DOL proposal could “revamp” advisor business practices: Fitch

By Editorial Staff *Thu, Jul 9, 2015*

Fitch analysts suggested in a new report that the DOL proposals “could curb the willingness of agents to promote complex and higher fee products to [the rollover IRA] market,” an apparent reference to fixed indexed annuities and some variable annuities.

Many registered investment advisors (RIA) and the financial advisors of broker dealers are likely to experience “significant revamps of business practices” if the DOL conflict-of-interest proposal takes effect in its current form, analysts at Fitch Ratings reported this week.

“The proposed rules raise the risk of regulatory enforcement and/or trial bar litigation, and will likely force RIAs to do more to prove that a client’s product choices indeed meet the individual’s best interests,” the Fitch analysts wrote.

But Fitch did not suggest that the proposal’s impact on the distribution and sales of annuities would be so great as to hurt the financial strength ratings of insurers who issue them.

“For it to start affecting the ratings of insurance companies, you would have to see adoption of best interest standard across a broader range of products,” said Doug Meyer, managing director, insurance, at Fitch Ratings in Chicago, in an interview with *RIJ* this week.

Meyer added that insurers might even be better off not selling as many variable annuities, a product whose at-times underpriced lifetime income guarantees may pose potential long-term risks for some of the insurers who have sold large numbers of them.

The Labor Department’s April 21 fiduciary proposals promote the proposal’s new “best-interest” standards that provide protections to investors for retirement accounts and annuities.

As proposed, the new standards would greatly expand the universe of individuals and corporations covered under the 1974 Employee Retirement Income Security Act (ERISA). That is, the $7 trillion rollover IRA market and, potentially, any producer who sells or manufactures products to or for that market, would be treated as if it were part of the highly-regulated 401(k) world.

The Fitch analysts were unsure how, in the real world, advisors or agents could promote specific products while simultaneously telling clients about the merits of competing investment or insurance options. “The precise extent to which an advisor would be required to explain product solutions not offered in order to demonstrate serving a client’s best interest is not yet entirely clear,” they wrote.

Fitch suggested that the DOL proposals “could curb the willingness of agents to promote complex and higher fee products to that market,” an apparent reference to fixed indexed annuities and some variable annuities.

Since an estimated 40% or more of current FIA sales are financed with qualified money, such a curb might have a big impact on FIA sales, which now run at about $11 billion per quarter.

With variable annuity sales softening and sales of income annuities still relatively small, fixed indexed annuities have become the most vibrant part of the annuity business—in part because of the appeal of their safety and their lifetime income riders but also because they pay some of the most aggressive sales incentives to agents and brokers.

Regarding the potential liability associated with selling complex products, “asset managers and insurance companies would also bear responsibility for examining distribution policies and commission structures paid to independent and affiliated distributors that sell many of the investment products reaching retirement accounts,” Fitch analysts wrote.

“Annuity products, arguably viewed by some investors as costly relative to lower priced products, could see fees pressured and/or commissions reduced under greater scrutiny,” their report said. The rest of the report read as follows:

“Adding to the challenge is the complexity of annuities, with guarantees that are difficult to value. Obtaining affirmations from clients that all features of any complex product are understood could become more common, but also burden the sales process and hurt volumes.

“ERISA rules were designed to ensure that trustees and plan sponsors were acting with prudence and not self-dealing. While investment advice to individuals planning for retirement has avoided being covered under ERISA, the proposals sweep general wealth and retail advisors under the rule in the interest of ensuring they are acting in client’s best interest.

“Meanwhile, life insurance companies and asset managers would be contractually bound to enhance conflict risk management, publicly disclose fee practices and provide enhanced disclosures of compliance to regulators.

“Under current fiduciary rules, a person responsible for serving in a fiduciary’s best interests (such as a trustee) may not receive compensation for selling to the fiduciary and may not self-deal in the same investment scheme for which he or she oversees as a fiduciary.

“Limitations on commission structures could have a disproportionate impact on the sale or fee structures of investment and retirement products sold in the middle market, which generally tends to have more fee-sensitive customers.

“Effectively, the rules may encourage some brokers to adopt advice-for-fee models for their advisors as a means of compensating them for the compression (or elimination) of their commissions.

“In an effort to preserve commissions while retaining certain established sales structures, the Labor department has established multiple levels of exemptions that could keep many practices in place, provided that compliance with the principles of rules is met.

“Overhauls over the past years to the UK, German and Australian retirement markets have included complete bans on commissions without resulting in significant curbs to dollar sales of the products, although there have been indications of the middle-market customer being less targeted. Higher-end customers have been offered and generally accepted moving to fee-for-advice models.

“In a sign of the political sensitivity of the issue, earlier in June, the House of Representatives’ 2016 appropriation bill for the department included a provision that would block the agency from spending any of the annual funds on finalizing, implementing, administering or enforcing the proposed rules.

“Full implementation is not envisioned until third-quarter 2016 at the earliest, giving all affected parties meaningful time to prepare for and respond to the changes. A comment period on the proposals closes on July 21.”