



*The Association for Insured Retirement Solutions*

### **Summary of Testimony**

Chairman Frank, Ranking Member Bachus and Members of the Committee, my name is Cathy Weatherford and I am President and CEO of NAVA—The Association for Insured Retirement Solutions. I am pleased to appear before you today to provide our perspective on the extensive regulatory structure under which our member companies currently operate and in light of the existing regulatory regime, to share our view regarding whether an independent consumer financial products regulator should have authority to regulate insurance products. I commend Chairman Frank and Ranking Member Bachus for holding this important hearing to examine gaps or perceived gaps in and overlapping regulation of financial products. I welcome the opportunity to address the Committee.

As many of you know, I have over 30 years of regulatory experience, including over half of that time as an elected Insurance Commissioner and Insurance Department Staff in the state of Oklahoma, and most recently, as CEO of the National Association of Insurance Commissioners for over 12 years. I did that work because I care deeply about serving the public and providing citizens necessary consumer protections, particularly measures aimed at safeguarding our senior citizens, and I joined NAVA less than a year ago because my life's work is perfectly aligned with the Board's mission.

We are the only national trade association focused on all types of annuities and other insured retirement products, and, just as important, our member companies represent every component of the industry: (1) manufacturers of all types of annuities and variable life products (the insurance companies); (2) distributors of those products, including broker-dealers and banks; (3) assets managers for the underlying mutual funds offered through variable insurance products, and other insurance company assets; and (4) law firms and other services providers for these companies. Our current board members represent the following companies: LPL Financial (largest independent broker dealer in the country); AXA Equitable; Hartford Life, Inc.; Nationwide Financial; MetLife, Inc. ; Wells Fargo-Wachovia Corporation; General Re-New England Asset Management, Inc.; Genworth Financial; Jackson National Life; Fidelity Investments Institutional Services; ING US Annuity; John Hancock Financial Services, Inc.; Legg Mason, Inc.; Prudential Annuities; T. Rowe Price Group, Inc.; PIMCO; UBS Global Asset Management (Americas) Inc.; Morgan Stanley Global Wealth Management Group.

In connection with our Board's new mission and expansion of our reach and focus, in just three weeks, we will be unveiling a new name for the association – a name that more fully reflects the work we do serving American consumers with good information and the industry that provides financial products consumers need as a part of their overall retirement planning. As a reminder, annuities are the only financial instruments available today, other than Social Security and pensions, that guarantee a lifetime stream of income during retirement.

Our members are represented by hundreds of thousands of registered financial advisors across the country, and therefore, we bring a perspective from Main Street America to the Congress today. After my many conversations with

these financial advisors, I have developed a deep level of appreciation for the long—standing relationships they have with their clients and friends—ten, twenty or even forty years. Our financial advisors consider that relationship to be a sacred trust and as such, they are intensely committed to helping their clients reach their retirement income objectives, which involves a series of the most significant financial decisions a person ever makes over a very long lifetime. The Congress has long recognized and incentivized retirement savings for our members' clients and all American citizens, and that decision has been shown to be wise foresight during these turbulent economic times when citizens recognize more than ever the need to plan for retirement.

As an association, our consumer focused mission includes our commitment to:

- Addressing the need and importance of retirement income preparation and management for retirement-focused Americans;
- Focusing on the growth, acceptance, and understanding of annuity and variable life products to fulfill important objectives of retirement income planning;
- Providing educational, standards and informational resources to our members and the public; and
- Promoting adherence to the highest ethical standards by insurers, distributors, and all other participants in our diverse industry.

Following this mission, the Board's very first guiding principles, "The best interests of the consumer come first."

Consistent with our consumer-focused mission and guiding principles, my testimony today will address five (5) key points.

1. **Retirement Savings Needs Have Never Been Greater.** Retirement savings is more critical to our nation's citizens because a very significant shortfall in asset accumulation is occurring at the very time of medical breakthroughs, which means Americans are living longer in retirement. In the future, the face of America will be radically different. One in three 65-year-old women today can expect to live into her 90s, and 77 million Baby Boomers will be entering retirement over the next few years. The aging of this huge number of Baby Boomers is placing increasing pressure on Social Security as well as on employer-funded retirement benefits. We commend Congressman Pomeroy's sponsorship of HR 2748, the Retirement Security Needs Lifetime Pay Act, which will encourage the purchase of annuities to supplement other retirement savings vehicles to provide a guaranteed stream of income for individuals during retirement.
2. **Key Role of Insured Retirement Products in Retirement—Only Product Providing Guaranteed Lifetime Income.** Life insurers hold \$2.6 trillion in annuity reserves, and in 2007, life insurers paid \$72 billion in annuity benefits to consumers. From 1999 to 2008, total annuity purchases almost doubled from \$164.7 Billion to \$264 billion. Variable annuity and fixed net assets under management grew from \$1.3 trillion in 1999 to over \$2 trillion in 2007, declining during the 2008 economic crisis to \$1.6 trillion, with over 23 million variable contracts in force. First quarter 2009 net purchases, which shows how many new consumers are buying annuities, showed a 20% increase over fourth quarter net purchases of \$4.2 billion. According to one source, annuity purchases were up nearly 33% in 2008. When comparing first quarter to the end of the fourth quarter of 2008, the combined net assets of U.S. variable annuities decreased 5.4% versus the steeper 11% drop in the S&P 500—showing the value of a diversified variable annuity in turbulent economic. Importantly, annuities appeal to individuals of all income levels and people who don't have another retirement savings vehicle. Two out of three owners have household incomes under

\$75,000. Almost one half (42%) of non-qualified annuities are business owners and professionals. Almost one half (42%) of non-qualified annuities are business owners and professionals. Nineteen percent are (or were) blue collar or service workers and 12% worked in supervisory positions.

3. **Support for Strong Consumer Protection Laws.** We are committed to mobilizing our member companies and their hundreds of thousands of registered financial advisors in support of uniform adoption either at the state level or federal level of three important consumer protection laws aimed at transparency, appropriate disclosure, and suitable sales. All consumers across country should benefit from these vital consumer protection measures, and our member companies should be subject to a uniform requirement, rather than a patchwork of requirements and regulatory interpretations that will make products more costly for the end consumer. For these reasons, we urge uniform passage of the current NAIC Model Suitability Law, NAIC Model Disclosure Law and NAIC Senior Designations Model. We also support the adoption of a summary prospectus by the SEC for annuity purchasers similar to the summary prospectus adopted for mutual funds to promote transparency and consumer understanding. In addition, while we do not believe an additional consumer protection regulator is necessary or advisable for the insurance industry as discussed below, we ask the Congress to continue to the focus on how regulatory structures can be operated in the most effective and efficient manner in the interests of consumers. Right now, the current system does not work well in terms of costs to consumer and regulatory burdens, and we support Treasury's proposals to modernize and improve our system of insurance regulation, as well as the six principles for insurance regulation.
4. **Consumers are Adequately Protected by Current Regulatory Structure Consisting of Extensive Regulation and Multiple Regulators.** As you will see from the extensive description of the current regulatory structure in my testimony, insurance consumers and annuity owners are protected by an existing, comprehensive regulatory structure consisting of the SEC, FINRA and insurance and securities regulators in over 50 different state and territorial jurisdictions, with total regulatory staff exceeding 11,000, as well as a large number of other federal and state agencies, probably more than any other industry. Our broker dealer members and their registered financial advisors are required to maintain comprehensive compliance systems, which are examined by FINRA at least every four (4) years and more often for larger firms. State insurance and other regulators routinely conduct comprehensive market conduct examinations for violations of state consumer protection laws, including Unfair Trade Practices and advertising laws. It is common for most large companies to be undergoing five (5) to ten (10), if not more, examinations by different state insurance departments simultaneously in any given year. Importantly, each and every product issued by an insurance company must contain legally required contractual provisions and be approved by every state insurance regulator where the product will be issued before the product can be sold to a consumer – a process that can take well over a year to obtain approvals in all states. Variable product registration statements must also be filed with and approved by the SEC. Given the current regulatory protections, the focus should be not on adding another layer of regulation. Instead, the focus should be on how the current regulatory structure can be operated in the most effective and efficient manner using limited resources to perform critical consumer protection activities—enforcing the right regulations, not just adding more regulation with no discernable additional value.
5. **New Layer of Regulation is Unnecessary and Potentially Harmful to Consumers.** While we have not conducted a comprehensive study of all issues related to the jurisdiction of the Financial Products Consumer Protection Agency, we urge the Congress to study the use of existing regulatory bodies with years of experience and expertise to

regulate industries previously subject to no or insufficient regulation. Considering the need to use limited resources for these industries and the extensive regulation under which our members currently operate, a new layer of regulation and another regulator for the insurance industry is unnecessary. Further, separating financial regulation and consumer protection regulation is not prudent and would present significant risks to consumers. Our members use sophisticated actuarial science methodologies to assure investments are properly structured to meet the contractual obligations set forth in the designed products. Therefore, product regulation is vitally linked to financial solvency regulation. Bifurcating product regulation and solvency could also result in consumers not having access to the most up-to-date products that meet their needs. As stated, given the current regulatory regime, the focus should be not on adding another layer of regulation, but rather on how the current regulatory structure can be operated in the most effective and efficient manner value to achieve our collective consumer protections objectives. To this end, we support the President's Office of National Insurance proposal, as well as Subcommittee Chairman Kanjorski and the Committee's continued efforts to advance insurance regulatory reform through HR 2609 creating an Office of Insurance Information within the Department of the Treasury.

## Testimony of Catherine Weatherford

### **Retirement Savings Needs Have Never Been Greater**

***Changing landscape for retirement income needs.*** Alarming, 49.7% of Americans recently surveyed by a leading annuity writer and NAVA member said the number one financial concern for retirement was “keeping up with daily expenses for food, shelter and other *basic needs* such as health care.” Just a year ago, when asked the same question, 43.2% of Americans responded “enjoying life.” “Having enough money to enjoy life” was cited as a key concern of the US citizens (43.2%), while running out of money was listed as one of the least appealing aspects about retirement (27%). The survey results concluded by noting 72.3% of Americans think they will be largely responsible for providing their own income in retirement.

As the population in the US ages and more baby boomers retire or approach retirement, concerns about financial preparedness remain high, according to industry reports. The combination of longer life spans and a declining birth rate mean the ratio of workers to retirees will continue to decline, increasing pressure on public and private pensions systems, and health care systems. The aging of 77 million Baby Boomers is placing increasing pressure on the Social Security as well as on employer funded retirement benefits. People are living longer, and savings have to last through retirements that can span 20-30 years or more.

According to another industry paper, individuals are assuming more of the risk and responsibility for retirement savings and income generation. Traditional defined benefit (DB) pension plans in the private sector are increasingly being frozen or terminated; virtually all replacement and new plans are definite contribution (DC) plans, such as 401k. Historically low personal savings rates, coupled with general insufficiency of DC plan savings, mean many retirees will have to consider alternative sources of retirement income, such as working in retirement and tapping into home equity. Healthcare expenses are rising more quickly than the general rate of inflation. Funding post retirement healthcare is looming larger as a threat to individual's retirement security. The shift in DB to DC plans has shifted much of the burden for retirement security from employers to individuals. In contrast to DB plans, where the employer generally bears all the risk and responsibility to the employee to decide to participate, save adequately, invest appropriately, and, at retirement, determine how to make the nest egg last for life – while managing the risks that go along with that. The retiree in a DB plan usually receives a pension check every month for life. Traditionally, the employer pays a lump sum to an insurer; in return; the insurer promises to pay the retiree a monthly amount as long the customer lives – sometimes for as long as a beneficiary lives as well, and sometimes with a number of years guaranteed. A retiree in a DC plan, however, has a sum of money that the consumer must decide how to use in retirement.

**The Face of Retirees.** A recent Ernst and Young report noted that one in three 65-year-old women today can expect to live into her 90s, and millions of Baby Boomers who will be entering retirement over the next few years. This is of particular concern for women, who have fewer full-time working years than men and have median earnings that are about \$10,000 less than those of working men. Women typically live longer than men and are likely to spend some of their retirement years alone due to widowhood or divorce. These disparities lead to lower savings and retirement income and smaller payouts from Social Security, ultimately resulting in a greater risk of poverty in retirement. It is especially important for women to investigate guaranteed retirement income sources such as annuities and protect their income while working and in retirement through vehicles such as life, disability and long-term care insurance.

***Here are two examples highlighting the importance of retirement savings from industry sources***

- A recently retired married couple earning \$75,000 a year with a defined benefit plan has a 57 percent chance that they will have enough financial resources in retirement. The same couple, without any guaranteed source of retirement income, is left with only a 6 percent chance of financial success.
- A near retiree single female, earning \$50,000 a year with a defined benefit plan, has a 66 percent chance that she will not outlive her financial resources. The same female, without any guaranteed source of income in retirement, is left with only an 18 percent chance of financial success.

We look forward to working with Congress as we help the American public adequately prepare for retirement. NAVA commends Congressman Pomeroy's recent sponsorship of HR 2748, the Retirement Security Needs Lifetime Pay Act. This legislation will encourage the purchase of annuities to provide a guaranteed stream of income for individuals during retirement. By using insurance tools that supply the much needed cash flow in retirement, annuities could be particularly attractive for those that do not have employer-sponsored retirement plans including the self-employed like farmers and ranchers, and small business owners. All Americans need secure reliable retirement to ensure savings will last through their lifetime and annuity products are an excellent financial tool to help secure their future.

### **Key Role of Insured Retirement Products in Retirement—Only Product Providing Guaranteed Lifetime Income**

***The Growing Use of Annuities:*** Annuities are the only financial instruments available today, other than social security and pensions, that guarantee a lifetime stream of income during retirement. With the proper use of annuity products and other retirement savings vehicles, retirees can be assured they will not outlive their assets and benefit significantly by having the ability to increase their current income.

An annuity is a contract between an individual and an insurance company, a secure product structured to offer a steady cash flow when there is no longer a paycheck in retirement. Annuities are designed to grow a person's assets to contribute to a secure retirement, and consumers, more and more, are turning to annuities as a part of their retirement planning.

Life insurers hold \$2.6 trillion in annuity reserves, and in 2007, life insurers paid \$72 billion in annuity benefits to consumers. From 1999 to 2008, total annuity purchases almost doubled from \$164.7 Billion to \$264 billion. In that same time period, variable annuity and fixed net assets under management grew from \$1.3 trillion to over \$2 trillion in 2007, but because of the economic turmoil, dropped to \$1.6 trillion in 2008. People put larger amounts into variable annuities, with the average contract size growing from \$33,000 to \$67,000 from 2000 to 2007. In 2008, over 23 million variable contracts were in force. First quarter 2009 net purchases, which shows how many new consumers are buying annuities, were \$5.1 billion compared to fourth quarter net purchases of \$4.2 billion -- an increase of nearly \$1 billion. Overall purchases of individual annuities continue at a record setting pace in 2008, reaching \$197.1 billion through the first three quarters, and according to one source, annuity purchases were up nearly 33% in 2008.

These numbers support a recent industry survey where 90% of the financial advisors said they expect their 2009 annuity purchases will be as high as or higher than in 2008. Good reasons exist for this increased level annuity purchases and the flight to the security and safety provide by annuities. The combined net assets of U.S. variable annuities decreased 5.4% to slightly over \$1 trillion, as compared to the end of the fourth quarter of 2008. However, in comparison, during the same time period, the S&P 500 dropped over 11%--showing the value of a diversified variable annuity in turbulent economic.

**Why Consumers Use Annuities?** Recent reports show eighty-nine percent (89%) of annuity purchasers use annuities as a source for retirement income, and 83% of annuity savings are used for a financial cushion in case they or their spouse live well beyond their life expectancy. The third most important reason individuals cite for purchasing an annuity (81%) is to avoid being a financial burden on children. Other reasons include use as an emergency fund in case of catastrophic illness or nursing home care (70%) as well as financial protection if other investments do not do well or inflation is high

As most would expect, reports reflect the largest source for retirement income currently is Social Security. However, according to information provided by the Social Security Administration, a reduction in benefits will be required in the future, so retirees and pre-retirees will need to take greater responsibility for their security in retirement. Thus, the roles of different retirement saving vehicles are ever-changing, and the importance of annuities is continually increasing.

Especially in the volatile economic times, annuities are viewed as providing financial stability and are an important income source to many retirees. According one report earlier this year, one in five retirees receives income from individually purchased annuities.

Finally, in terms of demographics, according to another study, a typical annuity owner earns a middle class income or lower. The majority of annuity owners have household incomes between \$20,000 and \$74,999, Two out of three owners have household incomes under \$75,000. Almost one half (42%) non-qualified annuities are business owners and professionals. Almost one half (42%) of non-qualified annuities are business owners and professionals. Nineteen percent are (or were) blue collar or service workers and 12% worked in supervisory positions.

Annuities appeal to individuals of all income levels and people who don't have another retirement savings vehicle. That is what makes annuities so versatile in an individual's retirement portfolio.

**Annuity Product Innovation to Meet Consumer Demand:** Companies and financial advisors have worked together extensively over the past 10 years to innovate annuity products to meet consumer demand. While some argue that annuities can be complicated and cost too much in terms of fees, the product features are driven by consumer demand and in the end, the additional benefits not provided by other financial products have a cost associated with that enhanced benefit.

For example, it is helpful to look at the product evolution resulting in the Variable Annuity Guarantee Living Withdrawal Benefits (GLWB). GLWB were developed to provide guaranteed lifetime income. GLWBs represent the latest generation of variable annuity guarantees that have developed logically over time to address certain concerns expressed by consumers and their financial representatives.

After variable annuities evolved to include death benefits, thereby addressing investors' concerns that their families be protected in the event of death, insurance companies turned to address the other major concern of investors — that they might not reach their income goals. To address this concern, insurance companies developed a series of "living benefits," beginning with the guaranteed minimum income benefit ("GMIB") riders.

GMIBs guaranteed a future level of annuity payments, but contract owners were required to annuitize to receive the guaranteed payments. Over time, insurance companies experienced a continued hesitation on the part of contract owners to give up control over the level and timing of their payments. Rather, it appeared that contract owners would prefer to take periodic discretionary withdrawals.



As a result, beginning in 2002, companies began offering guaranteed minimum withdrawal benefit (“GMWB”) riders. GMWBs guarantee a specified return of principal to contract holders. To do so, a GMWB sets a contractual withdrawal rate, and after a specified date (e.g., 65), investors may withdraw funds at their discretion within this rate. If an investor’s account falls to zero, the GMWB rider is triggered and provides regular withdrawals until the guaranteed amount (often equal to the initial premium) is paid out. Companies typically charge for GMWB riders by deducting an ongoing fraction of assets, rather than an up-front fee. They also usually add certain restrictions, such as requiring that a contract owner’s funds be invested in a conservative asset allocation model.

The latest generation of GMWBs, called guaranteed lifetime withdrawal benefits, went one step further by guaranteeing that if a contract owner’s account value is depleted before he or she dies, and assuming other contract conditions are satisfied, the insurance company will begin paying what amounts to a lifetime annuity for the remainder of the owner’s life. The annual amount of the payments equals some percentage (e.g., 5%) of the “benefit base” accumulated by the contract owner over the years. Therefore, if the benefit base under a contract was \$500,000, beginning at a specified age the contract owner would be able to withdraw \$25,000 annually, and if his account value declined to zero (or below some specified minimum amount), the insurance company would continue paying the \$25,000 annual payments for the remainder of the owner’s life.

GLWB riders have proven to be very popular. According to one estimate, close to 75% of variable annuity buyers in 2004 selected a GLWB rider (a more recent estimate puts the proportion of variable annuities carrying living benefit riders at two-thirds). Furthermore, the inclusion of GLWB riders caused some of those who had previously criticized variable annuities as overpriced to turn to recommending variable annuities.

This product evolution example shows how companies, broker dealers and financial advisors are constantly working to meet consumer demand for products that meet their needs.

### **Support for Strong Consumer Protection Laws and Enforcement of Those Laws**

We are committed to mobilizing our member companies and their hundreds of thousands of registered financial advisors in support of uniform adoption either at the state level or federal level of three important consumer protection laws aimed at transparency, appropriate disclosure, and suitable sales. All consumers across country should benefit from these vital consumer protection measures, and our member companies should be subject to a uniform requirement, rather than a patchwork of requirements and regulatory interpretations that will make products more costly for the end consumer. For these reasons, we urge uniform passage of the current NAIC Model Suitability Law, NAIC Model Disclosure Law and NAIC Senior Designations Model. We also support the adoption of a summary prospectus by the SEC for annuity purchasers similar to the summary prospectus adopted for mutual funds to promote transparency and consumer understanding. In addition, while we do not believe an additional consumer protection regulator is necessary or advisable for the insurance industry as discussed below, we ask the Congress to continue to focus on how regulatory structures can be operated in the most effective and efficient manner in the interests of consumers. Right now, the current system does not work well in terms of costs to consumer and regulatory burdens, and we support Treasury’s proposals to modernize and improve our system of insurance regulation, as well as the six principles for insurance regulation.



NAVA strongly urges states adopt the current NAIC Suitability Model, which has been adopted by more than 35 states but for less than 50% of the US population. We believe this would address concerns expressed by the Senate Special Committee on Aging that minimum standards have not proliferated to a sufficient number of states.

The Disclosure Model Regulation requires that certain information be disclosed, including an explanation of rates and how or if they change, a summary of the options and restrictions for accessing money, and an outline of fees. In an effort to ensure the model is adopted nationwide, NAVA will continue to work with the states to secure adoption of these important consumer protections. Building on the NAIC Disclosure Model, NAVA developed disclosure templates in cooperation with other associations for the purpose of presenting required disclosure information for fixed, index, and variable annuities in a consumer-friendly manner. These templates, which enhance the disclosure requirements found in the NAIC model and federal securities laws, have been positively viewed by all regulators who have conducted a review of the template. In fact, the Iowa Division of Insurance launched a pilot program in 2008 to introduce the templates to the marketplace. NAVA, along with several industry trades are working with the state and federal regulators to gain widespread adoption of the templates throughout the country.

The use of misleading senior citizen specific professional designations and credentials has been a top concern of regulators, the Congress and NAVA. NAVA will continue to work with regulators and other stakeholders to stop the use of deceptive certifications and designations. Therefore, NAVA strongly supports the uniform adoption in the states of the NAIC Senior Designation Model Regulation.

### **Consumers are Adequately Protected by Current Regulatory Structure Consisting of Extensive Regulation and Multiple Regulators**

As you will see, insurance consumers and annuity owners are protected by an existing, comprehensive regulatory structure consisting of the SEC, FINRA and insurance and securities regulators in over 50 different state and territorial jurisdictions, with total regulatory staff exceeding 11,000, as well as a large number of other federal and state agencies, probably more than any other industry. Our broker dealer members and their registered financial advisors are required to maintain comprehensive compliance systems, which are examined by FINRA at least every four (4) years and more often for larger firms. State insurance and other regulators routinely conduct comprehensive market conduct examinations for violations of state consumer protection laws, including Unfair Trade Practices and advertising laws. It is common for most large companies to be undergoing five (5) to ten (10), if not more, examinations by different state insurance departments simultaneously in any given year. Importantly, each and every product issued by an insurance company must contain legally required contractual provisions and be approved by every state insurance regulator where the product will be issued before the product can be sold to a consumer, a process that can take well over a year to obtain approvals in all states. Variable product registration statements must also be filed with and approved by the SEC. Given the current regulatory protections, the focus should be not on adding another layer of regulation. Instead, the focus should be on how the current regulatory structure can be operated in the most effective and efficient manner using limited resources to perform critical consumer protection activities—enforcing the right regulations, not just adding more regulation with no discernable additional value.

The following provides detailed information about how our member companies, their registered financial advisors and annuity products are currently subject to extensive regulatory oversight and enforcement. Annuities are insurance contracts and as such are regulated under state insurance laws. Variable annuities are securities as well. As a result, the

Securities and Exchange Commission (SEC) regulates them under the federal securities laws. The SEC and the Financial Industry Regulatory Authority (FINRA) (formerly known as the National Association of Securities Dealers, Inc., or NASD) both regulate firms that sell variable annuities.

## **REGULATION BY THE STATES**

### **Overview**

All fixed and variable annuities are governed by a comprehensive state regulatory framework. State laws govern the organization, licensing and activities of insurance companies, and state insurance departments oversee insurance company operations on an ongoing basis by receiving consumer complaints and requiring company responses, investigations, and routine market conduct and financial examinations. Annuity contracts and amendments must be filed with, and approved by, each state in which contracts are sold, which can take a year to eighteen months to obtain approval by all states nationwide. Insurance agents need to be licensed in each state in which they operate and regulators maintain enforcement units to investigation agent activity in violation of the law. Only licensed insurance agents may sell annuity contracts. As you can see, insurance companies and agents are subject to very complicated and interconnected regulatory oversight of many different parts of its operations and therefore, we urge the Congress that it would be unwise to separate financial solvency regulation from product or market conduct regulation. These two components are just too interrelated for that to occur.

### **Insurance Company Licensing**

In order to offer annuity products in a state, an insurance company must be licensed in that state. A company needs to be licensed regardless of whether it is a “domestic” insurance company (i.e., organized in the state) or a “foreign” insurance company (i.e., organized in another state). To be licensed, an insurance company must be organized according to specific state laws. Before it is granted a license, an insurance company must demonstrate compliance with strict capital, surplus, and financial requirements. In addition, the state scrutinizes the experience and character of the company’s management. The state issues a license only if it determines that the company is organized and managed in such a way that it will protect the interests of its contract owners.

### **Agent Licensing**

Insurance agents must be licensed by state insurance departments in each state where the agent has clients, which can be a large number of states in these days of increased mobility given the tendency for many clients to want to remain with their original agent. Applicants must submit a form to the state providing information about their experience, character, and financial responsibility. They also have to pass a written examination. (Agents selling variable annuities are also subject to FINRA requirements.). Agents are also subject to ongoing oversight of their activities and insurance departments have active enforcement programs aimed at rouge agents who violate unfair trade practices and other laws.

### **Contract Requirements and Prior Regulatory Approval**

Annuity contracts and related forms generally must be filed and approved in every state where they will be sold, which can take well over a year to obtain approval by all states. While there is no standard required form for annuity contracts, states mandate that certain provisions be included in all contracts, such as a free-look provision that allows a contract owner to examine the contract for a period of time and return it for a refund if dissatisfied for any reason. Generally, contracts need to be readable and cover all of the contract's basic features before the state will approve the contract for sale. Amendments to contracts also must be filed and approved. If the amendment could adversely affect existing contract owners' rights, the state may require prior approval from the contract owners.

### **Complaint Handling**

Every state insurance department has a Consumer Division that handles complaints and inquiries, as well as providing consumer buyers guides and other types of guides. From 2006 to 2008, the NAIC reports that of the complaints received by Departments in each of those years, less than 10% were related to life and annuity business. As a result of this service, consumers have a free, local, highly experienced regulatory forum in which to raise complaints and as a result have obtained money recoveries or other remedies when merited.

### **State Guarantee Funds**

All states, the District of Columbia, and Puerto Rico have guarantee funds to protect contract owners against insurance company insolvency. Insurers doing business in a state must contribute to that state's guarantee fund. The actual coverage provided for annuity contracts varies from state to state, but cash values and annuity benefits generally are protected for at least \$100,000. Coverage is not provided for variable annuity contracts (other than assets invested in the fixed account option under a variable annuity contract). However, as discussed below, variable annuity contracts are issued through life insurance company separate accounts, which are insulated from the general creditors of the insurance company in the event of insolvency.

### **Variable Annuity Asset Protection**

When a contract owner allocates purchase payments to a variable investment option under a variable annuity contract, those assets are held in the insurer's separate account. The assets in the separate account are insulated against the creditors of the insurance company in the event of the company's insolvency. In some states, annuity assets are shielded from a contract owner's creditors as well.

### **Advertising and Unfair Trade Practices Rules**

Most states have adopted advertising rules governing the marketing of annuity contracts. State insurance departments review advertising materials periodically. Advertising rules are designed to prevent misleading, deceptive, or confusing advertisements, as measured against the impression a person who is not knowledgeable in insurance matters may receive from the materials.

All states have adopted unfair trade practices acts with provisions that apply to an insurer's activities. These laws define and prohibit unfair methods of competition and unfair or deceptive business practices, including those involved with the issuance, sale, and administration of annuity contracts.

Over forty (40) states have adopted a requirement that all sales be suitable given the customer's financial condition and objectives, and most of those 40 states explicitly require companies to have a reasonably designed compliance system providing reasonable assurance of compliance with the suitability law.

### **National Association of Insurance Commissioners**

The National Association of Insurance Commissioners (NAIC) is an association that according to its mission promotes fairness and uniformity in state insurance laws. It has developed numerous "model laws" and "model regulations" many of which, while non-binding, have been adopted in one form or another by many states.

## **REGULATION UNDER THE FEDERAL SECURITIES LAWS**

### **Introduction**

Besides being governed by the state regulatory framework, variable annuities as securities are regulated under federal securities laws. The primary federal securities laws that regulate variable annuities and the separate accounts through which they are issued are the Securities Act of 1933 (1933 Act), the Securities Exchange Act of 1934 (1934 Act), and the Investment Company Act of 1940 (1940 Act). The SEC administers these acts. Fixed annuities, where the insurance company guarantees a specific rate of return to the contract owner, generally are not subject to these laws.

In summary, the federal securities laws require certain disclosure documents, including a prospectus, to be given to investors. Certain disclosure documents must also be filed with the SEC. In addition, written marketing materials such as advertisements are subject to regulation under SEC and FINRA rules. Certain periodic reports must be filed with the SEC and delivered to investors. These requirements are discussed in more detail on the following pages.

### **Securities Act of 1933**

#### ***Contract Registration***

Because variable annuities are securities, they must be registered with the SEC under the 1933 Act before they can be offered to the public (with two exceptions noted below). The SEC staff reviews and comments on registration statements, which usually must be amended in response to staff comments before they will be declared effective. (The SEC does not, however, approve or disapprove of any securities, including variable annuities, and does not pass on the accuracy or adequacy of any prospectus.) A "post-effective" amendment updating the variable annuities registration statement generally must be filed at least annually.

The first registration exception is for annuity contracts that are issued in connection with certain qualified plans such as 401(k) plans. The second exception is for privately placement annuities, which are contracts that, among other things, are offered only to sophisticated investors who meet certain requirements under federal security laws (and not to

members of the general public). Even with these exceptions, however, issuers and others involved in marketing non-registered variable annuities, remain subject to the anti-fraud provisions of the 1933 Act.

### ***Prospectus Delivery***

When someone purchases a registered non-qualified variable annuity, he or she receives a prospectus. Prospectuses are updated regularly. Separate prospectuses describe underlying investment options—the funds to which the purchaser may allocate his or her investments. This can result in a purchaser receiving numerous prospectuses. However, the SEC recently adopted a rule permitting fund “profiles,” that are shorter, user-friendly summary prospectuses, to be given to prospective investors. The SEC also permits limited use of variable annuity profiles.

### ***Disclosure of Fees and Expenses***

Variable annuity prospectuses contain fee tables that disclose the maximum guaranteed charge for all contract transaction expenses and recurring charges. These amounts are expressed in dollars or percentages of the contract value so purchasers will know what they will pay if they buy the contract. The fee tables also list the range of total operating expenses for all of the underlying funds offered by the contract. In addition, variable annuity prospectuses contain numerical examples showing in dollars per \$10,000 what a contract owner would pay for the contract and the maximum fees and expenses charged by any of the funds over one-, three-, five-, and ten-year periods. These examples assume a 5% return and that the contract is surrendered at the end of the relevant period. Additional examples are required that assume the investor does not surrender the contract if a sales load or other fee is charged upon surrender. This format shows the effect of any surrender charge.

### **Securities Exchange Act of 1934**

The 1934 Act generally requires variable annuities to be distributed through registered broker-dealer firms and their registered representatives. Broker-dealers and their representatives are subject to extensive operational and financial rules that cover minimum net capital requirements, reporting, recordkeeping, supervision, advertising, and sales activities.

In addition to the broker-dealer regulatory framework established by the 1934 Act, registered broker-dealer firms that sell variable annuities also must be members of FINRA. FINRA is a self-regulatory organization overseen by the SEC. It has an extensive body of rules with which broker-dealers must comply. For example, examinations are required; fingerprints must be provided; and numerous supervisory, suitability, advertising, recordkeeping, and reporting rules apply.

A 1934 Act rule requires broker-dealers to send confirmation statements to contract owners after each purchase and sale transaction made involving a variable annuity contract. In addition, insurance companies send contract owners periodic account statements showing a beginning balance, transactions during the period, and an ending balance so that the owner will have a record of all activity in his or her contract.

### **Investment Company Act of 1940**

The 1940 Act imposes an extensive federal regulatory structure on investment companies, including separate accounts and underlying funds. Some separate accounts and funds however, such as those used in connection with tax-qualified

retirement plans, are not subject to the 1940 Act. For example, the act governs how variable annuities and shares of underlying funds are issued and redeemed. There are also corporate governance requirements and prohibitions against self dealing.

Each separate account regulated under the 1940 Act must file a report on its operations annually with the SEC. In addition, an annual and semi-annual report containing information about the underlying mutual funds that serve as investment options for the variable annuities must be sent to contract owners. In some cases, these reports also contain information on the variable annuities themselves.

The SEC inspects variable annuity separate account operations regularly. The SEC also inspects various locations, such as broker-dealer offices, from which variable annuities are sold. Recommendations are made and any deficiencies are noted. If the situation is serious enough, it is referred to the SEC's enforcement division.

### ***Regulation of Fees and Charges***

Currently, the SEC does not regulate individual variable annuity fees and charges. However, the 1940 Act makes it unlawful for any registered separate account funding variable annuity contracts, or for the sponsoring insurance company, to sell any such contract unless the fees and charges deducted under the contract are, in the aggregate, reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company. The insurer must represent in the annuity contract's registration statement that the fees and charges are reasonable.

### **SEC and FINRA Advertising Rules**

#### ***SEC Rules***

SEC rules govern variable annuity advertising. If past performance of a fund or variable annuity is presented, performance must be calculated according to standardized formulas. "Non-standardized" performance may also be shown, but must be presented along with standardized performance. In addition, if an advertisement contains performance information, total returns current to the most recent month end must be made available within seven business days of the end of the month at a toll-free or collect telephone number or on a website.

#### ***FINRA Rules***

In addition to the SEC rules, FINRA rules also govern variable annuity advertisements. Broker-dealer firms that disseminate variable annuity advertising must file these communications with FINRA and take into account comments provided by FINRA staff.

### **FINRA Complaint Handling Requirements and Dispute Resolution Process**

Under FINRA Rule 8210, broker-dealers are required to maintain a separate file of all written complaints in each office of supervisory jurisdiction. The file must contain a description of action taken by the broker-dealer in regard to the complaint, and it must contain or refer to another file containing any correspondence regarding the complaint. FINRA reviews these complaint processes and complaint handling during its routine examinations.

FINRA also provides cost effective dispute resolution methods such as mediation and arbitration which are faster and less expensive than a state or federal lawsuit. In arbitration cases brought by investors, whether through settlements, decisions by arbitrators or stipulated awards, investors receive some compensation more than 70 percent of the time. In mediations, the overall settlement rate exceeds 80 percent. FINRA arbitrators and mediators are carefully selected from a broad cross-section of people with extensive business or professional experience.

### **Recent Regulatory Action**

There are several regulatory initiatives that have been adopted or are pending that affect or potentially could impact the sale of variable annuities.

#### ***Redemption Fees***

In May 2006, the SEC adopted new Rule 22c-2 under the 1940 Act that allows mutual funds to impose a redemption fee of up to 2% on short-term redemptions of fund shares. The rule also applies to short-term transfers among funds offered as subaccounts in variable annuities. In addition, regardless of whether a fund board approves a redemption fee, all funds must enter into written agreements with each of their financial intermediaries under which the intermediary agrees to provide information about share transactions upon request, and to execute instructions from the fund to restrict or prohibit further purchases or exchanges of shares by shareholders who have engaged in transactions that violate the fund's policies.

#### ***Point of Sale and Confirmation Disclosure***

On February 28, 2005, the SEC reopened the comment period on proposed rules, first published in January 2004 that would require broker-dealers to provide their customers with information regarding certain distribution-related costs and conflicts of interest that arise from the distribution of mutual fund shares, 529 college savings plan interest, and variable insurance products. The revised proposal would require disclosure of a substantial amount of information for variable annuities at the point of sale—up-front sales fees, surrender charges, ongoing fund fees and insurance charges, annual contract charges, narrative information, and the existence of conflicts of interest. No final action has been taken on the proposal. It is believed a further revised proposal likely will be released.

#### ***Deferred Variable Annuity Transactions***

In April 2009, the SEC approved Amended FINRA Rule 2821. The rule imposes a wide range of new requirements tailored specifically to deferred variable annuity transactions, including suitability, principal review, supervision, and training. The rule provides that, in recommending a deferred variable annuity, a registered representative must have a reasonable basis to believe that (a) the customer has been informed of the material features of a deferred variable annuity; (b) the customer would benefit from certain features of a deferred variable annuity, such as deferred growth, annuitization, or a death or living benefit; and (c) the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated, and riders and product enhancements, if any, are suitable for the particular customer based on required customer information.

#### ***Indexed Annuities***

In August 2005, FINRA (at the time "NASD") issued Notice to Members 05-50 that addresses the responsibility of member firms to supervise the sale by their personnel of indexed annuities (IAs) that are not registered under the federal securities laws. The notice recommends that firms consider whether they should supervise unregistered IA sales



as private securities transactions according to Rule 3040. The notice also recommends that firms consider maintaining a list of acceptable unregistered IAs and prohibit associated persons from selling any other unregistered IA without the firm's written confirmation that the sale is acceptable. The NASD at the time also updated its investor alert addressing IAs.

In December 2008, the SEC adopted Rule 151A to clarify the status under the federal securities laws of indexed annuities. The new rule defines certain contracts as not being "annuity contracts" under the exemption contained in Section 3(a)(8) of the Securities Act of 1933. The SEC noted that this action will provide purchasers of indexed annuities all of the consumer protections of the federal securities laws, including disclosure, antifraud, and sales practice protections. Under the Rule as adopted, both amounts payable and amounts guaranteed are to be determined by taking into account all charges. In addition to requiring registration of indexed annuity contracts, the Rule will also significantly impact the manner in which indexed annuities are sold, requiring a distributor to now either have to be registered as a broker-dealer, or enter into a networking arrangement with a registered broker dealer. The Rule is now subject to a court challenge in the United States District Court for the District of Columbia.

After reviewing this extensive statutory and regulatory regime, it should be clear that an additional regulator is not needed.

### **New Layer of Regulation is Unnecessary and Potentially Harmful to Consumers**

While we have not conducted a comprehensive study of all issues related to the jurisdiction of the Financial Products Consumer Protection Agency, we urge the Congress to study the use of existing regulatory bodies with years of experience and expertise to regulate industries previously subject to no or insufficient regulation. Considering the need to use limited resources for these industries and the extensive regulation under which our members currently operate, a new layer of regulation and another regulator for the insurance industry is unnecessary and potentially harmful to consumers. Further, separating financial regulation and consumer protection regulation is not prudent and would present significant risks to consumers. Our members use sophisticated actuarial science methodologies to assure investments are properly structured to meet the contractual obligations set forth in the designed products. Therefore, product regulation is vitally linked to financial solvency regulation. Bifurcating product regulation and solvency could also result in consumers not having access to the most up-to-date products that meet their needs. Finally, given the current regulatory regime, the focus should be not on adding another layer of regulation, but rather on how the current regulatory structure can be operated in the most effective and efficient manner to achieve our collective consumer protection objectives.

As stated above, we support strong and necessary consumer protection regulation. However, as explained, consumers are already protected by extensive regulation and multiple regulators, with over 11,000 regulator staff at the state level and a very well resourced and funded operation at FINRA and the SEC. No compelling need has been identified in the insurance and annuity market for an additional regulator focused on consumer protection. FINRA and state regulators have publicly identified senior sales protections as one of their top priorities, and therefore, they have identified and are addressing a key regulatory issue in this sector.

An additional layer of regulation would only risk confusion, which would exacerbate the already concerning issues with the current regulatory structure. Consumers would ultimately bear the burden in terms of increased costs and lack of

access to needed products on a timely basis, given the natural and inevitable scenario of two different regulators of the same product having differing views about product standards. That disagreement occurs at the state level now within the Interstate Insurance Product Compact, causing delays in adoption of products standards and lack of consumer access to products on a timely basis. So, it is reasonable to conclude this same regulatory friction would occur if a new regulator were introduced into the regulatory regime.

With regard to the dangers of splitting financial solvency and product and sales practices regulation, Patrick Baird, CEO, AEGON USA, a NAVA member company, stated the following during a Subcommittee Hearing on Systemic Risk last week:

“There are many regulatory elements that collectively constitute solvency regulation for a life insurance company, including capital and surplus, reserves, underwriting, risk classification, nonforfeiture, investments, accounting and, pertinent to this point, product regulation. For a life insurer, solvency regulation is inherently linked to the products it sells. Factors such as what is guaranteed, when the guarantee is triggered, the length of time the guarantee is in force and others product features are crucial to a determination of how the premiums are invested to assure assets will be available to pay claims. Effective solvency oversight necessitates that a single regulator have authority over all aspects of solvency, including product regulation. If different regulators assumed responsibility for any of these aspects of insurance solvency oversight, the net result would be an increase in systemic risk, not a reduction of it. For this reason, concepts such as a financial product safety commission, if made applicable to life insurance, would raise significant concerns.”

We agree.

As an alternative to subjecting insurance and annuity product to the jurisdiction of any new consumer protection agency, we support Subcommittee Kanjorski’s and the Committee’s continued efforts to advance insurance regulatory reform through HR 2609, which would create an Office of Insurance Information within the Department of the Treasury. While we are still reviewing the details of his plan, we applaud the President’s statement in his White Paper:

“Our legislation will propose the establishment of the Office of National Insurance within Treasury to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector. Treasury will support proposals to modernize and improve our system of insurance regulation in accordance with six principles outlined in the body of the report.”

The President’s White Paper proposes that “[t]he ONI should be responsible for monitoring all aspects of the insurance industry. It should gather information and be responsible for identifying the emergence of any problems or gaps in regulation that could contribute to a future crisis. The ONI should also recommend to the Federal Reserve any insurance companies that the Office believes should be supervised as Tier 1 FHCs.” Therefore, the President’s plan already includes a Treasury Department National Insurance Office. Any additional consumer protection agency would be duplicative and unnecessary.

Finally, given the current regulatory regime, the focus should be not on adding another layer of regulation, but rather on how the current regulatory structure can be operated in the most effective and efficient manner to achieve our collective consumer protection objectives. In addition, while we do not believe an additional consumer protection

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regulator is necessary or advisable for the insurance industry as discussed below, we ask the Congress to continue to the focus on how regulatory structures can be operated in the most effective and efficient manner in the interests of consumers. Right now, the current system does not work well in terms of costs to consumer and regulatory burdens, and we support Treasury's proposals to modernize and improve our system of insurance regulation, as well as its six principles for insurance regulation. As a part of this examination, we urge the Congress to continue to focus on the need for regulatory reform to allow consumers access to innovative retirement products in a timely manner nationwide, uniform adoption of suitability, disclosure and other consumer protection laws so all American citizens have the same safe guards, and efficient and costs effective licensing of our hundreds of thousands of financial advisors across the country provided by HR 2554 (NARAB II), as well as other important reforms we will be discussing with you in the coming weeks.

Mr. Chairman, I again want to thank you for holding today's hearing. Financial Services regulatory reform is arguably the most important matter before Congress, and determining how best to deal with insurance as part of the structural changes you will be making will be critical in assuring that the resulting regulatory framework works effectively and achieves our collective consumer protection objectives. We are committed to working with you and the Members of this Committee toward these ends.