
First Sign of Blood from DOL Fiduciary Rule

By Kerry Pechter *Fri, Apr 29, 2016*

'The unexpected change regarding FIAs in the final DOL rule and the related Best Interest Contract Exemption has cast a cloud over our future growth rate,' said John Matovina, CEO of American Equity, the second-largest seller of fixed indexed annuities in 2015.



In an aftershock of the April 6 release of the Department of Labor's "fiduciary rule," American Equity Life, the second larger issuer of fixed indexed annuities in 2015, told analysts on its Q1 earnings call yesterday that the new rule might hurt the distribution and sales of its flagship products.

The company's stock fell 10% during the half hour before the 10 a.m. call began. The share price instantly bounced back only to slump again, ending the day at \$14.33, down 12.68%. Since last November, AEL stock's value on the NYSE has fallen by almost half. Its FIA sales in 2015 were \$6.95 billion, second only to Allianz Life, and 67% higher than in 2014.

While these events pass largely unnoticed by most the financial world, they loom large within the niche of indexed annuities, whose returns are derived from bonds and options on equity-linked indices. It's a market long-dominated by Allianz Life. Since the financial crisis, however, private equity firms like Guggenheim Partners have invested opportunistically in issuers of FIAs, stoking competition.

Indexed annuities are complex and profitable, selling well to people who want both protection from any downside loss and more potential upside than bonds alone can provide. They thrive in ultra-low rate environments. Once the province of independent insurance agents, FIAs are increasingly built by highly-rated insurers and sold by brokerage advisors, often as a replacement for slumping variable annuities. FIAs often feature guaranteed lifetime income riders, which appeal to retirement investors. About 65% of the money going into FIAs is from tax-deferred accounts, so at least two-thirds of the industry's business is affected by the DOL rule.

On the call, AEL executives told analysts the firm's difficulties stemmed from two main sources: a faulty assumption about interest rates and the DOL's surprise announcement that sellers of FIAs would be held to a fiduciary-level standard of conduct—enforced by the so-

called Best Interest Contract or BIC—if they want to accept commissions from insurance companies.

Regarding the DOL announcement: FIA issuers and wholesalers were unprepared for it. When the rule was proposed, and throughout last year’s public comment period, tighter regulation of FIA sales wasn’t suggested.

Top Ten Sellers of Fixed Indexed Annuities, U.S., 2015	
FIA Issuer	(\$Thousands)
Allianz Life	\$8,745,756
American Equity Companies	6,952,986
Great American Insurance Group	3,690,073
AIG	3,296,992
Athene USA	2,545,172
Nationwide	2,487,400
Midland National Life	2,403,552
Symetra Financial	2,386,990
Fidelity & Guaranty Life	1,974,281
Security Benefit Life	1,826,154
Source: Wink, Inc. March, 2106.	

But under the final rule, instead of being lightly regulated, like plain-vanilla fixed annuities or income annuities, FIAs will be more tightly regulated, along with variable annuities. The rule is scheduled to go into partial effect in April 2017 and full effect at the start of 2018.

An industry group, the National Association of Fixed Annuities, released a statement Thursday saying that it would try to reverse the DOL’s action through legislation or legal action. “We wouldn’t be surprised if law suits are filed in the future,” said AEL CEO John Matovina on the earnings call.

Regarding the rate mis-assumption: AEL took a write-down on its deferred acquisition cost assets, which resulted in a 57% drop in operating income in 1Q2016, to about \$21 million, compared with \$48.8 million in 1Q2015. The company discovered, in effect, that it would earn less than expected from reinvesting premiums, relative to what it paid wholesalers and salesmen to bring in those premiums. It had assumed higher yields on new bond

investments in the first quarter, according to AEL CFO Ted Johnson.

(For accounting purposes, insurance companies treat the commissions that they pay to agents and advisors for selling their contracts as an investment, not as an expense. The sales activity generates premiums which, when invested profitably, enable the company to more than recoup the investment.)

Because of the DOL's surprise announcement, Matovina said, the company expected to stop selling indexed annuities in the independent agent channel—the channel where most indexed annuities are still sold—and try to sell fixed multi-year guaranteed-rate fixed annuities with income riders in that channel instead. Those products tend to be less profitable than FIAs.

“The unexpected change regarding FIAs in the final DOL rule and the related Best Interest Contract Exemption has cast a cloud over our future growth rate,” Matovina said. “If the rule isn't overturned or modified, it will limit access to fixed indexed annuities.”

Annuity wholesalers and independent agents favor indexed annuities in part because they shine in a low-rate environment, but also because the rewards can be singularly high. The total commission on an AEL FIA, for instance, has been as high as 9%, and the surrender period can be as long as 20 years for a product with a 10% initial bonus.

Not coincidentally, this is the type of product whose sale to middle-income senior citizens with large IRAs that the DOL aims to blunt. Agents would find it hard to rationalize the acceptance of such rich compensation under the new DOL rule, which requires sellers to ignore personal reward when recommending products to clients.



One of the equity analysts asked if AEL would consider simplifying their FIA, and shifting some of the value to the client and away from the distributors and agents. “We might come up with something simpler to sell in the independent channel,” Matovina (left) said. “Right now we think the risk is too great. That's the current view. But would the independent agents be willing to sell a lower commission product? We don't know.”

The DOL rule creates another serious compliance problem for issuers and wholesalers of FIAs. The product can't be sold on a commission-basis unless a financial institution enters into the BIC contract with the end-client, promising to ensure that the agent or broker acts in the client's best interest.

But there's the rub. It's not clear who can, will or should sign the so-called BIC contract for insurance agents who sell FIAs. Should it be the annuity wholesaler or marketing organization that hires the agents and teaches them how to sell FIAs? Or should it be the insurers who issue the FIAs, appoint the agents and wholesalers, and pay the agent commissions and wholesaler "overrides" that ultimately drive sales? The lack of clarity is one reason why the FIA industry considers the BIC "unworkable."

Not all annuity wholesalers are financial institutions, technically, and neither they nor the insurers supervise agents closely enough to bear liability for potentially unscrupulous sales practices. Although the insurer appoints agents and approves each new indexed annuity contract, it doesn't know the exact circumstances under which the contract was sold.

"It would be one thing if the DOL could only come after us for our own conduct. But the weak link is that we'd be responsible for the agent's conduct, including activities that we're unaware of," Matovina said. "Our reading of the fiduciary obligation says that the agent is supposed to look among his menu of FIAs and decide, without regard for any other factor, which would be in the best interest of the policyholder. Even if he picked American Equity for all the right reasons, we would still be responsible for what he did. All we will see is the application. We evaluate it for suitability. But it is impossible to know how the agent conducted his sales activities."

In other words, the DOL rule is incompatible the FIA business model, and threatens to disrupt what has become a \$50 billion-a-year business. (An estimated 60% to 70% of FIA sales are exchanges, not new sales, according to one industry expert.) The situation is very different when a securities-licensed broker sells an FIA, because the broker is more or less supervised by a broker-dealer, and the broker-dealer is a financial institution that can sign the BIC.

One AEL analyst believes that the DOL may have made itself vulnerable to a legal reversal of the new rule by not giving the FIA industry fair warning that there would be such a dramatic change in the legal treatment of the FIA between the proposal that was submitted for public comment and the final rule.

"Someone might argue that this rule is ripe to be overturned, because the DOL didn't investigate how the fixed indexed annuity market works," the analyst told *RIJ*. "So the change in the rule could be considered arbitrary and capricious. That will be the argument—that the DOL didn't do its homework."

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