National Association for Fixed Annuities
Securing the Future!

NAFA Principles on Suitability

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

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

This paper discusses suitability considerations involved in 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, such as Iowa and Minnesota, have specifically addressed suitability for over a decade. It has also been a common practice for state insurance regulators to address suitability concerns through their states' Unfair Trade Practices Act. More recently, states adopted the NAIC Suitability in Annuity Transactions Model Regulation, Model No. 275 (the "Model Regulation"). (Visit www.nafa.com for a complete list.)

With respect to variable annuity recommendations, suitability has been governed under FINRA Conduct Rule 2310 and its most recent manifestation, FINRA Conduct Rule 2821.

Both the Model Regulation and FINRA Conduct Rule 2310 impose similar suitability requirements, as follows:

> In recommending to a consumer [an annuity purchase or exchange transaction], an insurance agent, or an insurer if no insurance agent is involved [or "member" in FINRA nomenclature], shall have reasonable grounds for believing that the recommendation is suitable for the senior consumer upon 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. – Model Regulation, Section 6A.

Both FINRA Conduct Rule 2310 and the 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 producer's (or insurer's, where no producer is involved) duty to have a reasonable basis for the determination of a suitable recommendation, the Model Regulation imposes a duty upon the insurer to maintain a system of supervision or to ensure that a third party, such as a distribution partner, maintains such a system.

While both the FINRA rules and the Model Regulation impose responsibilities upon the various persons involved in the sale of the variable and fixed annuities, respectively, standards and practices have varied. Various industry participants have been enhancing their suitability standards and practices at a brisk pace. Regulators are also considering imposing more prescriptive suitability standards and practices that encompass licensing, training, supervision, liability, and uniform application.

NAFA offers these principles to provide guidance in shaping their development.

NAFA Suitability Principles

- As the recent market disruption has made abundantly clear, fixed declared rate annuities and indexed annuities are useful tools in assisting consumers to 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.

- All parties in the sales process, including insurers, marketing organizations, producers, and consumers should make reasonable efforts to avoid inappropriate, unsuitable, fraudulent, or misleading sales.

- Because of the long history of state insurance regulation, its continuing evolution to adapt to new products and market challenges, and the distinctly different value and sales considerations of insured products as opposed to securities, fixed indexed annuities and indexed life insurance which comply with insurance laws are best regulated as insurance exclusively and not as securities.

- An annuity sale should only take place if it benefits the consumer in light of each consumer's specific liquidity and financial needs. Consideration should be given to what values and benefits are available to the purchaser and what risks or opportunity costs will be borne by the purchaser under various possible future scenarios. These scenarios include:

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

    ii. Discretionary partial withdrawal for emergency needs or required minimum distributions under federal tax law,

    iii. The need for guaranteed income for a defined period of time or for the remainder of life,

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

    v. Distribution in the event of death.

- Proper evaluation of these scenarios requires the consumer to both give information to and receive information from the producer. Thus, every purchase decision should be a collaborative and educational process. Processes should exist to ensure that each consumer provides relevant information to the producer so that the producer may advise the consumer as to an appropriate product, but also so that the producer may inform the consumer of benefits, features, risks, and opportunities.

Information categories such as the following, as found in the Model Regulation, may be relevant:

i. The consumer's financial status,

ii. The consumer's tax status,

iii. The consumer's retirement objectives, and

iv. Such other information used or considered to be reasonable by the producer, or the insurer where no producer is involved, in making recommendations to the consumer.

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- 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 analysis may result in the producer advising the consumer not to purchase a fixed annuity.

- To the extent that the recommended annuity is replacing another financial product, the producer should consider whether the recommended annuity better satisfies the consumer's financial objectives, situation, and needs than the replaced financial product, and consider of any charges, fees, and income tax implications involved in the replacement transaction.

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

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

However, the Model Regulation allows consumers to opt out of providing the information needed to perform the suitability review if they desire to maintain the privacy of their financial information.

If an insurer allows consumers to opt out of submitting financial information, it should take steps to ensure that producers are not circumventing their required suitability responsibilities by urging consumers to elect the opt-out. A system of supervision could address this potential via auditing on a sampling basis or via statistical triggering. In the latter method, an audit could be initiated by a high percentage of sales opting-out for a given producer. The best 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.

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- To the extent that a producer is involved, the issuing insurer or a third-party, such as a distribution partner, should establish and maintain a system to supervise recommendations. It should involve education and training of producers on the importance of proper suitability review and the insurer's standards and practices for such a review. This includes informing producers of what information must be collected and how that information relates to the suitability assessment.

Under such a system of supervision, the insurer should develop and follow written procedures as well as conduct periodic reviews of its records to assist in detecting and preventing failures of producers in making suitable recommendations. If the insurer contracts with a distribution partner, the insurer must make reasonable inquiries to assure that the distribution partner is performing these responsibilities and shall enforce the third party's contractual obligation to perform the functions.

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- 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. NAFA strongly supports excising producers from the industry who show a pattern and practice of such sales. Therefore, NAFA generally supports:

    i. Processes which gather information about producer's sales practices and consumer sales,

    ii. Use of such information to reduce misleading, inappropriate, and unsuitable sales through education, training, and – in extreme cases – removal of producers who continue to make them,

    iii. Protecting insurers and regulators from legal liability for the appropriate use of that information,

    iv. Allowing a forum or procedure for producers to rebut, correct, and expunge incorrect or erroneous information, and

    v. Providing for legal penalties and restitution up to and including termination of producer contracts and revocation of state insurance licensing for producers who continue poor sales practices and sustain ongoing consumer complaints.

The foregoing principles recognize the insurance industry's roles and responsibilities in promoting suitable sales. Any system should be flexible enough to accommodate differing distribution systems and evolving products while being rigorous enough to detect possible abuses. It should provide insurers, marketing organizations, producers, regulators, and the public at large with comfort 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 purchasers.

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