

Indexed annuities gain popularity while rates remain low

A former black sheep, indexed annuities are becoming more popular

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Bernie Gacona, director of annuities at Wells Fargo Advisors.

Indexed annuities, long the black sheep of retirement products, are enjoying a wave of popularity among financial advisers grappling with low interest rates.

Indexed annuities are a type of fixed annuity that credits clients' accounts with a minimum guaranteed rate of interest and combines that with an interest rate tied to movement of an index. Clients don't fully capture the index's performance, though. Insurers put limits on customers' participation in the index and can cap the return. How generous the companies are on participation and cap rates is primarily a function of how well the carriers' own fixed-income investments are doing.

Reps at broker-dealers and wirehouses are viewing these products as a viable fixed-income alternative and a possible provider of lifetime-income benefits.

"We're seeing an increase in that line of business simply because interest rates are so low," said Bernie Gacona, director of annuities at Wells Fargo Advisors. "You have money for [certificates of deposit] and money market funds that's going into these investments because the yields on indexed annuities are higher, even though there is a cap."

At Raymond James Financial Inc., indexed annuity sales for fiscal year 2013, which ended Oct. 31, hit \$330 million, up 60% from the prior year, according to Scott Stolz, president of Raymond James Insurance Group.

“We've told people that this is for your client who says that the bank will credit 1% or less [in interest] and they don't want to lose money,” he said. “It's now purchased by those who are fixed-income buyers, not so much for income but for capital preservation.”

Notably, the indexed annuity wasn't always so widely accepted by securities-licensed reps. In fact, the product has been around for about 20 years, and for the most part, it's been the domain of insurance agents who don't sell securities products.

Indexed annuities became popular after the bond market massacre of 1994, noted Charlie Gipple, national director of index products at **Genworth Financial Inc.** At that time, inflation was negligible, and an Alan Greenspan-led **Federal Reserve** prematurely raised interest rates, resulting in sharp losses for bond investors.

“Their birth was on the back end of 1994, when the bond market was extremely rocky,” Mr. Gipple said. “These annuities were created for an environment like the one we're in today.”

The earliest incarnations of the indexed annuity came with many bells and whistles. They had 15-year surrender periods, meaning clients couldn't pull their money out for that length of time without facing penalties. Surrender charges topped 10%.

Above all, however, they weren't very easy for clients or brokers to understand.

Enter the two-tiered indexed annuity, which would credit a competitive interest rate during the accumulation phase and offer clients an attractive premium bonus. But clients could only qualify for the bonus if they annuitized their contract over a stated term after a certain deferral period. Generally, clients are reluctant to annuitize, because they turn over the principal in the annuity to the insurer and can receive their money only in the form of a stream of payments, rather than a lump-sum withdrawal, forgoing control of the asset.

FOCAL POINT OF LITIGATION

Though two-tiered indexed annuities aren't the norm anymore, they caused a stir in the 2000s when they were the focal point of litigation and regulatory action against insurers. In 2009, for instance, a federal jury in Minnesota ruled that Allianz Life Insurance Co. of North America used deceptive materials to market its two-tiered indexed annuities. The court did not assess damages against the insurer, though.

The negative attention led to a change for the better among the carriers in the form of simpler products. In 2005, Finra's predecessor, NASD, released Notice to Members 05-50, addressing broker-dealers' responsibility to supervise sales of indexed annuities — even though they are not securities products. At the same time, insurance regulators at the state level discouraged the creation of products with onerous surrender periods and charges through “desk drawer rules” (state policies on products, not technically regulations). More responsibility also has been heaped on brokers and

insurers via state annuity suitability rules, which require product-specific training of reps who sell these annuities.

As broker-dealers brought indexed annuities on board, they sought product changes that steered away from the features in the earlier versions of the products.

B-D STANDARDS

“Broker-dealers applied their own standards: the 10/10/8 rule,” said Rob Pettman, senior vice president of investment and planning solutions at **LPL Financial**. The rule means surrender periods can't be longer than 10 years, surrender charges were capped at 10%, and the broker can earn no more than 8% in commission. Sales of indexed annuities through the third quarter of 2013 at LPL hit \$649.4 million, up 15% year-over-year from \$564 million through Sept. 30, 2012.

A combination of consumer-friendly updates and desirable credited interest rates versus other fixed-income products has brought indexed annuities into favor at broker-dealer firms. And a new trend is emerging, too: the release of indexed annuities with living benefits, particularly in an era where lifetime-income riders are becoming scarce on variable annuities.

“The prominence of withdrawal benefits is one of the biggest developments in the indexed-annuity space, with over 70% of sales elected with lifetime-withdrawal benefits,” Mr. Gipple said.