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# Opinion: Regulators Need to Do More to Curb Egregious Annuities Sales Practices

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By **Gil Baumgarten**

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The Department of Labor is under pressure to release its new Retirement Security Rule, which would impose fiduciary obligations on more financial professionals working with retirement clients. But from my vantage point as a fiduciary advisor, regulators' focus on individual retirement accounts overlooks more egregious activity in non-IRAs happening right under their noses. Particularly absent from the discussion about the rule are annuities sold by the insurance industry—often with punishing fees and commissions that slide by with little scrutiny.

These products are retirement vehicles, whether they are in an IRA or not, and are the more deserving focus of regulatory attention. When selling annuities, agents say things that are factually true but that are also apt to be misunderstood, leaving investors with very mistaken impressions and agents with very large commissions.

**Living benefits riders.** Although annuities are tax-deferral vehicles, many have optional features—riders—that come with additional fees. In my experience, living benefits riders are near the top when it comes to faulty investor understanding. Living benefits ensure income payments at a certain level as long as the owner lives, even if the contract evaporates under regimented withdrawals or by market forces.

With a living benefits rider in place, it is allowable for the agent to say, "You get paid 8% no matter what." That might be technically true, but paying out 8% doesn't mean the contract earns 8%. The guaranteed distribution is paid out of the annuity's cash balance but is calculated based on what is in effect a second set of phantom books—the benefit base amount. At the contract initiation, the benefit base amount and the cash value are at parity. As time passes, fees, distributions, and investment performance affect the cash balance. The benefit base, however, changes based on some pre-agreed basis—for instance a guaranteed minimum value or a guaranteed annual percentage increase.

So, while the contract cash value experiences a market downturn, the benefit base doesn't. The 8% withdrawals, calculated against the benefit base, might now reflect 15% of the cash value. That increased benefit base drives the payout higher, but at the expense of the cash value. It also drives the contract fees higher because annuity providers charge fees against the larger of the benefit base or the cash value.

**"Phantom" credits.** I have also seen gimmicky income riders presented with a "cash bonus" for signing up. This is akin to an online gambling site or fantasy football draft site giving you a $250 credit to gamble with—they hope to hook you into a process that will ultimately profit them. Annuity credits work similarly, driving up the monthly income payout but at a cost to the contract's cash value, and often resulting in higher contract expenses. Agents often describe these incentives as "free money." But the rising benefit base —and therefore the future payments of the annuity owner—drag down the contract's cash value and cannot be withdrawn in a policy surrender. Many investors miss the point that these are phantom credits, not real money.

Worse, distributions from annuities can be presented as partially tax-free income, but only because the original already-taxed principal is being paid out along with taxable earnings. One hundred percent of the actual policy returns will be taxed as ordinary income—the worst kind. Agents frame these factors as features and not flaws.

**No exit.** Such obfuscated costs mean investors' experiences often follow a similar path. Once the contract goes upside down and the cash value is significantly below the benefit base, an investor's epiphany is too late. They feel trapped by the declining cash value and the looming surrender charges, which can last a decade, to ensure they stay put. The contract might underperform expectations, but the "phantom money" benefit base is so high people perceive they cannot afford to exit the contract. This guaranteed income arrangement often means the annuity company will likely be the policyholder's largest beneficiary, not the policyholder's children.

There are many considerations in defining the appropriateness of these types of contracts, but two factors are paramount: First, does the contract owner have offspring or another beneficiary who would be harmed by the contract imploding under excessive payments, possibly leaving no residuals? Second, is the contract owner so strapped for periodic income that a maximum payout vehicle is required, even if it brings about its own demise? When selling these products, agents aren't incentivized to be that discerning. These contracts and income riders are also mostly available in low-commission or no-commission versions with much better outcomes for investors. But don't expect your agent to tell you about those—or that the SEC or insurance regulators will be paying attention.

**Way forward.** The best path forward for the DOL and regulators is to address the totality of risks facing retirement investors and how investors engage with those who advise them— including annuity sales personnel. What they should *not* do is bear down one section at a time, only to realize another section needs attention at a later date. If regulators want robust change, they ought to focus on the entirety of the retirement spectrum of choices.

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