Chapter 7 Industry Products and Suitability

Insurance has always needed to be appropriate or suitable for the buyer, but in recent years various states have begun to concentrate on this requirement. Two notable areas have been suitability for long-term health care products and annuity contracts.

Product suitability pertains to the insurance policy's ability to meet the expectations and goals of the consumer. If the insurance product fails to meet the expectations and goals of the consumer, then it may not be suitable for the buyer. Even when the consumer wants to buy the product, when the agent knows it would cause financial stress today or in the future or fail to meet the buyer's expectations, the product may not meet the state's suitability standards.

In short, suitability information means obtaining the facts necessary to reasonably determine the appropriateness and suitability of the agent's recommendation to his or her client.

While all elements of determining suitability are important, the most important element of determining suitability might be communication. Agents who fail to adequately listen to the answers they receive from their questions are the most likely to face future lawsuits. Communication is not the art of asking questions; it is the art of listening to the answers received. No matter how many questions are asked during the sales presentation, if the answers are not fully heard or understood by the product seller, he or she will not be determining suitability with full information. When full information is not considered, mistakes can happen.

There are many elements that determine the suitability of a product for the buyer. These include, but are not necessarily limited to:

-Age;
-Annual income;
-Financial situation and needs, including financial resources used to fund the annuity;
-Financial experience;
-Financial objectives/goals;
-Intended use of the annuity purchased;
-Financial time horizon;
-Existing assets, including investment and life insurance;
-Liquidity requirements;
-Liquid net worth;
-Risk tolerance; and
-Tax status.

Age of the Buyer
Age and time horizons are closely linked, or at least should be. Annuities are traditionally viewed as retirement vehicles, which is why the Internal Revenue Service has placed a 10 percent penalty on funds withdrawn prior to age 59½. Annuities are used for other purposes, but they perform best in long-term environments, such as retirement.

Fixed-rate annuities are very safe financial vehicles. Because they are low risk, growth may be less than higher-risk investments, but those nearing retirement are very suseptible to risk, so they remain a good choice for those who are older. Variable annuities have higher risk than their fixed-rate annuity counterparts, and generally are not recommended for those nearing or in retirement.

Age as a suitability consideration is also tied to goals. Annuities would not be suitable for a young couple trying to save for a new car, for example. When the goal is retirement, and the buyer plans to fund the annuity over twenty years, they work very well. Older people often look to annuities when they have pension funds to reinvest for retirement.

Annual Income
Annual income is often linked to the buyer's retirement goals. Annual income is unlikely to be the first criteria when considering the appropriateness of an annuity product, but it is a factor to consider.

One of the problems we see when people enter retirement is a false sense of financial security. Individuals may look at their $50,000 in savings, for example, and believe they are well situated. In fact, that amount is very inadequate when considering the number of years the retiree will live. Longevity risk is very real in retirement. Longevity risk is the risk of living longer than the money lasts. If the retiree over-spends initially, it will affect the remainder of their retirement adversely.

When annual income is insufficient the annuity's goal might be to produce additional retirement income. An annuitized annuity may provide the additional annual income needed without the fear that the retiree will overspend, although that can still happen through credit card use and inappropriate spending. Initiating a car loan, for example, could cause financial stress if income is inadequate.

Financial Situation and Needs
The financial situation of the buyer and their retirement needs is a major factor when choosing financial products, including annuities. In some cases, it will impact the type of annuity product that is placed and in other cases, it will completely rule out buying an annuity at all. If there is too little cash available to deposit into the annuity, for example, a lifetime income is of little use. The amount received each month would be too small to adequately fund the buyer.

The financial resources used for funding the annuity must make sense. If the buyer has a nest-egg and wants to put the entire amount into an annuity, leaving no cash reserves, it would not make sense to tie the money up in a nonliquid annuity. Retirees need to have a cash reserve for emergencies. If the refrigerator stops working or the car needs repairs, the retiree must have the capital to handle the emergency. Tying up all funds in an annuity would not be logical.

Annuity Funding
There was a time when agents did not need to be concerned with the origins of money deposited into an annuity but that is no longer true. Several types of insurance products, including annuities, are now used by those wishing to launder funds, such as drug cartels and terrorists. If allowed to, they would deposit funds into an annuity, then remove them. By running their money through an insurance company they have the ability to show the funds as legitimate because they were received, upon withdrawal, from an insurer. In other words, they have given a new "origin" to their funds.

There is another reason for agents to ask where funds are coming from: buyers should not place funds into an annuity if the funds will be needed in the near future. Annuities are long-term vehicles. As such, they are not suitable for short-term requirements.

Financial Experience
The buyer's perception of annuities is often impacted by their financial experience. If great Uncle Charlie had an annuity that paid him handsomely each month, his nephew may assume it would do the same for him even though he knows nothing about the details. Great Uncle Charlie may have deposited a very large amount of money into the annuity upon retirement, which gave him the hansom income, but if his nephew has little cash to deposit, it will not perform the same for him.

One of the most difficult jobs an agent faces is educating those who have preconceived ideas that are incorrect. It is not easy to change what someone believes is true. Therefore, the financial experience of the investor can be either a major disadvantage or advantage, depending upon how much experience the buyer has. Those with experience are typically easier to present new ideas to because they already understand investing.

Individuals with little or no financial experience are often fearful of new financial ideas. While the agent's presentation may seem simple to the seller, the buyer may be viewing it differently. If he or she has no financial experience the annuity presentation may be only partially understood, leading to misunderstandings that the agent may not even realize exists. Those misunderstandings can cause both the buyer and seller problems in the future. The buyer may believe he or she has made their financial standing better than it actually has, and the seller may find themselves facing a lawsuit that is difficult to defend.

Agents must ask questions and determine the financial experience of the buyer as a means of determining how much information is necessary to cover. Certainly, it is necessary to ask questions to determine product suitability, but it is also necessary as self-protection for agents. It is always better to spend more time than actually necessary than too little time during the selling process. It is always better to over-educate the buyer than under-educate him or her. Annuities often work very well for retirement, but that is impossible to assess without enough information. When it relates to financial experience, asking questions and carefully listening to the answers received is vital.

Financial Objectives

Financial objectives always start with the math necessary to arrive at the answer. Objectives are often simply stated as retirement income. However, that simple answer is inadequate since each retiree has different perceptions of what retirement income means. To fine tune those objectives, agents must find out how much income is wanted each month or each year, the lifestyle of the buyer (some need more income than others), and longevity estimates. Financial objectives, while simple to state, are complex to deliver. A man telling his agent "I want to retire next year" is not stating an objective; he is stating a goal, without details of how that goal can be reached.

Financial objectives require math; figures must be put on paper, looked at, studied, and viability established. It is often the agent that must bring reality into the desires. While most goals are obtainable, they often mean the person must give up some luxuries today in pursuit of financial goals at retirement.

Typically, agents find that their clients have never looked at their objectives from a math perspective. In other words, seldom do people realize how much they should have saved.

Intended Use of the Annuity

The intended use of the annuity being considered will impact the type of annuity product purchased. This usually ties into age, time horizons, and other considerations. For example, a person in their forties may choose a different annuity than a person in their sixties would. The use of the annuity is really just a component of the financial objectives of the investor.

Time Horizons

The time horizon is the length of time over which a person's investments are acquired and held before they are liquidated for use in retirement or for some other goal. A day trader may consider his time horizon in seconds, whereas a person planning for retirement would look at time horizons in terms of many years. Investment time horizons are affected by the age at which saving for retirement begins and the year in which retirement is anticipated to begin.

Time horizons are always important when looking at retirement goals. An individual who will receive a lump sum from their employer upon retirement which can be reinvested will view time horizons differently than a person looking at retirement with only his or her personal savings in hand.

When goals cannot be reached by age 60, time horizons may need to be extended. Reality must always be part of the equation when it comes to retirement. Longevity estimates are also important. Few people adequately plan for the number of years they will live in retirement. The problem is simple: they fail to do the math. A person who lives today on $100,000 per year must multiple that amount out thirty years to adequately plan. Inflation is a factor t.hat is often ignored as well.

Existing Assets

We know that those with more assets upon reaching retirement will do better than those with little or no assets. Agents must be aware of their client's assets to determine the suitability of placing an annuity. Since it is important that retirees have some liquid assets for emergency needs, placing all available funds into an annuity is not suitable and should not be done.

Assets may be either liquid or nonliquid, but liquid assets are often the type preferred when agents are placing products since funds are readily available for deposit. Life insurance products, such as annuities are assets, even though they are typically not liquid in nature.

Liquid assets are things that can be converted into cash quickly, with minimal impact to the amount received. Assets can include money market instruments and government bonds. The most liquid market is the foreign exchange market because trillions of dollars exchange hands daily, making it impossible for any one individual to influence the exchange rate.

Nonliquid assets are things that can be cashed in, so to speak, but not quickly and maybe not even easily. Nonliquid assets, such as annuities, cannot be easily accessed for an emergency expense. Emergency expenses usually require immediate cash.

Liquidity Needs or Requirements

Liquidity risk in financial issues, is the risk that a given asset cannot be traded or sold quickly enough to produce the funds required immediately or that needing to sell it quickly will produce a financial loss. Liquidity requirements face potential liquidity risk.

Financial planners advise their clients to keep an emergency fund along with their rainy-day fund. The rainy-day fund, which may have a variety of names, is kept to fund household expenses in case of job loss. It should have enough funds to pay for between three and six months of living expenses in case of a job loss.

An emergency fund is not intended to fund a long-term unemployment, but rather to cover expenses that are not part of the monthly costs of living. Emergencies, requiring an immediate need to pay an unexpected bill, might include buying a new refrigerator or repairing a car.

Retirees seldom need a rainy-day fund since they no longer depend on earned income, but they do need an emergency fund to cover costs of items they had not anticipated. Retired homeowners especially need this type of fund because home repairs can be high and are certainly not included in their monthly maintenance bills.

When agents are recommending annuity products, they must be aware of potential emergency needs. Tying up all a client's cash in an annuity would be unsuitable in all cases. Determining how much should be in an emergency fund is difficult. A new roof can cost $10,000 or more whereas a new refrigerator may only require $1,000. It is always better to have more in an emergency fund than less.

Another consideration when addressing emergency funds is durational. Once $10,000 has been removed to replace their roof, for example, funds are unlikely to be replaced. Therefore, emergencies must be considered by agents and consumers for twenty or thirty-year periods.

While working, individuals can probably replace used funds, but that is not true once income ceases.

Liquid Net Worth
Generally, financial planners are looking at net worth in its entirety, not just liquid net worth. Liquidity relates to being able to quickly obtain cash from an asset, so liquid net worth would only be looking at assets that may be quickly cashed in. Some assets in a general net worth assessment are not liquid.

Net worth refers to an individual's wealth or lack thereof. Net worth is the value of the assets owned less the debts owed. Assets include investments, life insurance products, real estate, cars, and even clothing and furniture. It is the total of all that is owned, minus the debts that are unpaid. For example, a client has a high-quality leather couch that he paid $3,000 for, but he still owes $2,000 to the store he bought it from. That means he only has (ignoring depreciation for this example) $1,000 in assets from the couch. In reality, he or she would not have $1,000 in assets because the moment the couch left the store, it lost value.

An annuity does not lose value like the couch does, so $5,000 in an annuity translates to $5,000 in assets. When determining net worth, most professionals only look at assets that retain their value and not those that lose value. However, clothing, furniture, and other items can be considered as part of a person's net worth since their loss would mean replacement, and replacing the items requires money to do so.

To properly plan for retirement many things must be considered. Investors must know their net worth today, so they know what they have to work with. When annuities are being considered it is important to have liquid assets available since annuities are not liquid vehicles. It is not possible to withdraw funds easily from annuities, and that was the intention when they were created since they are intended to be long-term investments.

Risk Tolerance
All investments have risk, even if that risk is lost buying power due to inflation. Each investor has what is called "risk tolerance." This refers to the ability of investors to accept the risks of the investments they chose. Some investors enjoy risk, but as investors age, risk is seldom wise. A young investor has time on their side; if they lose values, they have time on their side to make up their losses. An older person does not have time on their side. Older investors should always seek safety rather than excessive risk.

Some types of annuities have more risk than other types. The riskiest annuity is the variable annuity; return is variable, not guaranteed. Professionals recommend fixed-rate annuities for retirees, since risk is not desirable by the time retirement has arrived.

There are various types of investments. Cash and cash equivalents are low risk investments that can be easily liquidated into cash, with mandatory holding periods of 12 months or less. These investments provide low returns, so there is little protection against loss to inflation, but for the retiree they are often the wisest choice since there is not high risk involved. As we know, annuities are not easily liquidated so they are not considered cash or cash equivalents.

It might surprise people to know that cash-and-cash-equivalents does not necessarily mean money folded in your pocket or purse. In fact, with the prevalent use of credit cards, few people today actually carry much cash with them. However, cash also means money that is in savings accounts, money markets, and certificates of deposit at the local bank.

Tax Status
Unfortunately, many people entering retirement will not have any idea what their retirement tax status will be. They will not know if their Social Security income will be taxed or how their total

monthly income may be affected by taxation. As a result, retirees may have less net income than they anticipated.

State and local governments all over the United States raise money through taxation, whether that happens to be sales tax, lodging tax (paid when you rent a hotel room), and other taxes. While there is taxation that affects people of all ages, such as sales tax and real estate tax, any type of tax lessens spendable income.

For those with an individual retirement account (IRA) or access to an employer 401(k) qualified retirement plan, a lower tax rate could make pre-tax retirement account contributions less attractive and might make it more likely that people will take taxable distributions. The IRS 10 percent early withdrawal penalty is likely to remain.

Entering Retirement

Accessing annuity funds during retirement may be accomplished through annuitization or by simply withdrawing funds periodically. If annuitization is selected it is extremely important to understand the various withdrawal options. When maximization of income is the goal, the policyowner is likely to take a lifetime income option, which also removes heirs from inheriting excess funds if the annuitant dies prior to receiving all that was deposited. In effect, lifetime income options make the issuing insurer the beneficiary. Agents must carefully explain all options prior to the annuitant's selection.

Many investors find it advantageous to involve their accountant or bookkeeper in their retirement planning, especially if that individual is knowledgeable about investing (some are not). Investors must know where they are today financially to plan their futures realistically.