162)
68	11	1,342,103	10%	1,476,313	(44,289)	1,432,023	1,432,023	1,432,023	-	(928,392)
69	12	1,432,023	13%	1,618,187	(48,546)	1,569,641	1,569,641	1,569,641	-	(1,022,173)
					(432,850)					
* Contract Value will be adjusted proportionally for surrenders and partial surrenders and for recapture of bonuses and enhancements.										
** Assumes Annual Step-up Death Benefit. (Many policies, mostly older, allow only limited step-up on a 1 or 2 time basis during first 10 years resulting in switching)										
Note While all surrenders reduce benefits proportionally, each VA prospectus should be consulted to calculate what counts as a partial surrender that impacts Death Benefits.										
Index*** and \$500K Life-20-yr Term Policy										
	A	B	C	D	E	F	G	H	I	J
age	Death Year	Open Value Contract Val	Avg Return	New Value Index Bal	0.25% Idx+ \$5200/yr Ins Prem	End Value	Policy Death Benefit \$	Upon Death G + F	Death Benefit	Death Delta VA vs.idx Term Life
58	1	1,000,000	14%	1,140,000	(8,050)	1,131,950	500,000	1,631,950	500,000	526,150
59	2	1,131,950	-5%	1,075,353	(7,688)	1,067,464	500,000	1,567,464	500,000	461,664
60	3	1,067,464	-25%	800,598	(7,201)	793,397	500,000	1,293,397	500,000	187,597
61	4	793,397	34%	1,063,151	(7,856)	1,055,294	500,000	1,555,294	500,000	449,494
62	5	1,055,294	12%	1,181,929	(8,155)	1,173,774	500,000	1,673,774	500,000	567,974
63	6	1,173,774	14%	1,338,102	(8,545)	1,329,557	500,000	1,829,557	500,000	671,986
64	7	1,329,557	2%	1,356,148	(8,590)	1,347,558	500,000	1,847,558	500,000	689,986
65	8	1,347,558	17%	1,576,643	(9,142)	1,567,501	500,000	2,067,501	500,000	767,699
66	9	1,567,501	-7%	1,457,776	(8,844)	1,448,932	500,000	1,948,932	500,000	649,129
67	10	1,448,932	18%	1,709,739	(9,474)	1,700,265	500,000	2,200,265	500,000	858,162
68	11	1,700,265	10%	1,870,291	(9,876)	1,860,416	500,000	2,360,416	500,000	928,392
69	12	1,860,416	13%	2,102,270	(10,456)	2,091,814	500,000	2,591,814	500,000	1,022,173
					(104,080)					
*** Capital Gains treatment on Index Distributions vs. Ordinary tax treatment on VA distributions, CDSC, and 72T restrictions										

The irony is that as markets rise, investors must pay an additional 0.5% to 0.85% for riders to step up benefits simply to “protect profit” and maintain guarantees. Absent step-up, over the long-term the put will likely be

permanently out-of-the-money and worthless even while premiums are collected each year. For most VAs, the mortality expense is more of a surcharge than a benefit cost.

Core Riders and Guarantees

VAs offer risk-averse investors lifetime guarantees of return and income, a death benefit and tax advantages by top-rated insurance companies. These benefits are unavailable with mutual funds alone.

VAs have two principal phases: accumulation and distribution. Accumulation is the period when assets in subaccounts grow. Distribution specifically means death, annuitization, or a lifetime income. Death benefits are discussed above. Annuitization requires the purchase of an annuity based upon mortality tables with a minimum payout of 10 years, or in recent years, an income election under a paid rider.

VA Rider Alphabet Soup

- 1) GMWB – A guaranteed minimum withdrawal benefit (“GMWB”) rider guarantees that a certain percentage (usually 5-10%) of the amount invested can be withdrawn annually until the entire premium is recovered, regardless of market performance. Withdrawals deplete profits first and premium second and can result in partial surrenders and penalties.
- 2) GMIB – A guaranteed minimum income benefit (“GMIB”) rider is designed to provide the investor with a base amount of lifetime income when he or she retires, regardless of how the investments performed. It guarantees that if the owner annuitizes, payments will be based on the amount invested, credited with a guaranteed interest rate--typically 5%-8%. An investor must annuitize to receive this benefit and there is typically a seven to ten-year withdrawal-free holding period before it can be exercised. This is sometimes called a roll-up benefit. Age limits may also apply.
- 3) GMAB – A guaranteed minimum accumulation benefit (“GMAB”) rider guarantees that an owner's contract value will be at least equal to a certain minimum amount after a specified number of years (typically 7-10 years), regardless of actual investment performance. GMABs limit asset allocation and withdrawals and work in conjunction with other riders.

- 4) GLWB – A guarantee of income for life and a specific percentage (typically 3-6% based on age) of the amount invested (“GLWB”) can be withdrawn each year for as long as the contract holder lives regardless of market performance. This percentage will vary depending on the person's age when withdrawals begin. There are substantial portfolio restrictions and withdrawals generally act as surrenders. Recovery of premium ranges between 16 and 25 years and payments continue until death, even if the account balance is fully depleted.

In comparing the GLWB election to annuitization, the annuity appears to offer better outcomes for less cost assuming identical investments and timing. With a 6.23% constant, the annuity will take 16 years to recover investments v. 20 years for the GLWB.

<u>GLWB vs Annuity 65-yr old male, \$1,000,000</u>	
<u>GLWB</u>	<u>Annuity (Life-20 guarantee)</u>
<ul style="list-style-type: none"> • 5 % Constant (20- year recovery) 	<ul style="list-style-type: none"> • 6.23% Constant (16-year recovery)
<ul style="list-style-type: none"> • \$4,166/mo. (\$50,000/yr.) 	<ul style="list-style-type: none"> • \$5,192/mo. (\$62,304/yr.) • \$12,304/yr. <i>increased Cash Flow (\$246,080 in 20 years)</i>
<ul style="list-style-type: none"> • Partial Liquidity 	<ul style="list-style-type: none"> • Illiquid
<ul style="list-style-type: none"> • Surrender Value 	<ul style="list-style-type: none"> • Discounted Cash Flow Valuation
<ul style="list-style-type: none"> • Continues until Death 	<ul style="list-style-type: none"> • Continues until Death with 20-year guarantee
<ul style="list-style-type: none"> • Death Benefit 	<ul style="list-style-type: none"> • No Death Benefit
<ul style="list-style-type: none"> • Recapture and Adjustments affect distributions 	<ul style="list-style-type: none"> • No Adjustments to Income
<ul style="list-style-type: none"> • 2-3% Pre and Post-Annuity Annual Fees • Fee % can be increased over time 	<ul style="list-style-type: none"> • No annual fees or costs

Over the past 15 or so years, living benefits have made deferred variable annuities a 2.5+ trillion-dollar industry with millions of policy holders paying 2.5-3.5% annually (i.e., \$75 billion a year)⁹. Importantly, all guarantees apply

9. See, e.g. LIMRA Secure Retirement Institute, supra at Fn. 2 and Fn. 3.

solely towards the purchase of an annuity or an income under a Lifetime Withdrawal Rider. Should the investor surrender the policy instead of annuitizing, she takes the portfolio at surrender value. If an annuity is elected, the sub-accounts are forfeited and there is no ability to increase distributions or withdraw additional funds. There simply will be no estate. The annuity does have collateral value for lending purposes and could be sold at discount.

Many investors mistake the GMWB's percentage withdrawal benefit with the fixed dollar withdrawal GLWB benefit. It isn't comparable. The GMWB only guarantees the withdrawal rate (e.g. 7%), not the distribution amount (e.g., \$70,000). Both can trigger surrenders.

If the sub-accounts decline below the \$1 million contract amount for any reason (including withdrawals and fees), the penalty-free withdrawal amount will decline. For example, if the portfolio drops to \$800,000 in year four, the GMWB 7% penalty-free withdrawal amount would be \$56,000 a year. Annual withdrawals of \$70,000 if continued are 8.75% of the portfolio or \$14,000 more than permitted. Penalties will apply on the \$14,000 excess and the excess withdrawal will be treated as a "partial surrender," reducing benefits proportionately and setting the stage for unsustainability in the decade to follow.

During market declines, VAs in distribution accelerate surrenders with long-term impairment of benefits. It is common to see potentially fatal portfolio declines of 10-20% in VA sub-accounts after 4 to 5 years of 5% "penalty-free" withdrawals and 3.5% annual fees. There are six correlating factors that explain these phenomena:

1. *High Hurdles*: High annual VA expenses of 3%-4% plus 1% fund management expenses impose a substantial drag on growth.
2. *Fixed Withdrawals*: If a portfolio initially distributing \$50,000 a year declines to \$700,000 after 4 or 5 years, a \$50,000 withdrawal amounts to 7.15% of the portfolio raising the hurdle to 11.1%, an impossible barrier to recovery after market declines.
3. *Portfolio Allocation*: VA contracts with withdrawal riders generally require about 20% in fixed income, which is readjusted periodically. Mutual fund sub-accounts provide for well diversified and balanced positions and high volatility funds are not offered or are restricted. Given a portfolio allocation that includes 20%+ fixed income, projected arithmetic returns are insufficient to sustain growth over the long-term given hurdle rates.
4. *Cannibalization of Shares*. Every share or unit is an engine of growth, a small enterprise that generates income or growth at identified risk. A 9% hurdle, however, requires liquidation of shares to fund the distributions

and expenses, something that typically is effected automatically regardless of stock performance. Once liquidated, those shares are no longer available to contribute to portfolio growth. Over the long-term, share depletion is a significant drag on a portfolio's recovery and typically when market recovery does occur, the share-depleted portfolio does not and distributions become unsustainable.

5. *Sequence Risk*: Sequence risk is unique to portfolios in distribution whereby portfolios even with modest declines in the early years of distribution will become prematurely unsustainable. Conversely, portfolios that experience early appreciation in the sequence of returns not only are sustainable but are potentially profitable. The only way to manage sequence risk is to cease withdrawals until the portfolio recovers, something most VA investors on automatic withdrawals cannot do.
6. *Partial Surrenders*. One of the consequences of adhering to a fixed monthly withdrawal regime when portfolio value falls below contract value is that it results in partial surrender reducing benefits proportionally. For example, the 5% penalty-free withdrawal on an \$800,000 portfolio is \$40,000. Should investors continue fixed withdrawals of \$50,000 a year, there will be \$10,000 in excess withdrawal that is treated as a partial surrender and subject to penalties. If distributions continue, portfolio erosion will accelerate, the excess distributions will increase and benefits will be reduced proportionately.

Financial Planning

Those six financial factors explain portfolio declines in variable annuity sub-accounts over the long term to the point of unsustainability. Financial planning is a behavioral contributor to the decline.

When confronted with portfolio declines, either during recession or in combination with withdrawals, investors relying on VA guarantees and bolstered by financial projections and broker advice typically stay the course and continue their automatic distributions, liquidating shares and shortening payout by a decade or more. Unfortunately, based on my observations, most investors have no choice having planned their lifestyle in reliance on monthly distributions and lack reserves to continue without them for more than a month or two.

Financial plans typically have another weakness. All projections are based on contemporary variables, the principal invested, life expectancy, average growth rate, withdrawals, and inflation. However, each of those variables can change significantly. If by year three the portfolio value has

declined to \$800,000, there arguably is no difference from a second investor investing \$800,000 whose financial plan also promises sustainable distributions of 5% or \$40,000 a year vs. the \$50,000 a year depleting the investor's identical portfolio. The fact is that the original projections are woefully out of date three years later and new forecasts incorporating updated variables will likely require substantial adjustments to withdrawals or annuitization.

Most projections assume the VA sub-accounts will appreciate, provide penalty-free income, and cover expenses over a lifetime. Given the 3%-4% annual expense hurdle, volatility, sequence risk, and share liquidations, the probability of capital appreciation after 5%-6% income distributions (even under normal market conditions) is dim at best, making long-term principal erosion a predictable outcome from day one. Sadly, most investors never come to realize this until portfolio erosion is irreversible, distributions unsustainable, and guaranteed income alternatives inadequate.

The vast majority VA policies will never be annuitized,¹⁰ yet investors still pay costly annual premiums for benefits and guarantees that apply only towards the purchase of an annuity or taking guaranteed lifetime income. If an investor does annuitize, the fixed distributions likely will be far lower over time than forecasted, the estate disappears, and benefits are terminated. In short, if the Investor annuitizes, the projections in the financial plan go out the window. There is much the same impact of taking lifetime income benefits.

There are meaningful defects in many projections that grossly overstate long-term growth and understate risk. The table below illustrates the difference that volatility and internal VA expenses can have on the sales forecasts investors rely upon. In my experience, most sales illustrations obtained in Discovery often used straight-line appreciation and omit internal VA costs in long-term projections. Adding market volatility to the growth rate and internal costs substantially alters the illustration.

10. Erick Halpern, *Ruark Releases Fall 2018 Variable Annuity Study Results*, Ruark (Nov. 28, 2018), <https://ruark.co/ruark-releases-fall-2018-variable-annuity-study-results/>.

Variable Annuity							VA + Volatility and Expense						
				Proj						Proj			
avg growth	8.50%	Port Val	exp*	Distr	Total	Acct		8.50%	Port Val	exp*	Distr	Total	Acct
Std Dev	0.00%	1,000,000	0.00%	-	cash out	Value **		10.25%	1,000,000	3.00%	-	Cash out	Value
Irr	8.50%			0%				4.77%			0%		
Year end		1,000,000				1,000,000	age		1,000,000				1,000,000
1	8.5%	1,085,000	-	-	-	1,085,000	58	14.0%	1,140,000	34,200	-	(34,200)	1,105,800
2	8.5%	1,177,225	-	-	-	1,177,225	59	12.0%	1,238,496	37,155	-	(37,155)	1,201,341
3	8.5%	1,277,289	-	-	-	1,277,289	60	-1.0%	1,189,328	35,680	-	(35,680)	1,153,648
4	8.5%	1,385,859	-	-	-	1,385,859	61	15.0%	1,326,695	39,801	-	(39,801)	1,286,894
5	8.5%	1,503,657	-	-	-	1,503,657	62	11.0%	1,428,453	42,854	-	(42,854)	1,385,599
6	8.5%	1,631,468	-	-	-	1,631,468	63	14.0%	1,579,583	47,387	-	(47,387)	1,532,195
7	8.5%	1,770,142	-	-	-	1,770,142	64	2.0%	1,562,839	46,885	-	(46,885)	1,515,954
8	8.5%	1,920,604	-	-	-	1,920,604	65	24.0%	1,879,783	56,393	-	(56,393)	1,823,390
9	8.5%	2,083,856	-	-	-	2,083,856	66	-11.0%	1,622,617	48,685	-	(48,685)	1,574,132
10	8.5%	2,260,983	-	-	-	2,260,983	67	15.0%	1,810,252	54,308	-	(54,308)	1,755,945
11	8.5%	2,453,167	-	-	-	2,453,167	68	1.0%	1,773,504	53,205	-	(53,205)	1,720,299
12	8.5%	2,661,686	-	-	-	2,661,686	69	8.0%	1,857,923	55,738	-	(55,738)	1,802,185
13	8.5%	2,887,930	-	-	-	2,887,930	70	18.0%	2,126,578	63,797	-	(63,797)	2,062,781
14	8.5%	3,133,404	-	-	-	3,133,404	71	22.0%	2,516,593	75,498	-	(75,498)	2,441,095
15	8.5%	3,399,743	-	-	-	3,399,743	72	3.0%	2,514,328	75,430	-	(75,430)	2,438,898
16	8.5%	3,688,721	-	-	-	3,688,721	73	17.0%	2,853,511	85,605	-	(85,605)	2,767,905
17	8.5%	4,002,262	-	-	-	4,002,262	74	9.0%	3,017,017	90,511	-	(90,511)	2,926,506
18	8.5%	4,342,455	-	-	-	4,342,455	75	2.0%	2,985,037	89,551	-	(89,551)	2,895,485
19	8.5%	4,711,563	-	-	-	4,711,563	76	11.0%	3,213,989	96,420	-	(96,420)	3,117,569
20	8.5%	5,112,046	-	-	-	5,112,046	77	-16.0%	2,618,758	78,563	-	(78,563)	2,540,195
								1,207,664				Difference (2,571,851)	

Variable Annuity							VA + Volatility and Expense						
				Proj						Proj			
avg growth	8.50%	Port Val	exp*	Distr	Total	Acct		8.50%	Port Val	exp*	Distr	Total	Acct
Std Dev	0.00%	1,000,000	0.00%	1,000,000	Cash out	Value **		10.25%	1,000,000	3.0%	1,000,000	Cash out	Value
Irr	8.50%			5%				5.28%			5%		
Year end		1,000,000				1,000,000	age		1,000,000				1,000,000
1	8.5%	1,085,000	-	50,000	(50,000)	1,035,000	58	14.0%	1,140,000	34,200	50,000	(84,200)	1,055,800
2	8.5%	1,122,975	-	50,000	(50,000)	1,072,975	59	12.0%	1,182,496	35,475	50,000	(85,475)	1,097,021
3	8.5%	1,164,178	-	50,000	(50,000)	1,114,178	60	-1.0%	1,086,051	32,582	50,000	(82,582)	1,003,469
4	8.5%	1,208,883	-	50,000	(50,000)	1,158,883	61	15.0%	1,153,990	34,620	50,000	(84,620)	1,069,370
5	8.5%	1,257,388	-	50,000	(50,000)	1,207,388	62	11.0%	1,187,001	35,610	50,000	(85,610)	1,101,391
6	8.5%	1,310,016	-	50,000	(50,000)	1,260,016	63	14.0%	1,255,585	37,668	50,000	(87,668)	1,167,918
7	8.5%	1,367,117	-	50,000	(50,000)	1,317,117	64	2.0%	1,191,276	35,738	50,000	(85,738)	1,105,538
8	8.5%	1,429,072	-	50,000	(50,000)	1,379,072	65	24.0%	1,370,867	41,126	50,000	(91,126)	1,279,741
9	8.5%	1,496,294	-	50,000	(50,000)	1,446,294	66	-11.0%	1,138,970	34,169	50,000	(84,169)	1,054,800
10	8.5%	1,569,228	-	50,000	(50,000)	1,519,228	67	15.0%	1,213,021	36,391	50,000	(86,391)	1,126,630
11	8.5%	1,648,363	-	50,000	(50,000)	1,598,363	68	1.0%	1,137,896	34,137	50,000	(84,137)	1,053,759
12	8.5%	1,734,224	-	50,000	(50,000)	1,684,224	69	8.0%	1,138,060	34,142	50,000	(84,142)	1,053,918
13	8.5%	1,827,383	-	50,000	(50,000)	1,777,383	70	18.0%	1,243,624	37,309	50,000	(87,309)	1,156,315
14	8.5%	1,928,460	-	50,000	(50,000)	1,878,460	71	22.0%	1,410,704	42,321	50,000	(92,321)	1,318,383
15	8.5%	2,038,129	-	50,000	(50,000)	1,988,129	72	3.0%	1,357,935	40,738	50,000	(90,738)	1,267,197
16	8.5%	2,157,120	-	50,000	(50,000)	2,107,120	73	17.0%	1,482,620	44,479	50,000	(94,479)	1,388,141
17	8.5%	2,286,226	-	50,000	(50,000)	2,236,226	74	9.0%	1,513,074	45,392	50,000	(95,392)	1,417,682
18	8.5%	2,426,305	-	50,000	(50,000)	2,376,305	75	2.0%	1,446,035	43,381	50,000	(93,381)	1,352,654
19	8.5%	2,578,291	-	50,000	(50,000)	2,528,291	76	11.0%	1,501,446	45,043	50,000	(95,043)	1,406,403
20	8.5%	2,743,195	-	50,000	(50,000)	2,693,195	77	-16.0%	1,181,378	35,441	50,000	(85,441)	1,095,937
								799,961		1,000,000		Difference (1,597,258)	

* Annual Fund Costs and Expenses charged against the Contract and paid through sub-accounts liquidations

** May be subject to Surrender Adjustment or Annuitization

The top half of the table compares forecasts without withdrawals, the bottom half compares forecasts with withdrawals. The market-adjusted portfolio projects only half the value of the typical sales forecast when expenses are included. Overstatement of outcome understates risk and that often leads to the false impression that the VA will produce both an estate and guaranteed lifetime income. In reality, it is surrender or income, never both.

Reaching the Break(ing) Point – Follow the Money

Brokers selling VAs typically receive 6% commissions regardless of investment amount. Loaded mutual funds reduce overall commissions at “breakpoints” on a scale from 8% to 0% depending on total investment. No commissions are paid whatsoever on a \$1 million investment.

By contrast, a \$1 million VA with the same mutual funds will pay the broker \$60,000 in commissions, giving a strong incentive to recommend a VA to circumvent breakpoint discounts. Does the investor truly benefit?¹¹ One company I surveyed pays commission of “5% Heaped” or 3.5% plus a 0.5% trailer for 10 years or 1.25% plus a 0.8% trailer for 10 years.

Trailers are calculated on the appreciated portfolio value, meaning that appreciating portfolios grow commissions substantially over 10 years, often exceeding 10% over that time while diminishing sub-account returns.

Share Types and Commissions

News Release

For Release: Wednesday, November 2, 2016
Contact(s): Nancy Condon (202) 728-8379

FINRA Fines Eight Firms a Total of \$6.2 Million for Supervisory Failures Related to Variable Annuity L-Shares

Five Firms Ordered to Pay More than \$6 Million to Customers

11. See NASD Notice To Members 02-85 NASD Requires Immediate Member Firm Action Regarding Mutual Fund Purchases and Breakpoint Schedules (December 2002) and NASD NTM 03-47 Refunds to Customers Who Did Not Receive Appropriate Breakpoint Discounts in Connection with the Purchase of Class A Shares of Front-End Loaded Mutual Funds and the Capital Treatment of Refund Liability (August 2003) (discussions of Mutual Fund breakpoints and damages for breakpoint violations.)

The typical variable annuity is a “B” share, with a 7-10 year Contingent Deferred Sales Charge (“CDSC”) on a declining scale from 8% to 0%. However, L shares aimed, oxymoronically, at short-term annuity investors reduced the CDSC to four years by increasing rider fees and paying higher commissions. L shares are not being offered today by most companies due in part to recent regulatory actions and fines related to excess fees and commissions. Transamerica’s Variable Annuity Series X¹² shares incorporate a Step-Up fee for longer and higher CDSCs and higher mortality costs.

The cost structures and rider charges are related to share type and therefore, on VA claims, damages will accrue differently and could be significant over the long-term. Increased commissions, mortality administration expenses, and 12(b) fees have a deleterious impact over time for no benefit other than to commissioned salesmen.

Twisting/Switching

Over the past 10-15 years, annuity companies have added a portfolio of “living benefit” riders. These riders, discussed above, are substantial enhancements and carry heavy costs over time. Simultaneously, many of the earlier VAs had limits on step-up and lacked comparable living benefits. Unable to step-up their death or income benefits to “protect” portfolio appreciation, many existing VA owners have been induced to switch policies and pay a CDSC to purchase a higher cost VA with additional features, restarting the CDSC and paying new commissions. Under state insurance laws, this may be defined as “twisting” when done to generate commissions. In FINRA parlance, the practice is known as “switching”.

FINRA Rule 2330 (B)(1) (b) provides that in the case of an exchange of a deferred variable annuity, the exchange must be consistent with the suitability determination required by paragraph (b)(1)(A) of this Rule, taking into consideration whether:

- (i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living, or other contractual benefits), or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees, or charges for riders and similar product enhancements)

12. Transamerica’s Variable Annuity Series X Share, http://www.transamerica.com/.../x-share-product-brochure-0718_tcm73-45969.pdf.

- (ii) the customer would benefit from product enhancements and improvements
- (iii) the customer has had another deferred variable annuity exchange within the preceding 36 months
- (iv) The determinations required by this paragraph shall be documented and signed by the associated person recommending the transaction.
- (v) Recent Regulatory Actions highlight the problem

News Release

For Release: Tuesday, May 3, 2016
Contact(s): Michelle Ong (202) 728-8464
Nancy Condon (202) 728-8379

FINRA Sanctions MetLife Securities, Inc. \$25 Million for Negligent Misrepresentations and Omissions in Connection With Variable Annuity Replacements

Largest FINRA Fine Relating to Variable Annuities

News Release

For Release: Tuesday, May 8, 2018
Contact(s): Michelle Ong (202) 728-8464

FINRA Sanctions Fifth Third Securities, Inc., \$6 Million for Cost and Fee Disclosure Failures and Unsuitable Recommendations Related to Variable Annuity Exchanges

Fixed Index Annuity:

An FIA is an insurance contract (not a security) designed to compete with CDs and T-Bills. Notional accounts replace VA sub-accounts with benefits and balances calculated according to the terms of the riders. Principal is guaranteed, but index returns are capped. Principal depletion occurs from fees and costs as well as from surrenders. CDSCs are high and surrender periods long. All benefits are recaptured from excess withdrawals and surrenders. Below are typical CDSC and recapture rates. Each of the categories, 10/8/5 year percentages, come with differing cost and commission structures and vary in terms of impairment.

Years Since Premium Paid	0	1	2	3	4	5	6	7	8	9	10
10-year surrender %	9%	9%	8%	7%	6%	5%	4%	3%	2%	1%	0%
8-year surrender %	8%	8%	7%	6%	5%	4%	3%	2%	0%	0%	0%
5-year surrender %	7%	7%	6%	5%	4%	0%	0%	0%	0%	0%	0%

Years since Policy Date	0	1	2	3	4	5	6	7	8	9	10
10-year Recapture %	100.0%	90.0%	80.0%	70.0%	60.0%	50.0%	40.0%	30.0%	20.0%	10.0%	0.0%
8-year Recapture %	100.0%	87.5%	75.0%	62.5%	50.0%	37.5%	25.0%	12.5%	0.0%	0.0%	0.0%
5-year Recapture %	100.0%	80.0%	60.0%	40.0%	20.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

FIA: Roll-Up

For investors not taking immediate distributions, GMIB roll-up options at guaranteed growth rates are intended to build an income base for higher annuity payments in later years. The table below illustrates an actual guaranteed Roll-Up benefit in a FIA.

The annual charge is 1.25% of the income base, a notional account growing 8% a year for 12 years assuming no withdrawals. As the income base grows over the years, so does the lifetime income. For example, at age 90, the investor can either take an annuity paying \$41,310 annually on an income base of \$550,800 extinguishing all benefits or pay an additional rider charge, grow the income base by 8% and maintain the death benefit for another year for a higher payout. Note also that the discounted cash flow (DCF) value of the lump sum death benefit vs. an annuity payout amount and the account value over 16 years.¹³

13. Source: an actual illustration of guaranteed benefits under American Valor 10 and Income Sustainer Plus Illustration Forms #P1431410NW and #R6032810NW, Great American Life Insurance Company February 5, 2015, Version 9.16.13.

Rollup Rate/Period: 8.00 % for 12 years

Rider Charge: 1.25 %

year	Age	Beginning Account Value	Beginning Income Base	Available Lifetime Income	W/draw	Rider Charge	Ending Income Base	Ending Account Value	Ending 5 Year Death Benefit	Lump Sum Death Benefit
1	80	306,000	306,000	-	-	3,825	330,480	302,175	302,175	302,175
2	81	302,175	330,480	21,812	-	4,131	354,960	298,044	298,044	298,044
3	82	298,044	354,960	23,782	-	4,437	379,440	293,607	293,607	293,607
4	83	293,607	379,440	25,802	-	4,743	403,920	288,864	291,961	291,961
5	84	288,864	403,920	27,870	-	5,049	428,400	283,815	298,274	298,274
6	85	283,815	428,400	29,988	-	5,355	452,880	278,460	452,880	365,670
7	86	278,460	452,880	32,154	-	5,661	477,360	272,799	477,360	375,080
8	87	272,799	477,360	34,370	-	5,967	501,840	266,832	501,840	384,336
9	88	266,832	501,840	36,634	-	6,273	526,320	260,559	526,320	393,440
10	89	260,559	526,320	38,948	-	6,579	550,800	253,980	550,800	402,390
11	90	253,980	550,800	41,310	-	6,885	575,280	247,095	575,280	411,188
12	91	247,095	575,280	43,146	-	7,191	599,760	239,904	599,760	419,832
13	92	239,904	599,760	44,982	-	7,497	599,760	232,407	599,760	416,084
14	93	232,407	599,760	44,982	-	7,497	599,760	224,910	599,760	412,335
15	94	224,910	599,760	44,982	-	7,497	599,760	217,413	599,760	408,587
16	95	217,413	599,760	44,982	-	7,497	599,760	209,916	599,760	404,838

The 1.25% rider cost is in addition to all other elected riders and expenses typically aggregating 3.5%+/- including portfolio management. Fees, withdrawals, and partial surrenders reduce benefits and with a declining account value, estate building is impossible. Collateral value - the amount a bank will lend against the FIA - is the lesser of surrender value or account value. If the annuitant dies before receiving an amount equal to the premium or contract value, the beneficiaries will receive a lump sum equal to the remainder of the premium which has not yet been paid.

It's the Constant, Stupid

Lifetime annuity payments are determined actuarially, so the shorter the life expectancy, the higher the payment. This is reflected in the "constant," the percentage of the original premium or contract value that will be paid out every year for life. As the first table below illustrates, even if the income base did not grow at all, the annuity payment would steadily increase as life-expectancy decreased. Familiarly, this is the same rationale used to delay taking Social Security payments until age 70.

I compare the immediate annuity payout to the payout of the GMIB for each year between 80 and 90 as illustrated in sales brochures. *Immediateannuities.com* does not publish rates beyond age 90 and so the comparison ends in the 11th year. Surprisingly, with zero growth in account value over 10 years, the immediate annuity still produced higher annual income than the escalating GMIB's Lifetime Income benefit¹⁴ every year, a result solely attributable to the constant.

Annuitization					GMIB w Roll-up				
Annuity year	Age	Account Value, grow/yr	Constant*	Annual \$	Beginning Income Base	GMIB Lifetime Income/yr	Constant	GLWB Rider Fee	Excess Annuity \$/yr.
1	80	306,000	8.95%	27,387	306,000	-	0.00%	(3,825)	27,387
2	81	306,000	9.73%	29,774	330,480	21,812	6.60%	(4,131)	7,962
3	82	306,000	9.97%	30,508	354,960	23,782	6.70%	(4,437)	6,726
4	83	306,000	10.20%	31,212	379,440	25,802	6.80%	(4,743)	5,410
5	84	306,000	10.45%	31,977	403,920	27,870	6.90%	(5,049)	4,107
6	85	306,000	11.19%	34,241	428,400	29,988	7.00%	(5,355)	4,253
7	86	306,000	11.64%	35,618	452,880	32,154	7.10%	(5,661)	3,464
8	87	306,000	12.11%	37,057	477,360	34,370	7.20%	(5,967)	2,687
9	88	306,000	12.61%	38,587	501,840	36,634	7.30%	(6,273)	1,953
10	89	306,000	13.12%	40,147	526,320	38,948	7.40%	(6,579)	1,199
11	90	306,000	13.66%	41,800	550,800	41,310	7.50%	(6,885)	490
								Total Fees	(58,905)

* based upon constants from immediateannuities.com

I next prepared a comparison escalating the account value by 2% a year, a safe rate equivalent or the TIPs rate (Treasury Inflation Protected notes) or the minimum guaranteed rate mandated under every state's insurance laws. Compounding at a safe-rate of 2% a year, the immediate annuity realizes a substantial annual increase over the GMIB Lifetime Income growing its base 8% a year.

14. All states mandate minimum growth rates on annuities so without any riders Account Value should appreciate at 2%+/- annually under State law.

Annuitization					GMIB w Roll-up				
Annuity year	Age	Account Value, grow/yr 102%	Constant*	Annual \$	Beginning Income Base	GMIB Lifetime Income/yr	0	GLWB Rider Fee	Excess Annuity \$/yr.
1	80	306,000	8.95%	27,387	306,000	-	0.00%	(3,825)	27,387
2	81	312,120	9.73%	30,369	330,480	21,812	6.60%	(4,131)	8,557
3	82	318,362	9.97%	31,741	354,960	23,782	6.70%	(4,437)	7,959
4	83	324,730	10.20%	33,122	379,440	25,802	6.80%	(4,743)	7,320
5	84	331,224	10.45%	34,613	403,920	27,870	6.90%	(5,049)	6,743
6	85	337,849	11.19%	37,805	428,400	29,988	7.00%	(5,355)	7,817
7	86	344,606	11.64%	40,112	452,880	32,154	7.10%	(5,661)	7,958
8	87	351,498	12.11%	42,566	477,360	34,370	7.20%	(5,967)	8,196
9	88	358,528	12.61%	45,210	501,840	36,634	7.30%	(6,273)	8,576
10	89	365,698	13.12%	47,980	526,320	38,948	7.40%	(6,579)	9,032
11	90	373,012	13.66%	50,953	550,800	41,310	7.50%	(6,885)	9,643
* based upon constants from immediateannuities.com							Total Fee:	(58,905)	

Finally, I prepared a third analysis applying the *Immediateannuity.com* constant to the GMIB income base. The annuity payout was consistently 50%-60% greater than the GMIB lifetime income with the same income base. Once again, the explanation lies with the substantially higher immediate annuity constant vs. the “haircut” constant applicable to the living benefit. Contributing the lower payout is the fact that most VAs and FIAs apply an age “setback” of 7-10 years on the annuity calculation of their riders reducing benefits based on a notional longer life expectancy. Caveat: The illustration is based on an actual annuity illustration, but payout rates vary widely as do guaranteed growth rates and each policy must be individually analyzed.

Damages could very well be measured as the difference in payouts between the immediate annuity and the recommended lifetime benefit.

Annuitization					GMIB w Roll-up				
Annuity year	Age	Account Value, grow/yr	Constant*	Annual \$	Beginning Income Base	GMIB Lifetime Income/yr	Constant	GLWB Rider Fee	Excess Annuity \$/yr.
1	80	306,000	8.95%	27,387	306,000	-		(3,825)	27,387
2	81	330,480	9.73%	32,156	330,480	21,812	6.60%	(4,131)	10,344
3	82	354,960	9.97%	35,390	354,960	23,782	6.70%	(4,437)	11,608
4	83	379,440	10.20%	38,703	379,440	25,802	6.80%	(4,743)	12,901
5	84	403,920	10.45%	42,210	403,920	27,870	6.90%	(5,049)	14,340
6	85	428,400	11.19%	47,938	428,400	29,988	7.00%	(5,355)	17,950
7	86	452,880	11.64%	52,715	452,880	32,154	7.10%	(5,661)	20,561
8	87	477,360	12.11%	57,808	477,360	34,370	7.20%	(5,967)	23,438
9	88	501,840	12.61%	63,282	501,840	36,634	7.30%	(6,273)	26,648
10	89	526,320	13.12%	69,053	526,320	38,948	7.40%	(6,579)	30,105
11	90	550,800	13.66%	75,239	550,800	41,310	7.50%	(6,885)	33,929
* based upon constants from immediateannuities.com							Total Fee:	(58,905)	

To further understand the benefits of deferral to the annuity company, consider the impact of all \$2.5 trillion outstanding in variable annuities annuitizing immediately (something many should probably do to avoid years of corrosive costs). Investors would get higher guaranteed payments and quicker recovery of premium. Variable annuity sponsors, however, would lose virtually all their ongoing revenues, perhaps \$75 Billion/ a year in mortality costs and rider fees; salesmen would lose their trailing commissions; VA portfolio managers would be put out of business. Or consider that the annuity company could buy an annuity with a 13.66% constant and payout only 7.5% on the lifetime benefit, a 6.16% profit spread for the life of the payments while still collecting fees.

In sum, while the investor fares substantially better with the immediate annuity, the insurance company and sales reps fare far better with the GMIB at investor expense.

Who Benefits from Deferral?

The insurance company profits most from deferral and investors suffer most. It should come as no surprise that annuity companies aggressively offer an ever-increasing number of riders, benefits and guarantees aimed specifically at delaying - if not preventing - annuitization, promoting living and death benefits that perpetuate VA fees and costs for a decade or more. For the annuity company, the longer the deferral the better, but for the investor, the long-term benefits of deferral are highly questionable given the continuing cost, restrictions, and the availability of an immediate annuity with a higher payout any time without the annual costs, conditions and limitations of a deferred annuity.

In short, investors are induced to pay substantial fees for notional benefits with truncated constants or worse, to switch to a new deferred annuity to obtain those benefits. Considering the <2% annual annuitization rate, the strategy is wildly successful.¹⁵ Investors rarely annuitize and switching is a growing problem.

15. Erick Halpern, *Ruark Releases Fall 2018 Variable Annuity Study Results*, Ruark (Nov. 28, 2018), <https://ruark.co/ruark-releases-fall-2018-variable-annuity-study-results/>.

Quarterly Statements

Deferred annuities typically report quarterly and the quality of statements vary widely, some reporting only balances, others include transactions. Reading and understanding the statements can be confusing, especially for retirees. For example, the notional “guaranteed withdrawal balance” - the total of all future guaranteed income payments - is often misinterpreted as “surrender value” and the death benefit confused as insurance. Surrender value may or may not be separately reported; it is not a benefit.

Reported notional balances such as death benefit, guaranteed income base, roll-up base and GMAB value, confuse if not mislead with foreseeable consequence. In truth, most investors cannot accurately tell you what their deferred annuity is worth after reading their statements.

Damages

Discounted Cash Flow Loss

Investors should realize that they are buying an annuity and that all guarantees and living benefits apply primarily towards annuitization and Lifetime Withdrawal Benefits, not savings or estate building. At the point of annuitization, the investor converts cash assets into a guaranteed stream of revenues valued on a discounted cash flow (“DCF”) basis with entirely different financial consequences. For example, JG Wentworth discounts revenue streams at 8.2%.

The table below illustrates the present value of annuity streams of 10, 15 and 20 years.¹⁶ As is crystal clear, on a discounted present value basis, annuitization results in an immediate, substantial, unreported and unrealized loss, a fact totally omitted from sales presentations, marketing materials and financial forecasts.

16. All annuity payments are based on quotations from immediateannuities.com for fixed terms of 10, 15, and 20 years. Actuarial factors on lifetime annuities often calculate lower payments and should be present valued for damages purposes.

Discounted Present Value of Annuity w/Fixed Payout			
	\$1,000,000		
	10 yr	15yr	20 yr
<i>JG Wentworth discount rate</i>			
8.20%	0.68%	0.68%	0.68%
<i>Monthly payment</i>	9,558	6,986	5,708
<i># pmts</i>	120	180	240
<i>Total Withdrawals *</i>	1,146,960	1,257,480	1,369,920
<i>Present Value</i>	<u>\$780,965</u>	<u>\$722,266</u>	<u>\$672,376</u>
<i>immediate DCF loss</i>	(\$219,035)	(\$277,734)	(\$327,624)

Constant Differential Loss

Damages amount to the difference between the net present value (“NPV”) of the immediate annuity and the net present value of the GLWB’s lifetime withdrawal that is based upon Sub-Account value. Here an Investor, age 81, could buy an immediate annuity with a 9.73% constant. The lifetime income benefit payout is 6.6%, a spread of 3.13% and an NPV shortfall of \$307,250.

Net Present Value of Annuity v. NPV Lifetime Income Benefit			
	\$1,000,000		<i>Shortfall</i>
	81 yr Male-20 yr		
	Immed Annuity	Lifetime Benefit	
<i>Discount rate</i>			
8.20%	0.68%	0.68%	
<i>Constant</i>	9.73%	6.60%	-3.13%
<i>Monthly payment</i>	8,108	5,500	\$ (2,608)
<i># pmts</i>	240	240	-
<i>Total Withdrawals *</i>	1,946,000	1,320,000	(626,000)
<i>Present Value</i>	<u>\$955,124</u>	<u>\$647,874</u>	(307,250)
<i>immediate DCF loss</i>	(\$44,876)	(\$352,126)	(307,250)

Impairment Loss:

Most VA investors never intend to annuitize specifically to maintain control of and access to their investment for unbudgeted expenses and

ultimately for an estate. The overwhelming percent of VA contracts are never annuitized. Consequently, many investors - retirees in particular - take automatic, penalty-free withdrawals under a GMWB during the accumulation phase and pay 3%+ in annual costs, totally unaware that over time they will likely deplete the subaccounts, reduce benefits and guarantees proportionately and ultimately leave them with a VA incapable of sustaining promised levels of distributions.

Losses arise from the impairment of return caused by the impact of annual costs for questionable features and benefits. VA sub-accounts are contractually restricted to contain market risk, and most allocations are moderate growth at worst. Instead, VA claims are about features, costs, illiquidity, sustainability and the sales practices and materials that induce customers to sign a contract and opt for benefits and riders that seriously impair returns.

To reemphasize, impairment is structural and damages are unrelated to profitability. Importantly, profitable VAs often suffer substantial impairment masked by market growth. The impact of impairment grows in direct relation to the drag that 3%-4% excess annual costs have on portfolio returns growing at market over the long-term. The impact can amount to well over original investment in 10 years and well worth analyzing.

Rescission:

Rather than holding on to the annuity with monetary damages, the alternative claim would be for rescission in which the investor would wind up with the original investment plus interest from the date of investment to the claim filing date, less withdrawals and surrenders and relinquishment of the annuity.

Portfolio Adjusted Damages:

Variable annuities generally restrict sub-account allocations depending on guarantees and living benefit riders. For example, the GLWB requires an allocation in fixed income that may not be required in the absence of the rider. In that case, and others, appropriate portfolio allocations or correlating indexes that do match customer objectives for income or growth can provide an analog for performance comparisons ex-costs.

False Choices vs Real Alternatives

Given the buffet of features and benefits promoted in VA prospectuses and sales materials, it should come as no surprise that even experienced investors are consistently confused. Over my entire forensic career, I have never met a VA investor who could explain the differences between a GLWB, GMAB and GMWB. Most do not understand the risk of withdrawals during the accumulation phase or the distinction between a death benefit and life insurance. Most rely on long-term sales illustrations utilizing average growth rates ignoring volatility and sequence risk and omitting internal VA costs, projections that are misleading at best.

My experience convinces me that variable annuities are often sold on benefits and guarantees that the customer and adviser never plan to implement at an annual cost of 3%-4%, draining the portfolio and impairing returns. In most VA-related customer complaints that I see, investors have taken fixed dollar, automatic withdrawals under a GMWB during the accumulation phase that resulted in partial surrenders, reduced benefits and portfolio declines and, predictably, premature unsustainability. Commonly, sub-accounts are projected to distribute 5%-6%, pay 3.5% costs, appreciate at market rate throughout life and build an estate. Based upon the sequence of returns that result may be possible, but not likely in a VA.

A significant inducement towards the purchase of a VA is tax-deferred growth in sub-accounts although income is taxed at ordinary rates. By comparison, index funds are taxed at capital gains rates upon sale and essentially grow tax-deferred without the restrictions of a VA. Considering that all the benefits of a VA can be obtained a-la-carte for a fraction of the annual expense of a VA including a \$500,000 term-life policy, it is hard to understand the penchant among financial planners, brokers and advisers for recommending VA purchases other than the commissions and the expectation that over time VA investors will need to switch into a new annuity, thereby generating new commissions in the future.

Investors must understand that they are buying an annuity and that all guarantees and living benefits apply primarily towards annuitization or a withdrawal benefit, not savings or estate building. VA presentations typically focus on comparisons of available benefits not investment alternatives. Many investors typically rely on retail forecasts that apply straight-line, zero-volatility growth rates long-term, and ignore internal VA expenses, making those forecasts extraordinarily unreliable, conflicted, and confusing.

Conclusion

In conclusion, is the long-term impact of VA fees and expenses on return worth the additional annual cost and promoted benefits? In most instances the answer is “No.” Still, every deferred annuity is different. Each may use different terms and names for identical features. In order to present a case, the prospectus of each annuity must be analyzed and compared with alternatives and costs. There are no cookie cutters. Calculating and substantiating Impairment is essential and rescission and market adjusted damages may apply.

Consult State insurance laws and regulatory actions before drafting an arbitration Statement of Claim and review the FINRA disciplinary cases cited below. VA claims in arbitration are replete with inaccurate testimony that can only be exposed by skilled examination. Since your expert cannot cross-examine witnesses and may not even attend the entire hearing, your understanding of the product’s features, benefits, and costs are essential.

There are \$2.5 trillion in deferred annuities at this time and chances are good that virtually every attorney representing customers in arbitration will confront them in years to come. Sadly, many lawyers fail to identify and state claims for substantial impairment losses simply because there are no net-out-of-pocket damages, a costly mistake. Hopefully, after reading this article, you won’t be one of them. Do the math and be prepared.

VA Related Disciplinary Actions 2017-2018

- [http://www.finra.org/industry/finra-disciplinary-actions-online\](http://www.finra.org/industry/finra-disciplinary-actions-online)
 - Case # Case Name
 - 2014040870001 METLIFE Securities Inc AWC
 - 2013035051401 Fifth Third Securities, Inc. BD 628 AWC
 - 2014039071101 Cadaret Grant & Co., Inc. BD 10641 AWC
 - 2015043319901 NEXT Financial Group, Inc. BD 46214 AWC
 - 2015043369501 JH Darbie & Co Inc CRD 43520 AWC
 - 2015043369502 Wolf A Popper CRD 365826 AWC
 - 2015043390301 Park Avenue Securities LLC CRD 46173 AWC
 - 2015043583901 Ameritas Investment Corp. BD 14869 AWC
 - 2015043641901 World Equity Group CRD 29087 AWC
 - 2015048048801 Hank M Werner CRD 1615495 OHO
 - 2015048048801 Legend Securities Inc Decision
 - 2015047177001 National Planning Corporation CRD 12984 AWC
 - 2016047566601 GWN Securities Inc CRD 128929 AWC
 - 2016047636601 Royal Alliance Associates CRD 421 AWC
 - 2016048243101 Securities America, Inc. CRD 10205 AWC
 - 2016049232201 Geoffrey Colin Turner CRD 4007735 AWC
 - 2016050025401 Frederick David Holloway CRD 248814 Complaint
 - 2016050474001 Donald Lane Preston CRD 4704220 AWC
 - 2017052410201 Lincoln Investment CRD 519 AWC
 - 2017054170501 Xavier Patino CRD 5528139 AWC

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Notes & Observations