Fees vs. Commissions in SPIA Sales

By Curtis Cloke *Wed, Nov 17, 2010*

When a client incorporates an immediate annuity into a custom financial plan, we shouldn't ask what revenue method is best for the advisor; we should ask what method is best for the client, writes advisor Curtis Cloke in a Letter to the Editor.

After reading RIJ's article last week on the proceedings of the recent NAPFA conference in Boston ("Singing from the Fee-Only Song Book," RIJ, November 11), financial planner Curtis Cloke of Burlington, Iowa, sent these comments:

There are many myths and misunderstandings about income annuities. The reality is not always obvious. Take the issue of advisor compensation, for instance. When a client incorporates an immediate annuity into a custom financial plan, we shouldn't ask what revenue method is best for the *advisor*; we should ask what method is best for the *client*.

When the issuer pays the advisor a 3% commission, the commission comes from the spread that's priced into the contract and the issuer recoups it over the life of the contract. A fee-only advisor, on the other hand, charges a fee in addition to the cost of the annuity and the client pays him or her with purely after-tax dollars.

Let's assume, for example, that you have a non-qualified deferred annuity contract that has been in effect for a period of time and has grown from an initial $75,000 to a current value of $100,000. Let's further assume that the client wants to 1035-exchange the contract to an immediate or deferred income annuity.

If the manufacturer pays the advisor—perhaps an insurance agent—a 3% commission, the manufacturer would amortize $3000 over the life of the contract, and deduct it internally with no tax implications for the client at the time of purchase.

But a fee-only advisor, recommending the same product, would discount the cost of the annuity by $3,000 and charge a one percent fee over three years. In that case, the client will have to pay that fee with after-tax earnings. Counting the tax, the client might end up effectively paying more like $3,550 than $3,000. Is that better for the client?

If the income annuity was purchased with qualified money from an IRA or a 401(k), the manufacturer who pays an upfront commission is re-paid from the client's pre-tax assets. The transaction creates zero tax impact to the client. The client who pays a fee-only advisor doesn't get the same benefit.

In addition to manufacturers that will price a "net of commission" single premium income annuity (SPIA), there are also platforms that offer institutionally priced SPIAs. The platform typically charges a 2% to 2.5% fee, on top of which the fee-only advisor charges one percent. The platform fee and the fee charged for the advice must now be paid for with after-tax income. In this scenario, the client may pay significantly more for the annuity than when a commission is internally financed by the manufacturer.

If you do the calculations, you'll find that charging a fee instead of a commission may in fact be less beneficial for the client. In any case, it's certainly no better for the client to pay three percent in fees than to pay a three percent commission.

Your story also touched on the cost of an inflation rider on an income annuity. Today you can purchase an inflation rider that increases the payout by a fixed annual percentage or by the change in the Consumer Price Index. I advise my clients to elect the fixed percentage and not the CPI-driven rider.

As the *RIJ* article accurately explains, when the insurance company prices an open-ended benefit like a CPI-driven adjustment, it will always use worst-case assumptions. If you elect a KNOWN percent inflation feature, there is no guesswork or risk to the manufacturer. A fixed inflation adjustment purchased as a rider on a period-certain income annuity will actually provide higher internal rates of return than an income annuity with no inflation rider. In our clients' retirement plans, we often build ladders of SPIAs and deferred income annuities with fixed-percentage inflation adjustments.

Curtis Cloke is the creator the THRIVE Income Distribution System.