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What's Behind the War on Variable Annuities?

Beyond the current fight over Ohio National trailing commissions, it seems that broker-dealers and regulators hate VAs; but for some investor clients, the security they offer makes them lovable.

After the market carnage of 2008-2009, a number of advisors shared stories with me about clients who would literally kiss them in adoration, so grateful for the fact that their nest egg suffered no losses during this market turbulence because they were invested in variable annuities with living benefits.

Clients like to make money. More importantly, they don't want to lose money. Advisors who market principal protection often fulfill these objectives with variable annuities and fixed indexed annuities, which provide underlying guarantees.

During the last two years, however, the regulatory environment has become increasingly hostile toward advisors that largely focus on variable annuities and fixed indexed annuities, as broker-dealers urge advisors to do more fee-based business.

From the representatives' perspective, many would love to do advisory work, but it lacks guarantees from losses. They frequently feel that their broker-dealer is pushing advisory platforms on them in order to boost the firm's own profit center. This results in an underlying mistrust when it comes to broker-dealer recommendations, which some advisors see as self-serving rather than benefiting the client.

The Heart of the Matter

Issues affecting variable annuity sales are quite complex and entail a variety of concerns, according to securities attorney Michelle Atlas, J.D., a managing associate with AdvisorLaw. Atlas believes that, although there are multiple reasons that variable annuities are not in favor today, the primary reason is pricing.

Atlas explains, "In the early 2000s, a variable annuity could cost 2.75% all in [for mortality, expense fees and administrative charges], plus a guaranteed minimum income benefit (GMIB) rider and the underlying management cost. Now, 3.5%-4.5% is standard.

"It's unrealistic to expect sub-account performance to keep up that cost and perform well. Also, most compliance departments are exhausted with FINRA's deep dive into variable annuities at every single cycle exam," she adds. "It was 'L' shares with living benefits, now it's exchange rates that are stirring the FINRA scrutiny pot."

According to Atlas, the result is that compliance teams have put bumpers around the recommendations. Examples of bumpers include no more than a specific percentage of liquid net worth in variable annuities, and no variable annuities for clients under age 50 or over 75.

"At this point, the scrutiny is so high, and the restrictions are so tight that advisors have no choice but to diversify the tools they use to help their clients to meet their goals," explains Atlas.

Broker-dealers also have been applying bumpers to representatives' overall business mix in variable annuities. Numerous BDs have implemented percentages of 50%, for instance, as the maximum level of a representative's total client assets that can be held in variable annuities. And some broker-dealers are going as low as 30%.

Are Investors Wrong?

Looking at both sides of the debate on variable annuities, industry insider and attorney Ace Forsythe gives his take on the landscape for variable annuities as follows: "There's no question that VAs require a lot of thought before and after purchase, and there are numerous examples in the industry of sales practice issues associated with them."

The attorney adds that, having said that, "there are millions of satisfied investors willing to pay for assurances not available in other investments, especially as we see fewer people with substantive pension income in retirement."

Forsythe points out that the somewhat Byzantine product approval system, complex features and rigid advisor compensation structures create challenges for investor clients, advisors and supervisory systems.

These products cry out for ongoing monitoring by clients and advisors. Typically, though, supervisory structures—built around regulatory pressures—focus on point-of-sale compliance that is largely only necessary for the few ethically challenged or improperly trained salespeople.

Further, Forsythe says, advisors and firms willing to disclose their compensation, and only offer the products to clients who understand and can benefit from them, typically have extremely high levels of client satisfaction.

In terms of liquidity, an unfortunate reality in the investment-advice business is that no client can know precisely what their liquidity needs will be down the road. For variable and fixed-income annuities, this is perhaps the most important issue to address with caution.

Going forward, Forsythe hopes that we can see something akin to mutual fund breakpoints that provide reduced cost (and compensation) for larger investments. "Sadly, regulators are not attuned to the features of different products and how they might fit into a financial plan, as they incorrectly assume the only motivation for offering it was the upfront compensation," he says.

There seems to be a pervading attitude that runs rampant with regulators, in that complex products like variable annuities—as well as structured products and alternative investments—frequently encounter a wall of prejudice.

Regulators seem to have a somewhat simplistic view of such products, with simple and cheap being good and complex and expensive being bad; some of those who police broker-dealers also appear to have a bias against them or a less-than-complete understanding of all the products' inner workings.

Ohio National

Two months ago, after I published a blog about Ohio National cutting VA trails, I was contacted by someone with the Office of Financial Research, which is part of the Treasury Department. The conversation was full of disparaging remarks about variable annuities.

As this person framed it, these products have been problematic in the past and will be so going forward. In his mind, variable annuities were nothing but trouble, with the clients who purchase them being victims and those who sold them being charlatans.

But given what's going on with Ohio National, it can be argued that his logic is paradoxically flawed. Here we have variable annuity products with living benefits so generous that the insurance firm was losing money on them and wanted to exchange their contracts for less attractive ones.

Being unsuccessful in this attempted swap, Ohio National then began to stop payments of trails to advisors in an effort to curtail losses. Advisors and clients are left holding on to these variable annuities, which turned out to be too good to be true.

The next time we have a major, protracted market correction, these same advisors will be showered with kisses from clients whose nest eggs should remain whole due to the living- benefits feature that variable annuities provide. Just as farmers pay for crop insurance, the public is willing to pay for protection guarantees for its nest egg.

PO Box 56, Marine on St. Croix
MN 55047
TEL 888.820.8107 651.433.3501
jon@henschenassoc.com
www.FindABrokerDealer.com
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