SEC Variable Annuity Comments

By Chris Tobe, CFA File No. S7-23-18 November 1, 2018

I want to thank the SEC for attempting to bring more disclosure to one of the worst investment products for consumers in the U.S. Especially important is the proposed fourth line item risk disclosure that these Variable Annuity products bear liquidity and single entity credit risk of the issuing insurance company.

The additional liquidity (surrender charges) and single entity credit risk taken by investors in variable annuities over mutual funds, has immaterial benefit to consumers, but is converted to $billions in secret profit via spread for the insurance companies that is still not disclosed. These secret profits allow insurance companies to offer high commissions to brokers to induce them to sell these inferior products to investors. Most are sold as mutual funds, pocketing higher commissions fees and spreads while offering a product with higher risks.

Excessive Risks

Annuities in an Insurance Company Separate Account are many times sold as similar to a mutual fund but in my opinion, are not. The investor does not own the underlying investments, they are still on the balance sheet of the insurance company. All the investor has in the end is a piece of paper, a claim on the assets of the insurance company.

As outlined in the SEC proposal historically Separate accounts used for Variable annuities were typically registered as investment companies under the Investment Company Act but by 2017 most variable annuity separate accounts registered as UITs on Form N-4.[1]
In this UIT structure, the insurer's separate account, not the variable contract investor, is the legal owner of the underlying fund shares. This is a huge risk difference making them much closer to general account in risk instead of being like mutual funds.

Insurance products in the United States are, for the most part, unregulated by the Federal Government and lack transparency in risk and fees. A 1992 Federal Reserve paper notes that the so-called insurance safety net is made of 50 different state regulators with a wide variety of regulations and is much weaker than most realize.[2] The European Union, in 2017, has also shown concern with the weakness of state regulators of insurance companies. [3]

Insurance Companies continue to make claims about Separate Account like "*identifies a segregated pool of assets held and owned by an insurance company but distinct from the insurer's general investment account, and therefore, not subject to claims of creditors should the insurance company become insolvent.*" I think this statement is misleading at best. While an Insurance company officer I managed an Insurance Company Separate Account product and became very familiar with solvency issues when trying to sell the product. I have reviewed very detailed legal opinions on what would happen in a default situation. My reading of a particular state's separate account contract that in the event of default, Separate Accounts would be above General account, but would be classified as a Class 2 priority. I believe class one would be payroll etc. of employees, while general account would be in the 3rd or 4th tier. Within class 2 the separate account would rank equal or pari passu with the claims of life insurance policyholders. However, a bankruptcy judge could control the order in the Class 2 to put all of the policy holders ahead of the separate account holders. In a bankruptcy situation while you are ahead in line of General account products it could still be months or years before you could get some much less all of your money out of a separate account.

The DOL in their 2011-07A Advisory opinion on the role of QPAMs in stable value plans made clear and distinctive differences between bond funds with a separate synthetic GIC wrap and insurance company separate account. [4] *We have assumed for purposes of this advisory opinion that the SVM is independent of the Wrapper, and that where the SVM is separate from the fixed income manager, the fixed income manager also is independent of the Wrapper and the SVM. ….* In the scenarios you have described, the Wrapper is not negotiating on behalf of the plan. Instead the Wrapper is negotiating the terms of the investment parameters to reduce its own exposure under the wrap contract. .... account. [5] The Sutherland Law firm analysis assumes DOL exemption applies only if the that the managers are independent of the wrap provider and, if different entities, also independent of each other. By the DOL making this official distinction between Synthetic and Insurance Company Separate Account I feel the Fiduciary risk associated with Separate Account has grown significantly.

I believe that in 2008 Federal Reserve Chairman Ben Bernanke was referring to both general and separate insurance investment products when he said that *"workers whose 401(k) plans had purchased $40 billion of insurance from AIG against the risk that their stable-value funds would decline in value would have seen that insurance disappear."* [6]

Spreads, Profits, and Fees

Prudential Financial Inc. (PRU), the top seller of variable annuities, said Wall Street should appreciate the fees the life insurer makes on the retirement products, even as some competitors cut sales to reduce risk."We're getting more than 2 percentage points of fees from the assets that are part of our annuity business," Mark Grier, Prudential's vice chairman, said at a Citigroup Inc. (C) financial- services conference in Boston today. "In your businesses, you probably would dance in the street over 40 or 50 or 60 basis points." [7]

While the overt fees look to be better disclosed the hidden profits remain. Anytime an insurance company "owns" the assets, they can squeeze out billions in balance sheet spread derived from risks investors take.

The US DOL put out in 2013 new fee disclosure guidelines for 401(k) plans which are Defined Contribution plans and the fastest growing in the U.S. [8] Insurance company separate account Stable value or guaranteed funds constitute billions in 401(k) plans and have varied and complex structures which complicate fee disclosure. Billions of dollars in what I call spread based fees in insurance products remain undisclosed under the 2013 DOL fee disclosure rules.

This loophole allows insurance companies to hide as much 2% or 200 basis points (bps) in yearly spread profits. I was quoted in the Wall Street Journal's Marketwatch *"These excessive profits, even if called spread, act like fees and are used like fees,"* [9] In addition they continue to pay commissions out of the hidden spread which drive even more sales. While the spreads in variable annuities may be less than separate account fixed annuities they are still material and excessive. Insurance companies have bragged to stock analysts on making over 200bps in fees on variable annuity products. This needs to be disclosed more fully even if it is internal spread and other profits.

Chris Tobe, CFA, CAIA is a top expert on insurance related investment products and is the founder of Stable Value Consultants. For nearly 7 years he served as a director for the Pension & Savings Group of AEGON Institutional Markets, where he worked on synthetic, separate account and general account products. He is the author of the "Consultants Guide to Stable Value" the only book published on Stable Value in the last 15 years. He has worked recently with a number of large DC plans and has been quoted in Wall Street Journal and Barron's on Stable Value and published a number of whitepapers on stable value. He provided written testimony on stable value to DOL's ERISA advisory committee and testified in person at the joint SEC-DOL hearing on Target Date Funds in summer of 2009. He has over 25 years of experience working as a consultant, money manager and regulator. He has spoken at a number of SVIA conferences and national conferences such as IFEBP, NAST, CIEBA and NAGDCA on stable value and other DC investment. He holds a BA in Economics from Tulane University, and an MBA in Finance from Indiana University – Bloomington.

[1] https://www.sec.gov/rules/proposed/2018/33-10569.pdf

[2] _Federal Reserve Bank of Minneapolis Summer 1992 Todd, Wallace SPDA's and GIC's
http://www.minneapolisfed.org/research/QR/QR1631.pdf

[3] https://www.nytimes.com/2017/03/31/business/dealbook/will-overseas-regulators-trust-the-states-to-watch-insurers.html

[4] *http://www.dol.gov/ebsa/regs/aos/ao2011-07a.html*
[5] *http://www.dol.gov/ebsa/regs/aos/ao2011-07a.html*
[6] http://www.federalreserve.gov/newsevents/testimony/bernanke20090324a.htm
[7] http://www.bloomberg.com/news/2013-03-06/prudential-says-annuity-fees-would-make-bankers-dance.html

[8] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2167341

[9] _http://www.marketwatch.com/story/these-funds-give-retirement-savers-stabili
ty-2012-10-16_