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NAFA Guiding Principles on Suitabiliity

Guiding Principles are produced by NAFA for Annuity Professionals to help them prepare to better communicate with consumers.

Fixed annuities play a vital role in helping consumers provide for their own financial security in retirement. All fixed annuity stakeholders – government, regulators, and the industry – share a critical objective: to protect consumers.

NAFA, is the only independent, non-profit organization dedicated exclusively to promoting the awareness and understanding of fixed annuities. NAFA has created a series of guiding principles papers to provide stakeholders with direction and education on key issues affecting fixed annuities.

This paper discusses suitability considerations for fixed annuity sales and offers guidance in shaping the development of suitability recommendations, review processes, and systems.

Background discussion on Suitability and its History

A number of states have specifically addressed suitability for over a decade, when the NAIC first introduced the Suitability in Annuity Transactions Model Regulation, #275. It has also been a common practice for state insurance regulators to address suitability concerns through their respective state's Unfair Trade Practices Act. More recently, states have adopted the revised version of the Model Regulation, as updated in April 2010 (the "NAIC Model Regulation"). (Visit www.nafa.com for a complete list of states that have adopted the updated 2010 Model.) And, well before the 2010 version of the Model Regulation, carriers had voluntarily developed and implemented suitability standards for their own annuity products.

With respect to variable annuity recommendations, suitability is governed under FINRA Conduct Rule 2111 (formerly NASD Rule 2310). Both the NAIC Model Regulation and FINRA Conduct Rule 2111 impose similar suitability requirements, as follows:

> In recommending to a consumer [an annuity purchase or exchange transaction] the insurance annuity professional, or the insurer where no annuity professional is involved, [or "member or associated person" in FINRA nomenclature] shall have reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer as to his or her investments and other insurance products [or "other security holdings" in FINRA nomenclature] and as to his or her financial situation and needs, including the consumer's suitability information . . . .

Model Regulation, Section 6A (See FINRA Rule 2111(a)).

2010_0710_PUB_SuitabilityGuidingPrinciples_Rev01132014

In addition to this general suitability requirement, which is a pre-solicitation requirement imposed on all selling agents, both FINRA and the NAIC Model Regulation require the collection of certain consumer-specific data (e.g., age, liquidity, income, assets) to inform the final suitability determination.

Both FINRA Conduct Rule 2111 and the NAIC Model Regulation recognize that the suitability determination is unique to each consumer's specific financial situation at the time of purchase.

In addition to the annuity professional's duty to have a reasonable basis for the determination of a suitable recommendation, the NAIC Model Regulation imposes a duty upon the insurer to maintain a system of supervision for a secondary suitability review of EVERY annuity application prior to issuing the policy. In addition, the liability of any sale deemed unsuitable is placed squarely on the insurer. Even if the insurer contracts with a third party, such as a distribution partner, to provide a system of supervision for the secondary review of each application, the insurer is not relieved from the liability of an unsuitable sale.

As this regulatory evolution unfolds and as market competition creates new methods to help with the suitability recommendation, review processes and systems, and in light of the adoption of the updated NAIC Model Regulation by states and insurers, NAFA offers these principles to provide guidance in shaping compliance with these new regulations.

NAFA Suitability Principles

As the 2008 market disruption made abundantly clear, fixed rate and fixed indexed annuities are useful tools to assist consumers accumulate assets and manage risk. Fixed annuities should be considered a valid part of a prudent retirement and asset management plan for some portion of a consumer's assets.

However, an annuity sale should only take place if it meets the NAIC Model Regulation's suitability standards and benefits the consumer in light of each consumer's specific liquidity, financial needs and retirement goals. All parties in the sales process, including insurers, marketing organizations, and annuity professionals, should make reasonable efforts to avoid inappropriate, unsuitable, fraudulent, or misleading sales.

Consideration should be given to what values and benefits are available to the annuity purchaser and what risks or opportunity costs will be borne by the purchaser under various possible future scenarios. These scenarios include:

a. Full surrender of the contract due to emergency needs or simply a desire to transfer money to another financial product;

b. Discretionary partial withdrawal for emergency needs or required minimum distributions under federal tax law;

c. The need for guaranteed income for a defined period of time or for the remainder of life, or lives if joint owners;

d. Withdrawals related to financial needs arising from the initiation of custodial care, diagnosis of terminal illness, or disability; and

e. Distribution, in the event of death.

In the case of an exchange or replacement of an annuity, the annuity professional must consider whether:

a. The consumer will incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits; or be subject to increased fees, investment advisory fees, or charges for riders or similar product enhancements;

b. The consumer would benefit from any product enhancements in the replaced annuity; and

c. The consumer has had another annuity exchanges or replacement within the preceding 36 months.[1]

Proper evaluation of these scenarios requires the annuity customer to both give information to and

[1] Some states, such as California, Florida, and Minnesota extend this period to 60 months.

receive information from the annuity professional. Thus, every purchase decision should be a collaborative and educational process.

The NAIC Model Regulation requires insurers to maintain reasonable procedures to detect unsuitable annuity transactions, which may include systems to confirm the collection of consumer suitability information in order to determine the suitability of a recommendation. Pursuant to the 2010 Model, suitability information includes the consumer's:

1. age (for the purpose of evaluating the effect of likelihood of death on the length of the investment);
2. annual income;
3. current financial situation and needs, including the financial resources used for the funding of the annuity;
4. financial experience;
5. financial objectives;
6. intended use of the annuity;
7. financial time horizon;
8. existing assets, including investment and life insurance holdings;
9. liquidity needs;
10. liquid net worth;
11. risk tolerance;
12. tax status; and,
13. holding of a reverse mortgage[2]

Regarding the consumer's source of funds to purchase the annuity, consideration should be given to whether the consumer will pay any penalties or fees to liquidate such funds to purchase the annuity or will lose any benefit under the replaced product that will not be available under the recommended annuity.

- Specific attention should be placed on the current and potential future liquidity needs of the consumer by assessing the possibilities for unexpected income loss and the need to fund medical and non-medical emergencies. Sales recommendations should consider whether the necessary liquidity would be met by the annuity or by other assets available to the consumer.

The NAIC Model Regulation requires insurance producers to make a record of any recommendation they make, and they should document the suitability analysis and discussion; such records are subject to state document retention requirements.

In some circumstances, the suitability analysis may result in the annuity professional advising the consumer not to purchase a fixed annuity. Nevertheless, the consumer may decide to purchase or replace an annuity that is not based on the producer's professional recommendation. Moreover, consumers may refuse to provide relevant suitability information. In such instances, the insurer and producer are relieved of their general obligations under the suitability standards. However, the NAIC Model Regulation requires that where a consumer refuses to provide suitability information or where a consumer enters into an annuity transaction that is not based on the producer's or insurer's recommendation, the consumer must provide a signed statement acknowledging such refusal or decision.

- Because of the possibility that the suitability analysis may be challenged later, the annuity professional should document the suitability analysis and discussion.

- Insurers should provide the annuityprofessional with a suitability form to capture important information about the consumer. They should also have a process to ensure that annuity professionals use the suitability form consistently and that all information is being retrieved, since obtaining all possible information from a consumer provides the best assurance of an adequate suitability review.

In situations where consumers decline to submit financial information, insurers should take steps to ensure that annuity professionals are not circumventing

[2] Although the 2010 NAIC Model Regulation does not include this last item, some states, including California and Minnesota, require that the holding of a reverse mortgage be a condition of the suitability review and many carriers have added that requirement to all states in which they do business.

their required suitability responsibilities by urging consumers to elect the opt-out. A system of supervision could address this potential situation, through auditing on a sampling basis or via statistical triggering. In the latter method, an audit could be triggered where there is a high percentage of opt-out sales for a given annuity salesperson. NAFA also recommends that the annuity professional follow up with each consumer who opted out, to ensure that they understand the product and have determined its suitability on their own.

- A good assurance that opt-outs are the consumer's decision is to follow up with each consumer who opted out, to ensure that they understand the product and have determined its suitability on their own. Insurers, or a third-party, must establish and maintain a system to supervise recommendations. It requires producer education and training on the importance of proper suitability review and the insurer's standards and practices for such a review. This includes informing annuity salespeople of what information must be collected and how that information relates to the suitability assessment.

Under the NAIC Model Regulation's requirements, the insurer must develop and follow procedures, as well as conduct periodic reviews of its records, to assist in detecting and preventing failures of annuity salespeople in making suitable recommendations. If the insurer contracts with a third-party suitability supervisor, the insurer must make reasonable efforts to assure that the supervisor is performing these responsibilities and shall enforce the third party's contractual obligation to perform the functions.

Conclusion

Because the insurance concept does not function well in the absence of public confidence and trust in the industry, NAFA is in favor of processes and procedures which will lower the incidence of misleading, inappropriate, and unsuitable sales including:

- Implementing processes which gather information about sales practices and consumer sales;
- Use of such information to reduce misleading, inappropriate, and unsuitable sales through education and training;
- Protecting insurers and regulators from legal liability for the appropriate use of that information;
- Allowing a forum or procedure for annuity salespeople to rebut, correct, and expunge incorrect or erroneous information regarding their sales practices; and,
- Providing for legal penalties and restitution up to and including termination of an annuity professional's contracts and revocation of state insurance license(s) for annuity salespeople who continue to pursue inappropriate sales practices and/or are the subject of ongoing consumer complaints.

The foregoing principles recognize the insurance industry's role and responsibility in promoting suitable sales. Any suitability system should be flexible enough to accommodate different distribution systems and product innovation, while being rigorous enough to detect possible abuses. It should provide insurers, marketing organizations, annuity professionals, regulators, and the public at large with confidence that suitable recommendations are being made and that insurers are maintaining adequate systems of training, supervision, and oversight so that the vast preponderance of sales are appropriate for consumers.

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