Dynamic Annuity Concentration Limits in Retirement Portfolios

A Guide for the Retirement Industry

Distribution firms in the financial services industry employ supervisory staff to ensure that the investment recommendations made by the firm's advisors to their clients are suitable – that is, that there is a reasonable basis to believe that the recommendations are in line with the investor's investment objectives and risk tolerance. Annuities, especially variable annuities but increasingly fixed and fixed indexed annuities, are subject to a particularly high level of scrutiny, which in some cases has resulted in arbitrary and sub-optimal hard limits on the concentration of annuities permitted in investor portfolios – the percentage of the portfolio that may be allocated to annuities. This has often been to the detriment of many retirement income investors who would benefit from higher allocations to annuities for guaranteed lifetime retirement income and to reduce risk. This paper discusses a new framework for evaluating annuity concentration limits, explores the regulatory history that led to the environment the industry operates in today and offers several arguments in support of taking a more flexible and goals-based approach to determining permissible allocations to annuities. In any highly regulated industry, it is difficult for any one firm to move to a new framework on its own. IRI hopes that presenting a new paradigm based on thoughtful analysis will provide the guidance and support the industry needs to move forward as a whole.c

Historical Context

> FINRA Rule 2330 (Members' Responsibilities Regarding Deferred Variable Annuities) was written to provide guidance and requirements for the sale of variable annuities, but broker-dealer supervisory policies and auditors generally put fixed and variable annuities in the same basket.

> Guidelines governing the concentration of annuities in a portfolio generally consider allocation to ALL annuities when setting limits, which can restrict appropriate use of fixed, fixed indexed and income annuities.

> When Rule 2330 was written, most broker-dealer annuity transactions were in variable annuities; today, transactions have shifted significantly toward fixed and fixed indexed annuities.

> Liquidity is a significant concern when setting investment concentration limits. However, many annuities are held in portfolios past their surrender charge periods or do not carry surrender penalties; annuities that are no more or less liquid than stocks, bonds, or CDs.

> Utilizing a single criterion for annuity recommendations irrespective of whether the annuity would be held in a non-qualified or qualified retirement plan can lead to a sub-optimal asset allocation.

Assertions

- Fixed, fixed indexed, variable and income annuities all play very different roles in a portfolio, and these roles should be acknowledged when determining an appropriate concentration of annuities.
- Strict concentration limits are often at odds with the recommendations of financial planning software programs, which solve for the needs of the client. These should be reconciled.
- Annuities offering long-term care benefits are sufficiently unique in terms of the value they deliver to clients that they should be considered separately from the annuity concentration.
- Distributor supervisory guidelines should ideally take a dynamic approach to determining suitable allocations to annuities in retirement income portfolios; put simply, provided sufficient liquidity is in place the focus should be on optimizing the potential of the portfolio to meet the client's goals rather than on adherence to a generalized and arbitrary guideline.

FINRA 2330 and the Origins of Annuity Concentration Rules

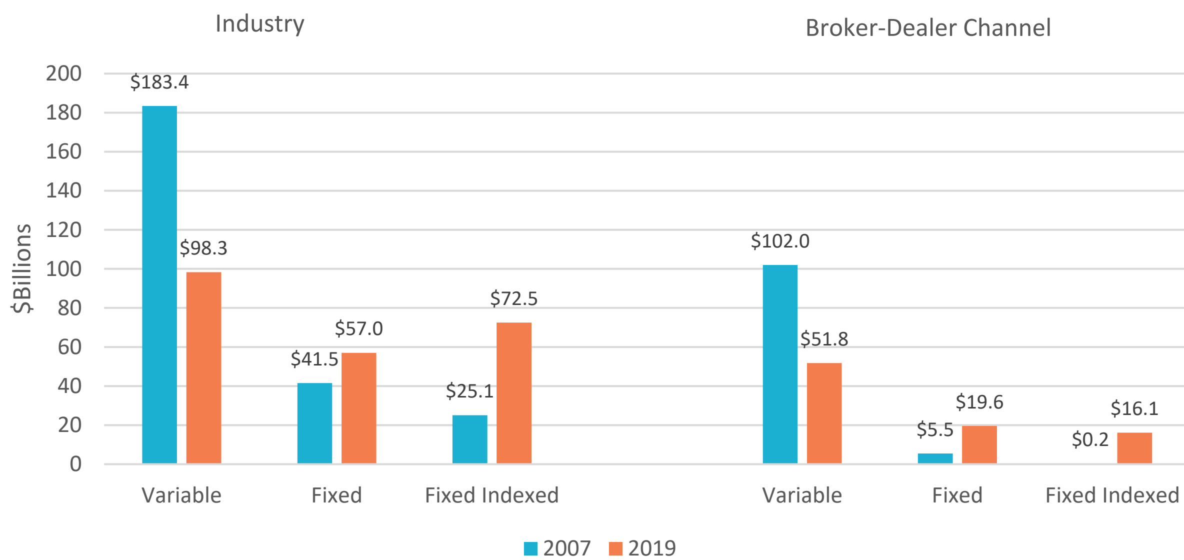
The Financial Industry Regulatory Authority (FINRA) originally adopted Rule 2330 (Members' Responsibilities Regarding Deferred Variable Annuities) in 2008. Although the Rule has been amended six times, none of those amendments had significant impact on how broker-dealers have supervised annuity recommendations since the original rule was adopted. Yet, the annuity industry looks vastly different today than it did when FINRA first formulated the rule. According to Beacon Annuity Solutions and Morningstar, in 2007 variable annuities accounted for 73 percent of the $250 billion in total industry sales. In contrast, fixed indexed annuity sales were only 10 percent of total industry sales. The broker-dealer channel (excluding banks, savings & loans and captive agents) sold $102 billion in variable annuities. That same channel accounted for just 8.5 percent of the fixed annuity category; only $5.7 billion in total sales, with only $200 million of that done in fixed indexed annuities. In addition, structured annuities were still new to the market and generated so few sales they were simply added to the variable annuity sales category as a rounding error. In summary, 95 percent of the annuity business done in the broker-dealer channel in 2007 was done in variable annuities. Given the sales mix at the time, it was understandable that broker-dealers built suitability rules based on the assumption that virtually every annuity recommendation to purchase a variable annuity.

FINRA Suitability Rule for Deferred Variable Annuities — Rule 2330

FINRA Rule 2330 imposes a wide range of requirements tailored specifically to deferred variable annuity transactions, including suitability, principal review, supervision, and training. This Rule provides that, in recommending a deferred variable annuity, a registered representative must have a reasonable basis to believe that (a) the customer has been informed in general terms of various features of a deferred variable annuity; (b) the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit; and (c) the particular deferred variable annuity as a whole, the underlying subaccounts to which the funds are allocated at the time of purchase or exchange of the deferred variable annuity, and riders and product enhancements, if any, are suitable for the particular customer based on required customer information. These specific requirements are in addition to the requirements of FINRA Rule 2111 governing suitability generally. As discussed above, the NAIC Suitability Model is patterned after FINRA's suitability standards. FINRA has published substantive guidance, in question and answer format, on the suitability obligations of member firms and registered representatives under FINRA Rule 2111, including with respect to hold recommendations, implicit recommendations, investment strategies, non-securities products, and recordkeeping, among other things.

Fast forward to today, and the marketplace is vastly different. In 2019, total annuity industry sales were $228 billion, down 9 percent from 2007. Variable annuity market share has fallen from 73 percent to just 43 percent ($98.3 billion). The broker-dealer channel generated only $51.8 billion in total variable annuity sales – half of what it did in 2007. Conversely, that channel sold $35.7 billion in fixed annuities of all kinds, or 27 percent of the total fixed annuity business. In twelve years, the mix of annuity business in the broker-dealer channel has gone from 95 percent variable annuities to 59 percent. In addition, fixed indexed annuities, which made up just 10 percent of total annuity sales in 2007, had climbed to 29 percent of industry sales by 2019. Moreover, fixed indexed annuities went from being practically non-existent in the broker-dealer channel to accounting for 15 percent of total annuity sales in 2019 – an 8,000 percent increase. Figure 1 shows how significantly the market has changed over this twelve-year period.

Figure 1: Variable Annuity Sales Versus Fixed/Fixed Indexed Annuity Sales 2007 – 2019



Sources: Morningstar, Inc. and Beacon Annuity Solutions

Considering this dramatic shift to fixed annuities, IRI is concerned that broker-dealers may not have updated their suitability guidelines to acknowledge the very different role fixed annuities play in an investment portfolio relative to their variable counterparts. A fresh look should be taken at rules governing the percentage of a portfolio that can consist of annuities to ensure that the type of annuity is taken into consideration. If concentration rules are set under the assumption that every annuity recommendation is a variable annuity designed to meet similar client goals, an opportunity may be missed to employ fixed and fixed indexed annuities to fill a very different role in the portfolio. For example, if a firm sets a guideline that no more than 30 percent of client’s portfolio can be allocated to annuities, distinctions are rarely made as to whether those annuities are variable, structured, fixed, indexed or immediate. Today, many fixed indexed & fixed annuities have terms and surrender charges only lasting three to five years with the ability to either draw 10 percent each year or credited interest, so a 30 percent limit does not make sense for annuities with lower fees and holding periods. In addition, many fee-based fixed indexed products do not have any surrender charges.

Given that Rule 2330 specifically refers to deferred variable annuities, firms have the opportunity to take a more nuanced view of annuity concentration guidelines, acknowledging differences in both the structure of different types of annuities and the roles they play in helping clients achieve their goals. The reason often cited for continuing to base concentration rules on the characteristics and mission of variable annuities is the practice of regulators lumping all annuities together when auditing supervisory practices. Auditors often ask for any client accounts that have an allocation to annuities above a certain percentage, irrespective of the type of annuity.

Therefore, while the rule speaks solely to deferred variable annuities, the same standard is often applied to other types of annuities.

One might argue that there is no harm in using one yardstick to measure annuity concentration in a portfolio. After all, while each firm uses their own guidelines, each can approve higher annuity allocations if there is a logical reason to do so. Certainly, in attempting to achieve principal protection, adding fixed or fixed indexed annuities to a portfolio that already has variable annuities can be an acceptable reason to go beyond the published guidelines. However, the reality is that making exceptions to guidelines leads to increased regulatory scrutiny. Therefore, as a means of minimizing risk, broker-dealers are often reluctant to take that step, even when the client would benefit. A new paradigm is needed, where the evaluation of the appropriateness of annuity concentration levels acknowledges the different types of annuities and the unique purposes they serve.

Six Arguments for a New Paradigm

1. Fixed annuities typically meet a very different need than variable annuities and therefore should be considered separately from variable annuities

Most fixed annuities are purchased as an alternative to certificates of deposit (CDs). For individuals with a longer time horizon and who are comfortable with a surrender charge period that typically exceeds a CD maturity, fixed annuities not only provide tax deferral but usually pay more interest. When used this way, fixed annuities are an accumulation vehicle, not a means to provide future income, and do not represent a risk of investment loss to the client. Not surprisingly, industry sales in fixed annuities often spike when the market experiences a significant correction. Fixed annuities provide a safe haven for money in times of uncertainty. If all annuities are lumped together when determining concentration limits, a client that already owns variable annuities may be prohibited from putting additional funds into fixed annuities.

2. Not all annuities are illiquid

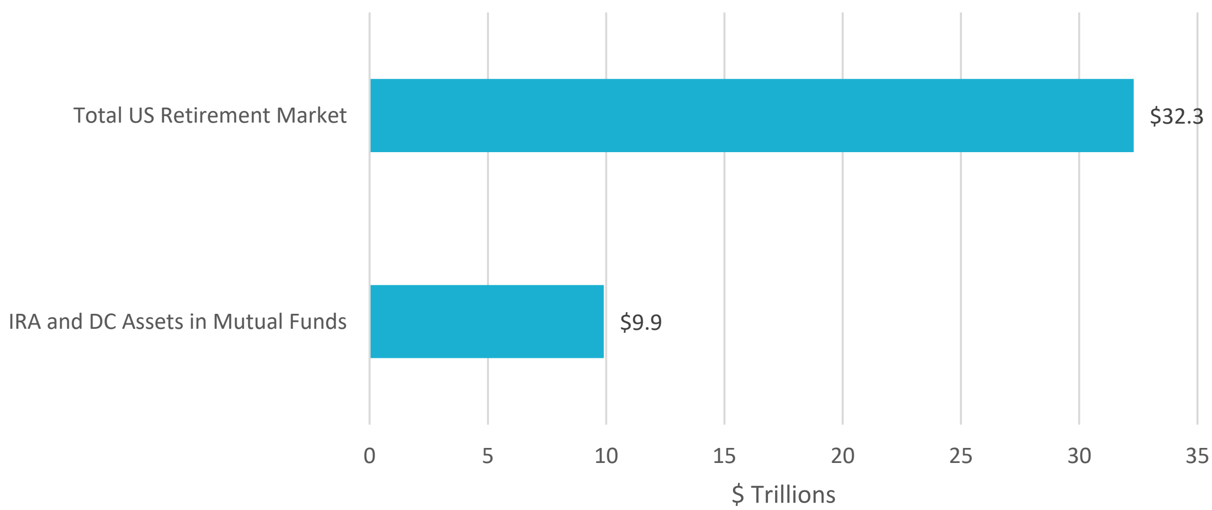
Broker-dealers set concentration limits for two reasons. First, concentration limits are set as a general diversification premise that is designed to ensure that investors are not overly concentrated in one type of investment of any kind. The second concern deals with liquidity. It is important that investors have sufficient assets in liquid investments to meet unexpected financial needs in order to avoid the potential need to sell illiquid investments in an adverse market and/or at a time when such a sale may result in penalties for early redemption.

In general, FINRA considers annuities to be illiquid. It does not make a distinction between annuities with surrender charges and annuities that are beyond the surrender charge period and therefore can be cashed in at full value. FINRA has also not formally acknowledged that virtually all annuities allow clients to withdraw 10 percent of the amount invested or the account value annually and free of surrender charges; most variable annuities also allow penalty-free withdrawal of earnings. And finally, as an example of how product design has evolved since 2008, there are now many advisory annuities in the marketplace that pay no commission and have no surrender charges. Since taxes are typically due when an annuity is cashed in, annuities should never be the first place anyone goes for liquidity. But annuities are far from the only asset that would have tax implications if sold to meet a liquidity need. That holds true for almost any investment. Individual stocks, mutual funds and ETFs are not deemed illiquid even though the sale can result in taxable capital gains. An annuity past its surrender charge period, or an advisory annuity with no surrender charge, is no more or less liquid than most other assets. Yet, that is the implication under many supervisory frameworks that exist today. This is not to suggest that annuities in general should be considered liquid investments, but rather that regulations and supervisory procedures should recognize that not all annuities are illiquid. Finally, it is important to note that liquidity may come at the cost of lower expected returns. If $50,000 more than necessary is held in a fully liquid instrument like a money market fund crediting 1% annual interest versus a (perhaps) less liquid fixed indexed annuity expected to credit 2.5 percent-3 percent on average, the investor will forgo approximately $9,000 to $12,000 in credited interest over 10 years.

3. Annuities in qualified plans are no more illiquid than any other asset in a qualified plan

Many investors hold the bulk of their investible assets in individual retirement accounts (IRAs) and defined contribution (DC) plans. In fact, at the end of 2019 the Investment Company Institute (ICI) reported IRAs and DC plans accounted for 62 percent of all retirement assets. However, Figure 2 shows that retirement accounts do not consist of just mutual funds.

Figure 2: Breakdown of US Retirement Market



Source: Investment Company Institute Fact Book (Investment Company Institute, 2020)

Increasingly, fixed and fixed indexed annuities are used to de-risk a portfolio without subjecting the portfolio to the interest rate risk that comes with traditional fixed income options such as CDs and bonds. However, since FINRA generally considers all annuities to be illiquid, compliance departments may limit the percentage of the IRA that may be allocated to fixed and fixed indexed annuities because of the assumed lack of liquidity. Similar to #2 above, the point here is not that annuities are a good place to go for necessary liquidity, but rather that due to the tax implications of the IRA itself, every asset is illiquid when it comes to an emergency source of liquidity. IRA assets will always be the last place an investor goes for liquidity, no matter the type of investment. Consequently, annuities should not be considered any more or any less liquid than any other investment within an IRA. The suitability of any annuity recommendation in an IRA or other qualified plan should therefore be based upon which goal that annuity meets, not the liquidity or lack thereof compared to other possible investments within an IRA. As an example, if the goal is to protect the portfolio from both market and interest rate risk, then a fixed or fixed indexed annuity should not be excluded in favor of a CD simply because one is an annuity and the other is not.

4. Fixed and immediate annuities are not complex

Given the numerous features and optional riders offered in variable annuities, it is hardly surprising the product invariably lands on FINRA's annual list of complex products. By default, complex products are subject to enhanced supervision by broker-dealers. Traditional fixed annuities and immediate annuities are far from complex. In fact, they are quite simple. Yet, when supervisory processes lump them together with other forms of annuities into one annuity category they are treated as though they are equally complex – often to the detriment of the client's investment goals.

5. Income annuities can fill an anticipated income gap

An increasing amount of research points to the potential efficiencies gained by buying an income annuity to cover any gap between the amount of retirement income a retiree needs to cover expenses and the amount realized from other sources such as Social Security and (ever more rarely) pensions. Such a strategy not only addresses longevity risk, but since it also mitigates sequence of returns' risk it provides more flexibility when investing the rest of the portfolio. For investors with $500,000 to $2,000,000 in investible assets, but no pension, financial planning software may calculate that an allocation of 50 percent to 60 percent of total assets to annuities provides the highest likelihood of meeting all of a client's retirement income goals. An analysis conducted in one recent study found that all retirement savings would be depleted by age 88 when no annuity was used. Savings would last until the mid-90s with a 30 percent allocation to annuities – a common advisory and often an allocation limit. However, the probability of having enough retirement income to last through age 100 was highest when 50 to 60 percent of retirement savings were allocated to annuities in the model.[1]

6. Long-Term Care Qualified Annuities – Addressing a Serious Financial Risk

As traditional long-term care policies have become less attractive and less available due to high cost and onerous underwriting requirements and restrictions, the industry has seen an increase in the use of long-term care qualified annuities as a means to help cover the high cost of long-term care. These are typically purchased by investors that either have an old annuity with taxable gains that they do not expect to need for income or by investors that are uninsurable. While these are annuity contracts both legally and by name, they serve a different function from the viewpoint of the investor. Rather, they represent a way to cover future long-term care costs without incurring taxes. Yet, because they are annuities, someone that already owns a significant portion of their assets in annuities could be prohibited from buying one for this purpose, for the same reasons as noted in item #1 above. This long-term care solution works well for clients because the Pension Protection Act of 2006 created a new category of annuities called long-term care qualified annuities. To qualify for tax-free withdrawals, the benefit must be in an annuity wrapper. This type of annuity has a unique and singular purpose – not only does it differ from any other annuity, but no contracts had even been developed at the time FINRA contemplated Rule 2330.

Recommendations for Supervisory Staff

> Set a minimum liquidity target before any non-qualified annuity is recommended rather than starting a review by putting a cap on the maximum amount of annuity concentration to limit illiquidity. For example, perhaps a client must have enough liquid assets to cover 18 months of living expenses before an annuity can be recommended. If that condition exists, then the annuity recommendation should be limited only by a prudent conclusion as to the amount allocated to any one product, of any type.

> Employ soft rather than hard limits to annuity allocation. To the extent any limits on annuity allocation are set, they should at most trigger additional review rather than hard limits that automatically reject applications.

> Set soft limits based on product type. For example, where a 50 percent allocation to a variable annuity might trigger an additional review, a 30 percent allocation to a VA with a guaranteed lifetime withdrawal benefit and 20 percent to a 5-year fixed annuity should not.

> Incorporate the output from planning software into the review process. If the software recommends 60 percent allocation to the annuity and the investor has sufficient liquidity, this should be weighted into the decision process and maintained as documentation for the recommendation.

Conclusion

Retirement income portfolios are markedly different from accumulation portfolios. When income is steadily drawn from a portfolio by someone who no longer receives earned income, and who is aging and has little or no ability to re-enter the workforce, market corrections and negative returns are far more impactful. When a retiree's needs are met by guaranteed income sources and investment risks are mitigated for the portion of the portfolio which produces that income, more risk can be taken with that part of the portfolio that isn't set aside for emergencies or near-term purchases without fear of impacting lifestyle. Whether the allocation is optimal for achieving the investor's goals should be the primary consideration.

Notes

[1] "Optimizing Annuity Income Benefits – A Case Study," by Eva L. Levine, JD, CFP, RIA (Financial Advisor, June 2019)

Question or comments?

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