This Year’s Legal Battles

By Kerry Pechter *Mon, Mar 4, 2024*

The life/annuity industry faces three big legal issues this year. All stem from, or are complicated by, the patchwork regulation of financial products in the US, our out-of-date pension laws, and the treatment of all annuities as a single type of product. They also all involve fixed indexed annuities (FIAs).

The life/annuity industry entered 2024 with unresolved issues: the enduring conflict over the Department of Labor’s latest “fiduciary rule,” the harder-than-it-looks insertion of annuities into 401(k) plans, and the problematic capital-reduction strategy that I’ve called the Bermuda Triangle.

These stubborn issues all involve deferred fixed index annuities, or FIAs. They also stem from the patchwork regulation of financial products in the US, our out-of-date pension laws, and the specious treatment of all annuities as a single type of product. Let’s consider them.

The new DOL fiduciary rule

The outcome of the fight—or rather, re-match—over the fiduciary rule will determine whether insurance agents are free to encourage older investors to buy fixed indexed annuities with the tax-deferred savings in their rollover IRAs, and to earn substantial commissions on the sales.

During the Obama and Biden administrations, the DOL has viewed the consumer value of FIAs with skepticism. It has tried to make insurance agents who sell FIAs to IRA owners as accountable to clients as sellers of mutual funds to 401(k) plan participants are. Prohibitively so.

It’s an odd situation. Pension law clearly lets the DOL regulate 401(k) plans. But the Employee Retirement Income Security Act of 1974 (ERISA) predates IRAs, and isn’t clear on whether the DOL has any authority over savings in IRAs (most of which was rolled over from 401(k) plans). In 2018, the US Court of Appeals, Fifth Circuit, said the DOL doesn’t. But that 2-1 split decision is open to **question**.

I once assumed that, since rollover IRAs contain tax-deferred money, that the DOL’s ERISA duties should extend to those accounts. (The DOL seems indifferent to sales of FIAs for after-tax savings.) But state insurance commissions regulate insurance agents and tax-deferred insurance products. So they can arguably claim IRAs as their turf.

In states where large insurance companies are domiciled, state insurance commissioners are protective of their income-generating jurisdiction over them, which the McCarran-Ferguson Act granted in 1945. Many life/annuity companies rely on state-regulated insurance agents to sell FIAs to the $12.6 trillion IRA market. There’s a lot at stake.

Annuities in 401(k) plans

The introduction of annuities into 401(k) plans faces no apparent legal hurdles at the moment. But some people see them looming on the horizon. While Congress smoothed the path for annuities in 401(k) with the SECURE Acts of 2019 and 2022, legislators left plan sponsors to sort through the diverse set of products called “annuities.”

Congress seemed not to recognize the crucial differences among annuities. Two annuities might have different underlying investments, distributors, regulations and levels of transparency. Different annuity issuers have different business models, sell different kinds of annuities, levy implicit or explicit fees, and have different relationships with their policyholders.

Some products will, in hindsight if not at first, reveal themselves to be more legally problematic than others. Plan sponsors who have a fiduciary duty to select the best possible annuity for their participants may not understand the products well enough to compare and contrast them.

Not all annuities may be equally fiduciary, or equally defensible in a lawsuit over breach of fiduciary duty. Financial strength ratings, as awarded by NRSROs (nationally recognized statistical rating organizations), may not be sufficient grounds for a choice.

A fixed indexed annuity with a volatility-controlled index and a lifetime withdrawal guarantee, embedded in an auto-enrolled target date fund and assessing insurance fees prior to retirement, for instance, is impossible to compare to a single premium fixed immediate income annuity that participants must actively choose to buy at retirement.

No law compels plan sponsors to bring an annuity or annuities into their plans. Annuities are sold, not bought, and issuers will bear the burden of proving that their product is not only the best of its breed, but also better than other annuity breeds. The SECURE Acts notwithstanding, plaintiffs’ attorneys will be waiting for a big plan sponsor to blunder.

The “Bermuda Triangle”

The Bermuda Triangle strategy spills across state, national and international jurisdictions. The strategy is typically led by an asset manager that designs leveraged loans (“private credit”). The asset manager coordinates the activities of an affiliated US-based seller of deferred fixed annuities and of an affiliated reinsurer, often domiciled in Bermuda.

This three-way strategy uses the sale of annuities as a way to source long-term funds, in part for the purpose of reaching for higher yields through the extension of riskier loans than a traditional life insurer might make. Reserving for the annuity liabilities can be cheaper in Bermuda, where reinsurers operate under a less stringent accounting regime.

Over the past decade, there’s been almost a gold rush among affiliated asset managers, annuity issuers and reinsurers to use the strategy to make certain annuity products less capital-intensive and more profitable. (Bermuda Triangle reinsurance is not to be confused with “captive reinsurance,” where a company reinsures itself, or with unaffiliated reinsurance, where an annuity issuer buys reinsurance from an unrelated, independently-capitalized third-party reinsurer, or with the sale of blocks of annuity assets and liabilities to third-party insurers.)

Here too, the deferred FIA plays an important role. With its contract lengths of up to 10 years, the FIA provides insurers with liabilities that have durations of up to 10 years. Those long durations match up well with the long durations of the high-yield leveraged loans in which the Bermuda Triangle’s private credit experts specialize. Deferred fixed-rate annuities can also serve as fuel for the strategy, but the contracts have much shorter durations than FIAs and they are more vulnerable than FIAs to an environment of declining interest rates.

The prudence and legality of the Bermuda Triangle strategy have been questioned. Life/annuity companies aren’t supposed to buy reinsurance from sister companies purely for the purpose of reducing the amount of surplus capital they hold. The Senate Banking Committee, the Treasury’s Federal Insurance Office (Dodd-Frank’s toothless invention), the International Monetary Fund and others have shown concern that the Bermuda Triangle strategy could raise the fragility in the financial system. The use of loans to high-risk companies and of CLOs (collateralized loan obligations) in the strategy, for instance, reminds some of the use of sub-prime mortgages and CDOs (collateralized debt obligations) before the 2008 financial crisis.

The NAIC and insurance commissioners have pushed back, however. They say they’ve monitored the strategy for about a decade and have it under control. To me, it appears that the asset managers have exploited cracks, loopholes and discontinuities in regulatory regimes to turn insurance into a servant of the investment business, while simultaneously benefiting from the tax advantages of insurance, the thin resources of state insurance regulators, and opportunities for regulatory arbitrage offshore. Stay tuned.