FIA Yields That Clients May Never See

By Kerry Pechter *Fri, Mar 17, 2017*

Not long ago, an investor read about a new, fee-based, fixed indexed annuity (FIA) contract with a crediting rate that was 50% richer than similar commission-based products. So he called an online insurance broker to buy it from one of their licensed agents. Slight confusion ensued. The agent executed the paperwork, but when he contacted... Read more »

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Slight confusion ensued. The agent executed the paperwork, but when he contacted the life insurance company that issued the FIA, he found he couldn't collect a commission or charge an advisory fee. Unsure what to do, the agent—who didn't want his name used—completed the transaction anyway.

In the past six months, three life insurers have issued no-commission FIAs. They did so because many agents and advisors who have been selling FIAs on commission are expected to switch to asset-based compensation (in part to avoid signing the Department of Labor's legally onerous "Best Interest" pledge). At least three more carriers are said to be building fee-based FIAs.

Stripped of distribution costs, the new no-commission FIAs are potentially much richer than commission-paying FIAs. Great American's no-commission Index Protector 7 FIA, for instance, caps the maximum amount of interest the client can earn in a year from growth of the S&P 500 at 7.25%, or 40% to 50% higher than on the commission version.

Even if investors are paying close enough attention to notice the bump in value, they probably won't be able to benefit from it. Fee-based advisors who sell FIAs are expected to charge their customary annual fees of 1.0% to 1.5% on the annuity assets, which would offset the clients' gains. They could charge less, but at their own expense. As for FIA issuers, they generally don't want one of their distribution channels to have a price advanage over another.

Fixed indexed annuities, whose premiums are invested bonds and equity options, have always been "black boxes," with opaque crediting methods. Some insurance marketers have billed them as "no fee" products; because the commissions are built into the calculations of the caps on crediting rates. But the heightened transparency of the new no-commission products reveals how much FIA buyers have been paying agents: an estimated 40% of the potential gains of a multi-year contract.

Would more people buy FIAs, which in certain markets offer better downside protection and more upside potential than bonds, if more of the value trickled down to the client? Unless fee-based advisors decide to sell FIAs for less than their usual fee, we may never find out. But the opportunity now exists, and the new products are clearly more consumer-friendly.

“If I were buying an FIA, I’d rather have the value in the product. That’s the product I would sell to my mother,” said Paul McGillivray, an attorney, sales director at M&O Marketing, an insurance marketing organization (IMO) in the Detroit area, and former senior vice president at CreativeOne, a Kansas IMO.

“A few years back I predicted $100 billion in FIA sales by now, based on the appeal of the core value proposition of the product,” said David Macchia, CEO of Wealth2k, which creates online marketing packages for independent advisors. “I postulated that the ‘good’ (the core value) would be delinked from the ‘bad’ (high commissions), and that more advisors and investors would crave the value prop. I still believe that, although the date has been pushed back a bit.”

In practice, the no-commission FIA may simply plug a potential hole in the issuer’s product offering, giving FIA-loving agents a product they can sell if they switch to fee compensation. “At least during the transition from the old world to the new world, I suspect that no-load FIAs won’t just step in and produce the kinds of sales numbers that we’ve seen from commissioned products,” said Tim Pfeifer, a consulting actuary who is currently helping companies design no-commission FIAs. “There will probably be a transition with lower sales. A lot of companies will have them, but we won’t see billions and billions of dollars in sales.”

The fee-based advantage

So far, Great American Life, Allianz Life and Lincoln Financial Group have issued no-commission annuities. At least three other firms are building them. At the wholesale level, these products offer as much as 50% more upside to policyholders as they do when a commission is factored into the calculation of their crediting formulas. (The basic principle behind FIAs is fairly simple; most of the contract assets are invested in the insurer’s general fund, but a small percentage of it is invested in options on an equity index.)

For instance, the maximum annual interest rate that could be credited to a typical commission-based FIA linked to the S&P 500 might be 4% per contract year, while the no-commission product might be as much as 6%. (Commission-based FIAs have sometimes been marketed as having “no fees,” because the distribution costs were built into the crediting terms.)

“There are higher rates/caps and higher income benefit guarantees on our fee-based FIA product relative to the most comparable commission-based FIA product we offer,” said Jeff Faust, a spokesperson for Allianz Life, which launched its Retirement Foundation ADV fee-based FIA, which has a lifetime income rider, told *RIJ* recently.

“However, once you factor in a typical advisory fee (coming from client assets outside the annuity for the advice on the annuity), the economics to the client are very similar between the fee-based FIA and the commission based FIA. Technically, an insurance agent cannot sell a no-commission product and collect a fee for this advice,” Faust wrote in an email. “Regarding how much a fee-based advisor can charge, it is the advisor’s responsibility to work out with their client the fees that they are charging for the advice they are providing."

At Lincoln Financial, the fixed rate option for the Covered Choice 5 FIA is 2.85% for the no-commission version and 2.25% for the commission version. The crediting cap with a one-year point-to-point contract linked to the S&P 500 is 5.60% on the no-commission product, versus 4.25% on the commission product, according to Brian Wilson, Lincoln Financial's assistant vice president, product development, FIAs.

Under the "performance trigger" option, the fee-based version of Covered Choice 5 pays 4.75% in contract years when the S&P 500 is positive, versus 3.75% for the commission product, Wilson said in an interview.

One important difference between the two types of FIAs is that someone needs only an insurance license to sell the commission-based version. But to sell a fee-based FIA, advisors who recommend the product must have securities licenses (even though the product is not a registered security) and they or their firm must be insurance-licensed and have a selling agreement with the life insurer that issued the contract.

"A fee-based fixed indexed annuity is an insurance contract but we do have the restriction that you must be both insurance-licensed and an investment advisor—primarily because it pays no compensation and we don't want insurance agents running around charging fees without the proper licensure," said Joe Maringer, national sales vice president for annuities at Great American Insurance Group. "There are certain scenarios where an RIA (registered investment advisor) firm may have an insurance-only person on staff that we would allow to write this contract. The billing for the annuity would take place at the firm level."

There's "no channel conflict," Maringer added, in the sense that consumers might get a better deal with an advisor than with an agent. The new product simply "opens up to fee-based advisors who want principal protection and upside opportunities that haven't sold FIAs because they paid a commission" and "provides choice to the consumer on how they want to pay for service. This will become a bigger point over time and as the market continues to be educated around financial planning," he said.

How distributors see it

Mike Tripses is CEO at CreativeOne, which acts as a wholesaler to retail insurance agents. It also owns Client Securities, a broker-dealer, and has set up an RIA that employs investment advisor representatives (IARs), who are fiduciaries. As an actuary, Tripses has also designed FIAs.

"Yes, the [no-commission FIAs] have higher crediting rates or adjustment factors on the indexed allocations. However, these products are not distributed for free. Agents are not 'Mother Theresa.' They have expenses, businesses and families to feed," he told *RIJ* in an email.

"No-commission FIAs are designed to be sold by IARs who manage money," Tripses wrote. "Some of these allow fees of 1% or more per year to be withdrawn directly from the account value of the annuity. Others do not: the fee must be deducted from other cash accounts of the assets under management. Over the term of the product the results of non-commissioned and commissioned FIAs may not be that different. The non-commissioned FIA will just be more transparent."

He added: “Yes, market pressures will move things in the future. However, all of the carriers we are working with today have indicated that they believe their all-in pricing for commissions in today’s products are reasonable. I see no ‘rush to the bottom’ occurring. That doesn’t mean there might not be an eventual inexorable drift. There may be advisors/agents who charge less than a point, reasoning that the FIA asset is more hands-off for them. That would change the calculation, of course, and may lead to downward pressure on up-front commissions as well.”

Commonwealth Financial Network, a Waltham, Mass. broker-dealer and RIA, no longer allows its 1,700 independent advisors to accept commissions when selling annuities to clients with pre-tax retirement accounts, such as rollover IRAs. So when they recommend an FIA to a client, they will include the FIA contract value in the balance on which they charge an annual percentage.

Brian Donahue, the relationship manager for insurance and annuities at Commonwealth, told *RIJ* that the firm’s advisors may end up selling fewer FIAs in the future because the commissions, at least in part, drove the sales. And even though the higher caps on the fee-based FIAs are alluring, the new products won’t necessarily offer any higher returns for investors and won’t offer advisors any more compensation than they can earn by recommending simpler products, like mutual funds.

“The nice thing about these products is that, once you strip the compensation, they are super robust—amazingly so. You’d be crazy not to look at these products because of how rich they are,” Donahue said. “But there’s less incentive to sell it. That’s why there’s a concern with the fiduciary rule, and why it ends up hurting investors.” His firm is unsure how much guidance to give its advisors about fees. In theory, Commonwealth advisors can charge anywhere from zero to 2.25% per year on the FIA assets.

“These products are still brand new. We’re still deciding internally whether to tell advisors, ‘You can’t charge more than 1.25% as a wrap fee,’” Donahue added. But that’s not Commonwealth’s style. “At Commonwealth we hate to put too much overbearing restraint on advisors. They are independent, and obviously different from wirehouse advisors.”

The ground rules for selling annuities to retirement clients is different at Raymond James. Its advisors can still sell commission-based FIAs to retirement clients, as long as they sign the DOL’s Best Interest Contract Exemption, which forces them to promise to act as a fiduciary and ignore their own financial interests. They can avoid signing the BICE by selling no-commission FIAs and charging an asset-based fee. They are fiduciaries nonetheless, but unlike signers of the BICE they would not be vulnerable to a federal class action lawsuit from dissatisfied investors.

“We’re offering both [fee-based and commission-based FIAs],” said Scott Stolz, senior vice president, PCG Investment Products, at Raymond James. “It’s obvious that, DOL or no DOL, this whole process is pushing more and more advisors to a fee-base-only model. We have told our insurance companies that they will need a fee-based alternative for those advisors [who don’t take commissions or use the BICE]. Even the firms like ours, that are planning to use the BICE and will continue to offer commission-based products, will find that the advisors will make their own choices.”

‘Nothing stops commoditization’

The future of FIA sales is more uncertain than it has been since the George W. Bush administration, when the Securities & Exchange Commission attempted unsuccessfully to classify them as securities products subject to supervision by the SEC and FINRA. The Obama fiduciary rule was almost certain to dent FIA sales because it added a regulatory hurdle to sales by commissioned agents. But now that rule is in jeopardy.

David Macchia, CEO of Wealth2k, believes that with the increasing transparency and commoditization of financial products, the old labor-intensive model of making money by selling products is coming to an end, with or without the Obama fiduciary rule.

“Even if manufacturers wish to avoid channel conflict, the mere existence and availability of a zero-commission FIA creates pressure to lower compensation on all FIAs,” Macchia told *RIJ* in an e-mail. “It’s like injecting a bacteria-fighting cell into the body. Gradually the drug wipes-out more and more high-commission disease cells. Placing the FIA in an advisory account offers benefits. But I cannot see how charging 1.25% or even 1% is justifiable. Maybe not immediately, but over the mid-term I don’t think that will be viable. Nothing stops commoditization.”

At the least, FIA sales, which have risen steadily for several years because of their unique combination of downside protection and upside potential, will be adversely affected this year. “You see dire projections that sales will drop by 50% percent. I’m not in that camp,” said actuary Tim Pfeifer. “There’s a demographic movement in favor of FIAs. I have confidence in the creativity of carriers. They will overcome the challenges facing FIAs and the marketplace will rebound.”