Legal Deception: The M&E Fee

By Editor Test *Wed, Jul 17, 2013*

To make variable annuities more transparent and rehabilitate their reputation, start by not hiding commission recovery behind the so-called "mortality and expense risk" fee.

When and how did it became acceptable for variable annuity issuers to pad their mortality and expense risk (M&E) fee to get the client to pay the sales commission (and then some) without realizing it? The back-story of the M&E subterfuge, it turns out, is a fascinating one. Especially because it helps explain the VA boom of the last decade and a half.

For those of you who don't read VA prospectuses, the "mortality and expense risk" fee is one of the asset-based fees listed in the fee table of a VA contract. Technically, the fee protects the insurer against the risks that its mortality projections might be off or that the costs of servicing the contract might rise unexpectedly.

Sounds plausible. But the M&E fees vary widely among contracts. For instance, the M&E charge on the variable annuity with guaranteed lifetime withdrawal benefit sold directly to investors by Vanguard and underwritten by Monumental Life is 0.195%, with a 0.10% administrative charge. That's 29.5 basis points, or $295 per $100,000 invested. Sounds reasonable.

If you look at the prospectus for the B-share of a typical VA sold through the independent advisor channel from the last few years, you find a much higher M&E. Picking three recent contracts at random, I find M&Es of 1.52%, 1.05% (with a 0.25% administrative charge), 0.95% (plus a 0.15%) and 1.55% (plus a 0.15% administrative charge). That's $1,520, $1,300, $1,100 and $1,700 per year per $100,000 invested, respectively. (I include the administrative charge because its distinction from the M&E fee, as the term is loosely used, seems weak. Both are part of aggregrated, vaguely-defined costs.)

The M&Es of the B-share contracts (which represent two-thirds of variable annuity sales, according to Morningstar) are much bigger than that of the direct-sold contract because the B-share contract owner, in effect, is gradually reimbursing the insurance company for the 6% or 7% commission that the insurer paid the independent advisor or registered representative for making the sale.

In practice, this fact is not disclosed. It's unlikely that the advisor would tell the purchaser that this ostensibly painless arrangement exists, or that it would be cheaper in the long run for him or her to buy an "A" share variable annuity and pay the entire commission up front. Contracts do disclose of the merging of the M&E and the sales charge, but not in "plain English." Here's how three disclosures from three contracts read (italics added):

- "The mortality and expense risk charge is expected to result in a profit. Profit may be used for any cost or expense including *supporting distribution*."
- "If the charge exceeds the actual expenses, we will add the excess to our profit and it may be used to *finance distribution expenses* or for any other purpose."

- "Any gain will become part of our General Account. We may use it for any reason, including *covering sales expenses* on the Contracts."

The contracts do not explicitly say that the policyholder is reimbursing the insurer for the commission over time, or that the padded M&E fee may remain in place long after it has made the issuer whole.

Padding the M&E wasn't always legal. It only became legal in 1996, when the National Securities Markets Improvement Act of 1996 (NSMIA) amended the Investment Company Act of 1940 to allow (among other things) insurers leeway to charge more for variable annuities.

Before 1997, deductions from variable subaccounts for insurance charges, including mortality and expense risk charges, were capped at 1.25% for variable annuities (0.90% for variable life products). Variable annuity issuers were also required to obtain an "exemptive order" before they could change any M&E fee. Administrative charges had to be "at cost."

The NSMIA of 1996 changed that. After the amendment, the direct limit on insurance fees was removed, the exemption requirement was lifted, and insurance charges could be combined with other (such as administrative) charges that, in the aggregate, merely had to be "reasonable," according to a 1999 analysis of the law by the Washington law firm of Sutherland, Asbill & Brennan. Such a loose standard sparked innovation and invited abuse.

(The NSMIA of 1996 was sponsored by Jack Fields Jr. [R-TX] and was part of a wave of deregulatory legislation that shaped today's financial and telecommunications landscape. In the same year, the Glass-Steagall Act was "reinterpreted" to let bank holding companies earn up to 25% of their revenues from investment banking. The telecom industry was also deregulated that year. At the time, Republicans controlled both houses of Congress for the first time in 40 years. Robert Rubin of Goldman Sachs was Treasury Secretary under President Bill Clinton.)

As mentioned above, this change in the law helps explain the VA boom of the last 15 years, which has been characterized by new products, new features and rising prices—as well as the messy bust that followed. The Sutherland analysis noted that:

"By eliminating the regulatory "straightjacket" that for years constrained the design of variable contracts, the 1996 Amendments have permitted insurers to introduce new product features and designs and to charge consumers prices that are competitive with the fixed market. Pricing is now subject only to the constraint of new Section 26(e) of the 1940 Act and its requirement that total fees and charges under the variable insurance contract be 'reasonable.'"

More to the point: "The primary effect of the Reasonableness Standard so far on VA contracts has been to facilitate the introduction of new product features (such as enhanced death benefits, guaranteed minimum income benefits, and bonus credits), since insurers can now charge what these product features are "reasonably" worth to consumers without being subject to arbitrary price limitations," wrote the same Sutherland attorney in another analysis.

The rest is history. The deregulation of fees on variable annuities allowed the products to become more feature-laden, more attractive to registered representatives and more profitable. It enabled the issuers to pass along new manufacturing and distribution costs to the consumer. But the weight of those fees, and their necessary disguises, made variable annuities expensive, complex, and inherently deceptive. To rehabilitate the reputation of the product, we could start by ending the legal fraud of the M&E charge.