RESEARCH

Credit FAQ:

Equity-Indexed Deferred-Annuity Market Conduct Risk Can Affect Life Insurer Ratings

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Allianz Life Insurance Co. of North America (Az Life)—the largest writer of equity-indexed annuities (EIAs), with more than one-quarter of the market—was sued by Minnesota's attorney general on Jan. 9, 2007. The complaint alleges unsuitable sales of deferred annuities to seniors in violation of state laws.

Although the suit is nominally about deferred annuities, approximately 90% of Az Life's new product sales are EIAs, and these products are repeatedly named in the complaint. In addition, litigation by individuals and in class actions is emerging and growing against various insurers offering EIAs, alleging unsuitability and other misconduct.

We published a bulletin on Jan. 11, 2007, stating that our ratings on Az Life are not currently affected by this complaint but that we are monitoring the situation. Nonetheless, this suit highlights concerns we have about this emerging and lightly regulated segment of the deferred annuity market and about evolving standards for acceptable market conduct.

In our commentary " Increasing Competitive And Regulatory Risks Cloud Future of Equity-Indexed Annuity Industry," published June 13, 2005, on Ratings Direct, we said, "Product complexity, large inducements to speed sales, long surrender-charge periods even when sold to older individuals, and the difficulty companies have monitoring the conduct of IMOs heighten concerns that companies proactively establish and enforce appropriate standards of suitability and market conduct. A number of EIA providers have recently strengthened their standards and procedures in response to increased criticism, but practices vary widely, and effectiveness is difficult to assess without a longer track record. With the public demanding ever greater vigilance from the financial services community, relying on traditional standards for suitability and market conduct might not be enough to protect a company from liability and reputational damage."

Whether or not the Az Life suit's allegations of unsuitability are proven, this case is notable as the first significant action by a regulator to test market conduct practices for EIA sales and could portend greater regulatory activism in this area. Because of a rising chorus of criticism and litigation alleging unsuitable annuity sales, we are responding to frequently asked questions about how the potential adverse consequences of unsuitable sales affect our ratings opinion on insurers offering EIAs.

Frequently Asked Questions

Why the focus on EIAs?

As we said in our June 13, 2005, commentary about EIAs: "Because the new [EIA] product structures are largely unregulated, product innovation, in some areas, … [has] reached levels that strain the standards of suitability and appropriate market conduct. Whether lines have been crossed could depend on shifting public expectations, and former standards might not provide a safe harbor."

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When any new insurance product concept or new selling methodology is introduced for an insurance product, new types of market misconduct can emerge. EIAs are a relatively new type of deferred annuity that first appeared in the late 1990s but really began to flourish in 2002. At that point—the second year of the three-year "perfect storm"—falling markets had left the market risks of variable annuities plainly exposed, and sagging interest rates had rendered traditional fixed annuities less attractive.

Now, with about $100 billion in industry sales in the past five years, we believe EIAs have established a lasting foothold in the annuity market. EIAs constitute about one-third of all fixed-annuity sales and one-ninth of all deferred annuity sales. The other two-thirds of deferred annuity sales are variable annuities.

As a result, agent and company sales practices surrounding EIAs are garnering increasing scrutiny. Pervasive, systemic, and obvious market misconduct has historically been treated harshly by insurance regulators. Sporadic and nonsystemic incidents of market misconduct, however, tend to fly under the radar.

EIA sales practices have not received the same consistent level of scrutiny as have variable annuity sales practices. Although EIA products are linked to equity securities, they are not themselves registered products, meaning EIAs are not defined as securities by the SEC. This means EIAs are not subject to the same kind of regulatory scrutiny as are variable annuity products and sellers. Sellers of EIAs do not have to be NASD-licensed and so do not have to comply with the NASD's suitability standards, which include directives to make balanced sales presentations and ensure suitability. EIA sellers are also not generally subject either to the NASD's active monitoring of sales behavior of registered representatives nor to its methods of redress.

EIAs can be, and are, sold by securities dealers, with those sales usually classified as "outside business activity" that is not subject to NASD standards or oversight. Some NASD member firms do exercise their optional prerogative to restrict outside business activity and permit its brokers to sell EIAs only if it is done under the firm's supervision and in compliance with all NASD standards. However, this addresses only a very small fraction of EIA sales.

Also, current statutory suitability standards apply primarily to sales to seniors older than 65 or 70. Given the complexity of EIAs, many are of the opinion that suitability standards should apply to all sales not just sales to seniors. Even though most consumer-protection statutes don't explicitly consider suitability standards for younger ages, recent history demonstrates how regulators can expand the application of existing law to protect consumers. The bar for suitable sales has already been raised, and insurers selling EIAs ought to be concerned about ensuring the suitability for all consumers, not just seniors.

How much does the risk of unsuitable sales affect ratings compared with the other risks insurers face?

Although EIAs are unregistered financial products, they are as complex and as difficult to understand as registered securities such as variable annuities. Agents not licensed or trained to sell securities could find it challenging to understand and explain an EIA's inner workings to consumers. When this results in consumers purchasing a product they later realize they didn't understand, the agent and the insurer could be held responsible for misselling.

Insurers offering annuities face numerous risks, many of which—such as interest rate risk, investment credit risk, equity market risk, and competition—are driven by relatively constant external forces. Market conduct risk, on the other hand, is internally driven, as it emerges from how an insurer markets and distributes its product. Market misconduct is difficult for an external observer to quantify until evidence of misconduct accumulates to the point that it is confronted openly by injured parties or their representatives.

Market conduct and suitability are important elements of the ratings on an insurance company because of misconduct's adverse consequences. Misconduct is more likely to affect ratings when a systematic pattern exists that must be remedied. This was the case with the vanishing-premium scandal that hit the life insurance industry in the 1990s. Although the words "vanishing premium," by themselves, were innocuous, the words, as well as the concept, became a popular sales tool. Ultimately, the vanishing-premium concept became a one-sided sales misrepresentation because few agents bothered to explain that additional premiums would be required if interest rates declined. When rates declined, policyholders recoiled at being told the so-called vanishing premiums hadn't really vanished. The industry

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paid dearly for this misconduct and is prohibited from using the words "vanishing premium" in its marketing lexicon. Beginning in 1997, new burdensome and costly life insurance illustration regulations were necessary to prevent some of the past abuses from recurring.

For life insurance companies, consequences of the life insurance and annuity market conduct scandals of the mid-1990s included the financial costs of litigation, fines, penalties, and restitution costs. Prudential, hit hardest, had to pay $35 million in fines to various states and about $2 billion in restitution to its policyholders. In addition, adverse consequences can include indirect costs such as reputational damage, weakened competitive advantage, diverted management resources, and increased regulation.

How can unsuitable annuity sales affect a company's competitive position?

Trust is the primary currency of the life insurance industry. Misconduct that erodes trust is a material risk for all insurers, as it impairs an insurer's ability to sustain top-line sales revenues, an important metric for assessing competitive advantage. Companies that encounter material complaints or litigation for unsuitable sales might see their top lines erode if consumers no longer want their products and if distributors shift their sales efforts to competing products from other providers to distance themselves from the allegations. A viable competitive position also means being able to hang on to existing customers. Once customer confidence is lost, surrender activity can increase precipitously.

Aggregate EIA sales for the industry peaked in the second quarter of 2005 even though a number of new providers have come into the market since then. This suggests inherent limitations in the EIA business model, which could be exacerbated if unsuitable sales or other misconduct is widely exposed because it would imply that a meaningful portion of sales were the result of misconduct.

Insurers selling equity-indexed deferred annuities have some of the most concentrated business models in the life insurance and annuity industry. Such concentration magnifies the potential impact of any misconduct.

The EIA business model could also be eroded if product innovation is constrained by more extensive regulation intended to make the products more understandable and to prevent unsuitable sales.

Erosion of competitive advantage for any reason could be compounded as the age wave expands the need for retirement savings vehicles and other insurance and financial services companies fill the need.

Could a company's operating performance be affected by unsuitable sales?

The operating performance of any insurer selling annuities (or, indeed, any insurance product) in ways that run counter to standards for market conduct and suitability could be at risk. In addition to the items cited above—such as the cost of defending against legal actions, diversion of management resources, and cost of settlements and restitution—other risks could also affect operating performance. These risks include:

- Competition from other financial products, which could limit the ability to pass through cost of complying with additional regulations.
- New constraints on product innovation, which could increase commoditization and reduce margins.
- Deferred acquisition cost recoverability would be affected by remediation and surrender activity.
- Reduced spread income from a slower growing or reduced asset base.
- Higher fixed-cost expense ratios because of the reduced base over which fixed costs can be spread.

How severely can marketing misconduct affect capitalization?

If remediation results in settlement costs, these costs—even if a one-time event—can reduce earnings and capital. If the costs are large enough, capitalization could be reduced to a point beyond which the rating can be supported. If capital cannot be restored quickly enough to the levels expected for the rating, we would take action.

Capitalization could also be negatively affected if a company has to rescind a large block of contracts as part of remediation or if surrender activity spikes as a consequence of a settlement or loss of trust. The related early sale of assets could expose the company to realized capital losses.

Pressure on capitalization could be moderated by lower sales volume, which would reduce the need to

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grow risk capital.

How is Standard & Poor's reflecting these issues in its ratings?

Our opinion of the current level of market conduct risk is fully integrated in our overall ratings opinion on each insurer and industry outlook. Our average life insurance company financial strength rating is 'AA-', but ratings on insurers with high concentrations in EIA and deferred annuity sales are generally in the 'BBB' and 'A' categories. (Higher ratings are possible when such an insurer is an integral part of a stronger parent group.) These ratings reflect our opinion of the collective risks (including market conduct risks) these companies must manage daily.

Because misconduct usually requires litigation or regulatory intervention to quantify and remedy, we monitor potential developments at every company we rate that could adversely affect ratings. If we develop a materially less-favorable view of a company's competitive position, operating performance, or capitalization, it could lead to at least a one-notch downgrade of the affected industry players. The reputational and financial costs of EIA market conduct risk will remain ambiguous until regulators or the courts clarify EIA suitability standards and market conduct expectations. Until then, insurers offering EIAs will remain exposed to market conduct challenges.

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