



2012 CEFLI
Annuity Suitability
Benchmarking Survey Report



2012 CEFLI Annuity Suitability Benchmarking Survey Report

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Introduction

CEFLI was asked recently by members of its Compliance & Ethics Committee to conduct a benchmarking survey to gauge the current state of life insurance industry practices with respect to annuity suitability. To conduct this analysis, a series of questions pertaining to annuity suitability practices was developed in conjunction with members of CEFLI's Annuity Suitability Working Group. These questions were presented to respondents to CEFLI's Annuity Suitability Benchmarking Survey (the "Survey"). This Report outlines the key findings of responses to the Survey.

CEFLI's Benchmarking Series is designed to review current life insurance industry practices on a range of compliance and ethics issues. For more information about CEFLI's Benchmarking Series, please contact CEFLI at info@CEFLI.org or (240) 744-3023.



Purpose and Background

The purpose of this Survey was to determine the current state of life insurance industry practices with respect to annuity suitability. Interest in these issues has grown in prominence during the past few years in light of the continuing evolution of suitability standards applicable to the sale of registered products (i.e., variable annuities) and non-registered products (i.e., fixed and indexed annuities).

The life insurance industry has been addressing suitability requirements for decades. Life insurers distributing variable annuity products through affiliated and unaffiliated broker-dealers had to demonstrate compliance with former National Association of Securities Dealers (“NASD”) Rule 2310 pertaining to suitability and, in some instances, the former New York Stock Exchange (“NYSE”) Rule 405 “Know Your Customer” that impacted suitability analysis for NYSE broker-dealer firms.

NAIC Model Regulations: NAIC Senior Protection in Annuity Transactions Model Regulation and the NAIC Suitability in Annuity Transactions Model Regulation

Discussions concerning development of suitability standards applicable to both life insurance and annuity products began in earnest in the late 1990s. Initiatives were undertaken at the NAIC to explore the feasibility of developing suitability standards that would apply to both life insurance and annuity products.

The NAIC began this review by establishing a Suitability Working Group that developed a White Paper on Suitability. In early 2000, the Suitability Working Group published its White Paper entitled: *Suitability of Sales of Life Insurance and Annuities*. The White Paper included a recommendation for the NAIC to consider developing a Model Law or Regulation to address suitable sales of non-registered life insurance and annuity products. Further examination of this recommendation revealed that it would be more feasible to possibly develop a Model Law or Regulation applicable to non-registered annuity products rather than life insurance products.

In 2003, the NAIC identified potential issues associated with the sale of non-registered annuity products to seniors. To address these issues, the NAIC charged its Suitability



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Working Group to develop a Model Regulation designed to address the suitability of non-registered annuity product sales to seniors.

This initiative led to the development of the NAIC Senior Protection in Annuity Transactions Model Regulation. This new Model Regulation imposed various requirements on insurers and producers regarding the suitability of sales of non-registered annuity products to seniors age 65 and above.

Thereafter, the NAIC revised the Senior Protection in Annuity Transactions Model Regulation by eliminating the age requirement and applying its provisions to all non-registered annuity sales; regardless of the age of the customer.

Several years later, the NAIC introduced an initiative to develop a Suitability in Annuity Transactions Model Regulation which was adopted by the NAIC in 2006.

One of the key provisions of the 2006 version of the NAIC Suitability in Annuity Transactions Model Regulation was the introduction of a "safe harbor" provision that allowed life insurers to satisfy suitability requirements pertaining to the sale of variable annuities to the extent they could demonstrate compliance with NASD Rules pertaining to suitability. Another key provision also permitted insurers to contract with third parties to establish and maintain a system of supervision of the suitability of annuity sales.

During this time period, life insurers had to develop a myriad of compliance strategies in order to address the fact that some states had adopted the Senior Protection and Annuity Transactions Model Regulation whereas others chose to adopt the newer Suitability in Annuity Transactions Model Regulation.

FINRA Suitability Rules: FINRA Rules 2111 and 2090

In late 2006, the NASD and NYSE announced plans to merge and the merger was approved by the U.S. Securities and Exchange Commission ("SEC") in mid-2007. The merger of the NASD and NYSE led to the establishment of the Financial Industry Regulatory Authority ("FINRA").

One of the primary charges that arose in light of the merger was the need to consolidate the rule books of the NYSE and NASD. FINRA had been working on this consolidation initiative for several years and, in November 2010, the SEC approved a new FINRA suitability rule (FINRA Rule 2111) which was based upon former NASD Rule 2310 and a



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new FINRA "Know Your Customer" Rule (FINRA Rule 2090) that was based upon the former NYSE Rule 405.

Since adoption of FINRA Rule 2111, FINRA has issued several Regulatory Notices (Regulatory Notices 11-02, 11-25 and 12-25) to clarify the scope and application of its new suitability rule.¹

2010 Revisions to the NAIC Suitability in Annuity Transactions Model Regulation

As a growing number of states adopted the 2006 version of the NAIC Suitability in Annuity Transactions Model Regulation, the NAIC continued to explore additional modifications to the Model Regulation.

The NAIC convened a Working Group to examine possible revisions to the NAIC Suitability in Annuity Transactions Model Regulation. In 2010, the NAIC adopted revisions to the 2006 version of the NAIC Suitability in Annuity Transactions Model Regulation to include, among its other provisions, specific requirements with respect to training of producers (continuing education and product-specific training) and "secondary review" of the suitability of non-registered annuity transactions.

* * * * *

This Survey was designed primarily to gauge current industry practices regarding these state insurance regulatory developments. Therefore, the Survey questions were designed to evaluate various compliance strategies life insurers employ currently with respect to demonstrating compliance with the requirements of the 2010 version of the NAIC Suitability in Annuity Transactions Model Regulation.

¹ A detailed discussion of applicable suitability laws and regulations is beyond the scope of this Survey Report.

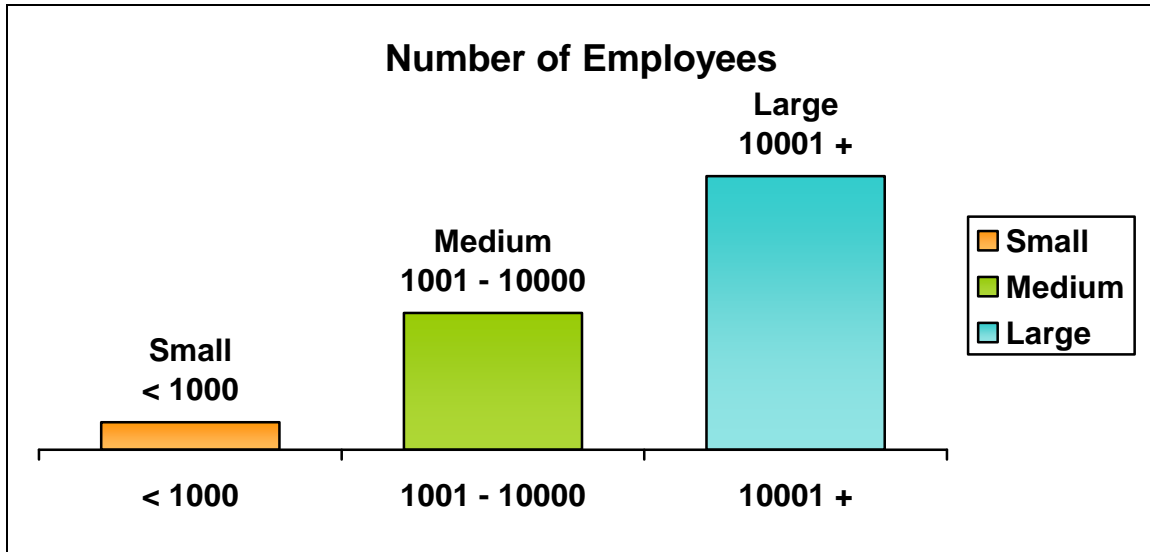


Methodology

To complete its review, CEFLI solicited input from both CEFLI member life insurance companies as well as non-CEFLI member life insurance companies. CEFLI received Survey responses from 56 life insurance companies representing a range of company sizes (large, medium and small) and distribution systems.

Survey respondents were asked to indicate their company's size based upon its number of employees. For purposes of the Survey:

- Companies with less than 1,000 employees were deemed to be Small companies;
- Companies with more than 1,000 but less than 10,000 employees were considered to be Medium-size companies; and
- Companies with more than 10,000 employees were considered to be Large companies.



When Survey respondents were asked to characterize their role within their respective organizations, the majority of overall Survey respondents (66%) described their role as having responsibility for compliance oversight of annuity sales by the issuing life insurance company. Other roles reported by Survey respondents included business



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management (10%), suitability reviewer for transactions (9%), compliance oversight of an affiliated broker-dealer (5%), administrative management (5%) and other (5%).

The Survey respondents were asked to identify what forms of distribution may be used by their company for purposes of annuity sales. The Survey examined several different categories of distribution systems including: captive agents, third-party distribution firms (selling registered products), third-party distribution firms (selling non-registered products), independent agents, direct sales (including Internet sales), worksite sales and other.

The Survey results indicated that small companies use primarily independent agents for annuity product sales but also use third-party distribution firms (selling non-registered products) to a lesser degree. Medium-size companies reported using a broader range of distribution systems and use (in descending order) third-party distribution firms (selling registered products), captive agents, third-party distribution firms (selling non-registered products) and independent agents to distribute annuity products. Large companies reported four dominant means of annuity distribution which were equally divided between the use of third-party distribution firms (selling registered products), third-party distribution firms (selling non-registered products), captive agents and independent agents.

In sum, the respondents to the Survey constituted a representative cross-section of different company sizes, roles and responsibilities and distribution systems for purposes of analysis of annuity suitability practices.



Recent Revisions to the NAIC Suitability in Annuity Transactions Model Regulation

In 2010, the NAIC approved several revisions to the 2006 version of the NAIC Suitability in Annuity Transactions Model Regulation (the "Model Regulation"). Since that time, several states have adopted the 2010 revisions to the Model Regulation. As a result, companies have expressed interest in current strategies to demonstrate compliance with the requirements of the 2010 revisions to the Model Regulation. Therefore, the Survey asked several questions designed to discern company practices with respect to key elements of the 2010 revisions to the Model Regulation.

Compliance Strategies

The Survey sought to determine strategies companies will employ to comply with the adoption of various versions of the NAIC Suitability in Annuity Transactions Model Regulation in several states.

It was interesting to note that the Survey data confirmed a split in strategies among Survey respondents on this issue. Approximately half of Survey respondents indicated that they plan to apply the requirements of the Model Regulation across all states² (assumedly regardless of whether the state has adopted the Model Regulation) whereas other Survey respondents indicated that they will review state specific requirements on a state-by-state basis. Primarily large and medium-size companies reported they follow a strategy to apply the requirements of the Model Regulation across all states. Though this strategy may be considered a "best practice" across the industry, the strategy is reportedly premised upon operational efficiencies offered by the volume of business generated by these companies. Most small companies reported that they will review state specific-requirements on a state-by-state basis.

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² Companies pursuing this strategy apply applicable elements of the Model Regulation in all jurisdictions but also design systems to accommodate any state-specific requirements that may not be elements of the Model Regulation.



Training

One of the important changes in the 2010 revisions to the Model Regulation was the introduction of new training requirements. Specifically, the 2010 revisions to the Model Regulation required producers to undergo general annuity continuing education training as well as product-specific training in order to be eligible to continue to distribute annuity products on behalf of life insurers.

The Survey sought to determine current company practices with regard to several elements of the training requirements associated with the 2010 revisions to the Model Regulation.

1) Continuing Education Training Requirements

The Survey sought to determine the extent to which life insurance companies were applying the continuing education training requirements of the Model Regulation uniformly across all states for various distribution channels.

For those Survey respondents representing companies distributing annuity products through captive agents, a minority of Survey respondents (38%) indicated that they apply the continuing education training requirements uniformly across all states for their captive agents. However, most Survey respondents (62%) representing companies with captive agents indicated that they will not be applying the continuing education training requirements uniformly across all states in the captive distribution channel.

For those Survey respondents representing companies distributing annuity products through third-party distributors, a similar response was offered. In the case of Survey respondents representing companies distributing annuity products through third-party distributors, a minority of Survey respondents (34%) indicated that they apply the continuing education training requirements uniformly across all states for their third-party distributors but most Survey respondents (66%) indicated that they do not apply the continuing education training requirements uniformly across all states for purposes of their third-party distribution. Moreover, a minority of Survey respondents (40%) in this category indicated that they rely upon the third-party distributor to fulfill the continuing



education training requirement on behalf of the insurer whereas the majority of Survey respondents (60%) do not.

2) Product-Specific Training Requirements

The Survey asked respondents to reply to similar questions with respect to the product-specific training requirements of the 2010 revisions to the Model Regulation.

When asked whether they plan to apply the product-specific training requirements uniformly across all states for their captive agents and third-party distributors, a majority of Survey respondents (55%) with captive agents indicated they will apply these requirements uniformly across all states whereas a majority of Survey respondents (56%) with third-party distributors indicated they will not. These strategies may reflect the nature of the relationship between a life insurance company and its captive agents versus its third-party distributors.

However, it was interesting to note that relatively few Survey respondents (27%) will rely upon their third-party distribution partners to fulfill the product-specific training requirements of the 2010 revisions to the Model Regulation.

CEFLI has fielded several inquiries from companies attempting to discern industry practice with respect to the frequency of requiring their producers to complete product-specific training in light of the 2010 revisions to the Model Regulation. The Survey confirmed that there was a high level of consistency with respect to industry practices regarding the frequency of product-specific training. The majority of Survey respondents stated that their company requires their producers to undergo product-specific training every time there is a material change in the annuity product. In other instances, a smaller number of Survey respondents indicated that they would require their producers to complete product-specific training only once for the duration of their sales appointment.

The Survey confirmed that the majority of Survey respondents stated that their company requires their producers to undergo product-specific training every time there is a material change in the annuity product.



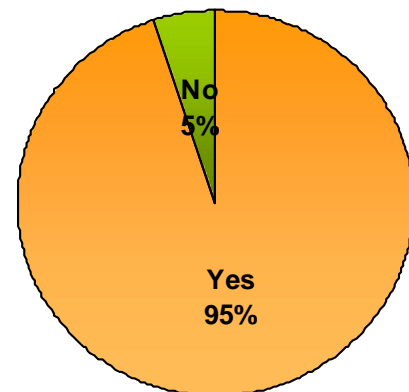
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Questions remain with respect to the strategies companies employ to track the completion of the state continuing education and product-specific training requirements under the 2010 revisions to the Model Regulation. The Survey findings indicated that most Survey respondent companies (37%) will rely on reports from the vendor that provides the training whereas other Survey respondent companies (34%) will use company generated reports to track completion of the various training modules.

3) Verification of Training Requirements Prior to Contract Issuance

The life insurance industry has undertaken various steps to demonstrate compliance with the 2010 revisions to the Model Regulation. The Survey data confirmed that companies are very focused on ensuring compliance with the training requirements under the 2010 revisions to the Model Regulation before issuing an annuity contract. An overwhelming majority (95%) of Survey respondent companies indicated that they have a process in place that requires the company to verify completion of the applicable training requirements by the selling producer prior to the issuance of an annuity contract for all transactions.

Does your company have a process to verify completion of the training requirements by the selling producer prior to the issuance of the annuity on every transaction?

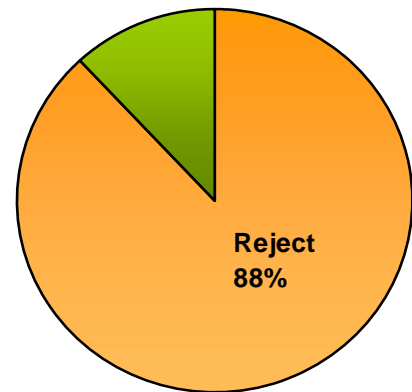




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CEFLI also has fielded several questions regarding industry practices concerning actions a company may take in the event that it has determined that a producer has not met the applicable training requirements at the time the application for an annuity product has been submitted to the company. An overwhelming majority (88%) of Survey respondents indicated that the submission of new business will be rejected until the mandated training requirements are met. Other Survey respondents indicated that their company will hold on to the submission of the application pending the proper completion of training requirements and then will submit the application for approval.

What does your company do if it is determined that the producer has not met the training requirement?



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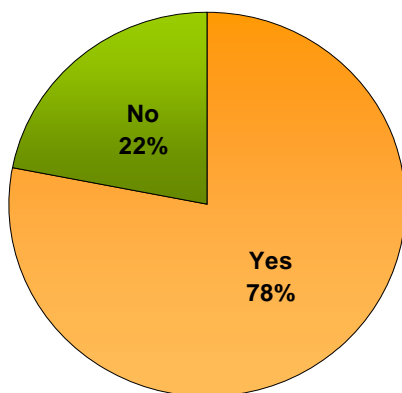
Secondary Review

Many companies have employed a "secondary review" to assess the suitability of annuity transactions. For purposes of this Survey, "secondary review" is defined as the review after the initial review of the selling producer. The Model Regulation requires life insurers to maintain procedures for review of each recommendation prior to issuance of an annuity. The Survey sought to determine the manner in which this type of "secondary review" takes place.

Survey results on this question were consistent for companies of all size. Approximately 3/4 of all Survey respondents indicated that their companies conduct a "secondary review" of every annuity transaction.

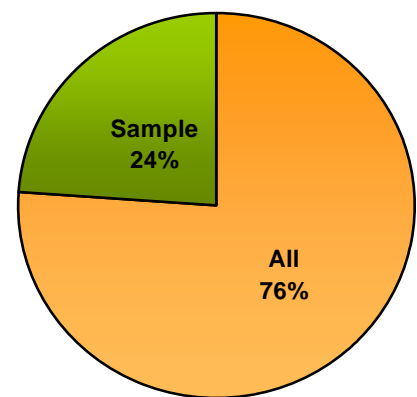
Approximately 1/4 of all Survey respondents indicated that

Does your company have a specific functional area used for the annuity suitability secondary review?



their companies apply a screening process that includes review of a sample of transactions to determine whether any transactions may require additional review. Moreover, approximately 3/4 of Survey respondents indicated that their company has established a specific functional area to conduct the "secondary review."

What strategies does your company use for the "secondary review" of each recommendation prior to issuance of an annuity?





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The Survey also sought to determine who conducts the "secondary review" for the company. The Survey responses were analyzed according to company size and product type.

Survey respondents representing medium-size companies described a range of practices with respect to conducting "secondary reviews." The dominant practice reported by Survey respondents affiliated with medium-size companies indicated that they contract with their third-party distributors to review all registered annuity product sales yet conduct all "secondary reviews" of non-registered annuity product sales through the company's internal annuity suitability review process. Still other medium-size companies reported that they contract with their third-party distributors to also review all non-registered annuity product sales as well. The majority of Survey respondents representing small companies indicated that their company reviews all non-registered annuity sales through the company's internal annuity suitability review process.

The dominant practice reported by Survey respondents affiliated with medium-size companies indicated that they contract with their third-party distributors to review all registered annuity product sales yet conduct all "secondary reviews" of unregistered annuity product sales through the company's internal annuity suitability review process.



Supervision and Monitoring Practices

Contractual Relationship for Supervision and Monitoring with Third-Party Distributors

The Survey attempted to discern company practices with respect to their contractual relationships with third-party distributors for purposes of supervision and monitoring of annuity suitability sales practices. Specifically, we were interested in determining whether practices differed with regard to the contractual relationship between an insurer and a third-party distributor for supervision and monitoring of annuity suitability for registered products sales versus non-registered products sales.

In the case of distribution of registered products through third-party distributor broker-dealers, Survey respondents representing large companies indicated that they maintain such contractual relationships whereas Survey respondents representing medium-size companies and smaller companies were less likely to contract supervision and monitoring functions to their third-party distribution broker-dealers.

The Survey also sought to determine the extent to which companies maintain contractual relationships with third-party distributors for supervision and monitoring of non-registered annuity sales. To make this determination, Survey respondents were asked to provide answers to three alternative strategies:

- 1) *The company maintains contractual relationships for supervision and monitoring with all third-party distribution firms for non-registered products;*
- 2) *The company maintains contractual relationships for supervision and monitoring of annuity suitability only to firms that can certify that they subject non-registered sales to FINRA's system of supervision; or*
- 3) *The company does not maintain such contractual relationships.*



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The Survey results found that respondents representing small companies were only willing to establish contractual relationships with third-party distributors who subjected non-registered products sales to FINRA's system of supervision.

Survey respondents representing medium-size companies that maintain contractual relationships with third-party distributors for supervision and monitoring of annuity sales for non-registered products sales were equally divided in their responses to this question. Approximately 1/3 of Survey respondents representing medium-size companies indicated that their companies maintain contractual relationships for supervision and monitoring of non-registered products sales with all third-party distributors whereas another 1/3 indicated they will only maintain contractual relationships with third-party distributors that subject non-registered products sales to FINRA's system of supervision and another 1/3 indicated that they do not maintain such contractual relationships.

A greater percentage of Survey Respondents representing large companies (50%) indicated that they maintain contractual relationships with all third-party distributors for supervision and monitoring of annuity sales for all firms including those firms that subject the insurer's non-registered annuity product sales to FINRA's system of supervision.

Due Diligence

The Survey also sought to determine the extent to which due diligence is conducted on third-party distributors with whom a company may choose to enter into a contractual agreement to perform supervision and monitoring of annuity sales. The Survey attempted to gauge current practices with respect to this due diligence process.

Specifically, we were interested in determining whether due diligence is performed, what steps are taken to conduct such due diligence, what types of data are gathered and whether the due diligence process is different for third-party distributors that are broker-dealers versus those that are not.

The Survey results indicated that life insurer practices with respect to conducting due diligence of third-party distributors before entering into contractual arrangements with the third-party distributor for supervision and monitoring of annuity sales differ across the industry. Some Survey respondents indicated

The Survey results found that respondents representing small companies were only willing to establish contractual relationships with third-party distributors who subjected non-registered products sales to FINRA's system of supervision.



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that their company requires a due diligence analysis of a third-party distributor prior to entering into a contractual agreement to have the third-party distributor perform supervision and monitoring of annuity sales.

To the extent due diligence activities take place, they often incorporate one of several processes including (listed in order from most to least used):

- interviewing management,
- sending out due diligence questionnaires, and
- reviewing internal processes.

The Survey found that companies collect a variety of different data in conducting their due diligence analysis including (listed in order from most to least used):

- obtaining applicable policies and procedures,
- receiving a description of the third-party distributor's automated screening process (if applicable),
- a list of scenarios that generate "red flags,"
- a list of actions that will be taken when unsuitable sales are identified, and
- receiving examples of oversight reports.

Moreover, the majority of Survey respondents that conduct due diligence activities indicated that their due diligence activities do not differ with respect to whether the third-party distributor is a broker-dealer or is not a broker-dealer.



Additional Review Activities for Contractual Agreements

For companies that entered into contractual agreements for supervision and monitoring of annuity sales with their third-party distributors, the Survey sought to determine any additional steps that companies take to monitor the performance of these contractual obligations. The Survey results indicated that the primary means most companies take to confirm compliance with contractual obligations is to obtain an annual annuity suitability certification. Many companies obtain these certifications through CEFLI's Annuity Suitability Clearinghouse.

However, in addition, some companies indicated that they perform other types of monitoring activities as well. These monitoring activities included (listed in order from most to least used):

- periodic review of randomly selected contracts,
- use of customer survey programs, and
- periodic "red flag" monitoring of trends based on business data obtained from the third-party distributor.



Annuity Suitability Review Practices

Internal Suitability Reviews

Many companies have elected to conduct "in-house" suitability reviews of annuity transactions. Recognizing this trend, the Survey sought to identify the role of the Compliance Department within this process.

The Survey findings indicated that Compliance is involved in three primary functions:

- general oversight of the function,
- developing policies and procedures for the review, and
- actually performing the review itself.

When this data was analyzed according to company size, small and medium-size companies reported that they conduct all three functions within the Compliance Department whereas large-company Survey respondents indicated that their Compliance Departments are responsible for general oversight of the function and developing policies and procedures for the review but that the actual review itself takes place elsewhere within their company (e.g., new business).

The Survey findings indicated that Compliance is involved in three primary functions: general oversight of the function, developing policies and procedures for the review and actually performing the review itself.



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When asked to identify the elements of the suitability review, the overwhelming majority of Survey respondents indicated that they review specific cases identified through "red flag" scenarios. The "red flag" criteria are established by each company.

Other techniques used for this purpose included (listed in order from most to least used):

- aging complaint activity,
- client surveys,
- random customer outreach calls,
- customer outreach calls to all seniors,
- and periodic questionnaires to producers.

When asked to identify the elements of the suitability review, the overwhelming majority of Survey respondents indicated that they review specific cases identified through "red flag" scenarios.

The Survey data found that the use of a customer call out program is not a pervasive industry practice. However, to the extent such calls are made, the Survey also attempted to determine the timing of the customer call out program. Most Survey respondents representing companies that use a customer call out program identified that this program is used on a pre-issue basis for all distribution channels. A smaller percentage of Survey respondents indicated that they use a customer call out program on a post-issue basis.



Trend Monitoring

With respect to monitoring of trends of third-party distributor transactions to identify potential unsuitable sales, the Survey results indicated a variety of practices. The primary means used by most companies to monitor trends with respect to potential unsuitable sales is to review customer complaint data. Other areas identified by Survey respondents included (listed in order from most to least used):

- the volume of replacement cases,
- product surrenders shortly after purchase,
- senior sales,
- lack of product understanding by the customer, and
- questionable sales patterns due to benefit election and share class/product concentrations or asset allocation concentrations.

The primary means used by most companies to monitor trends with respect to potential unsuitable sales is to review customer complaint data.

The Survey also sought to determine what area of the company performs this trend monitoring analysis of third-party distributors. The majority of Survey respondents from companies of all sizes indicated that this monitoring analysis takes place in the Compliance Department. The Survey results also indicated that this type of analysis is performed by those in the service operations area and, in some instances, several companies indicated that they have developed a specialty group specifically trained for this purpose.

The Survey also attempted to gauge the timing of the periodic monitoring of third-party distributors. Most Survey respondents indicated that this type of analysis is performed at least annually but many companies choose to perform this analysis on a monthly or (to a lesser degree) on a quarterly basis.



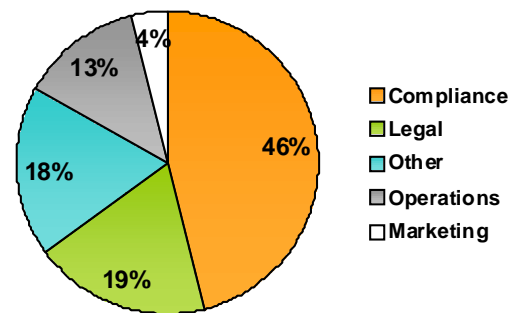
"Heightened Review"

In most instances, companies are employing a review process that is designed to identify certain questionable transactions that may be subject to a "heightened review" due to the characteristics of a particular transaction. For purposes of this Survey, a "heightened review" is defined as an additional review after the "secondary review." There also are questions concerning what actions take place once a transaction is identified for "heightened review." The Survey attempted to identify industry practices with respect to these and other related questions.

Companies employ a variety of methods to identify potential transactions for "heightened review." The Survey data confirmed that the overwhelming majority of companies (81%) use data collection methods to identify transactions that implicate "red flags" that require further review. The Survey data also confirmed that the overwhelming majority of companies (82%) maintain a formal escalation process for annuity transactions that do not "pass" the standard review process.

When Survey respondents representing companies that maintain a formal escalation process were asked "who has the final say" on whether a particular transaction may be subject to the escalation process, the most common response was Compliance (46%) followed by Legal (19%), Other (which included responses such as an Annuity Suitability Review Committee as well as a "Joint Discussion" among departments) (18%), Operations (13%), and Marketing (4%).

"...who has the final say?"



Specific analysis of the transaction characteristics that may implicate "red flags" differ from company to company and, therefore, were not the subject of analysis of the Survey. However, the Survey did find strong support for certain key elements of data collection that were reviewed as part of the "red flag" identification process.



These elements included:

- whether the case was a replacement transaction,
- the amount of the applicant's liquid assets after purchase of the annuity,
- the applicant's net worth,
- the age of the applicant,
- the applicant's monthly income, and
- the applicant's disposable income.

To the extent a specific transaction is identified as a "red flag" transaction thereby requiring "heightened review," the Survey attempted to discern the next step in the analysis of the suitability of that particular transaction. The most common next step Survey respondents employ with respect to conducting a "heightened review" of "red flag" transactions is to call the agent or the third-party distributor's back office for additional information concerning the transaction.

The most common next step Survey respondents employ with respect to conducting a "heightened review" of "red flag" transactions is to call the agent or the third-party distributor's back office for additional information concerning the transaction.

Unsuitable Sales

As a company undergoes its annuity suitability review process, it is not unreasonable to surmise that they will identify unsuitable annuity sales. In this instance, the Survey sought to determine what practices are followed when an annuity transaction is deemed to be unsuitable.

The most common response with respect to actions taken when an unsuitable sale is identified is that the company notifies the agent. In some cases, companies will also return any funds submitted to the agent as well.

Other strategies identified through Survey results included notifying the applicant directly, returning funds directly to the applicant and submitting a notification to the company's operations or its third-party distributor.



Examination Activities

Examinations - Annuity Suitability

The Survey also sought to evaluate the areas of focus and the types of information state insurance examiners may be seeking when conducting examination activities to determine company compliance practices with annuity suitability regulatory requirements.

The Survey findings indicated that most states are focused on having insurers provide documentation to support the transactional suitability determination. In addition, Survey respondents indicated that many states are requesting a review of the insurer's policies and procedures and have paid particular attention to annuity sales involving replacement activity.

When Survey respondents were asked to identify the primary ways their companies are demonstrating proof of compliance with the requirements of the Model Regulation or other state specific annuity requirements, the most common response indicated that companies are showing, at a minimum, documented annuity suitability policies and procedures to regulators.

In addition, Survey respondents reported that they are providing other documentation as well. Survey respondents reported the following top three items as useful in their annuity suitability examination activities:

- An annual report to senior management designed to determine the effectiveness of the overall supervision system, including results from an appropriate level of testing;
- Review of systems and processes to ensure selling producers have met annuity training requirements prior to the company accepting annuity business; and

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- Internal audit results to determine the effectiveness of the company's "secondary review" process.



Other Issues

Sales to Seniors - Cognitive Impairment

Recent demographic trends suggest that an increasing number of senior Americans may suffer from some type of cognitive impairment. Therefore, the Survey sought to determine whether companies may be conducting activities to raise awareness of possible cognitive skills impairments for senior applicants for annuity products and whether this type of assessment is part of the overall evaluation of product suitability for sales to seniors.

Survey results indicated that a growing number of companies have instituted practices to raise awareness of potential cognitive skills impairments of senior annuity applicants. The primary practice in this area is to provide training to allow producers to become aware of signs of potential cognitive skills impairments at the point-of-sale. Other practices identified through the Survey results included interviews conducted by independent third parties engaged by the insurer or conducted by specifically trained home office personnel.

Use of Suitability Forms

Many companies have instituted the use of specific suitability forms in addition to their application forms for annuity product sales. The Survey attempted to gauge the extent to which these practices are employed throughout the life insurance industry.

The Survey results indicated that the use of suitability forms appears to be a predominant practice for companies distributing their annuity products through captive agents. The majority of Survey respondents (61%) whose companies distribute their annuity products through captive agents require a suitability form to be completed in addition to the application form.

In addition, many Survey respondents (46%) distributing non-registered annuity products through third-party distributors also require the use of a suitability form in the sale of their company's products. In some cases, a small minority of companies (5%) only require the use of a suitability form when the applicant is of a specific age (e.g., 65 years of age) or older.



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The Survey also inquired as to whether the suitability form must be the insurance company's form. Approximately half of Survey respondents indicated that they require the insurance company's form to be used for this purpose.

Direct Sales

Direct sales of annuities to customers (i.e., with no producer involvement) is a distribution method employed by a relatively small percentage of Survey respondent companies. The Survey attempted to indicate whether there may be a difference in the suitability review applied to transactions conducted through direct sales activities versus producer-based sales.

The Survey indicated that, because the direct sales distribution system at many companies does not involve a recommendation by a producer, a suitability review is deemed to be unwarranted. However, in other instances, Survey respondents indicated that their direct sales process provides online information that is viewed as providing a recommendation to the applicant and, therefore, these Survey respondents reported that all of their direct sales undergo a suitability review similar to the type of review conducted on the company's producer-based sales.

Auditing Review of Annuity Suitability Requirements

The Survey also sought to gauge strategies companies employ to conduct audits to determine compliance with annuity suitability requirements. The majority of Survey respondents (57%) indicated that their company conducts an internal audit review of the internal annuity suitability process. Other audit strategies include review of a specific agent's or a specific third-party distributor's business.

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Summary

The overall Survey results indicate that the life insurance industry continues to examine a range of strategies to encourage and promote suitable annuity sales. These findings are supported by the broad representation of Survey respondents throughout the industry and the number of issues explored during the analysis.

The life insurance industry has a long history of demonstrating compliance with annuity suitability requirements. Applicable regulatory requirements continue to evolve with respect to distribution of registered products (e.g., variable annuities) as well as non-registered products (e.g., fixed and indexed annuities). These developments prompted the initiation of the Survey as companies continue to examine appropriate strategies to address annuity suitability issues.

The 2010 revisions to the NAIC Suitability in Annuity Transactions Model Regulation introduced new concepts with respect to annuity suitability. The 2010 version of the Model Regulation is being adopted by more and more states and, therefore, companies have developed various strategies to demonstrate compliance with its requirements.

The Survey indicated that approximately half of the responding companies are planning to apply the requirements of the Model Regulation in all jurisdictions regardless of whether a particular state has adopted the Model Regulation. Other companies are conducting a state-by-state analysis of annuity suitability requirements.

With respect to training requirements under the Model Regulation, companies are examining various strategies to address the continuing education and product-specific training requirements. Most companies are using third-party vendors to track completion of the state continuing education and product-specific training requirements. Moreover, the majority of Survey respondents indicated that their company requires their producers to undergo product-specific training every time there is a material product change.

In addition, the Survey results indicate that companies have taken a stringent review of the necessity to comply with the Model Regulation's training requirements by rejecting business submitted by producer that has failed to meet these requirements.



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Company practices differ with respect to the manner in which they conduct a "secondary review" of annuity transactions. In fact, many companies have established a separate functional area whose primary responsibility is to conduct the "secondary review."

Supervision and monitoring of the suitability of annuity transactions continues to present challenges in the marketplace. Many life insurers contract with their third-party distribution partners to conduct supervision and monitoring of the suitability of annuity sales. The Survey examined these practices and found that some companies will only permit contractual relationships for supervision and monitoring of annuity suitability for non-registered product sales to firms they can certify that they subject these transactions to FINRA's system of supervision.

Most large and medium-size companies distributing products through a broker dealer maintain contractual agreements to require the broker dealer to supervise and monitor registered annuity product sales. Practices differ with respect to whether companies also authorizing the third-party distributor broker dealer to supervise and monitor non-registered annuity sales. Some companies elect to conduct the review of non-registered annuity product sales through their internal annuity suitability review process.

The most common means used by life insurance companies to verify compliance by third-party distributors with contractual obligations to supervise and monitor the suitability of annuity sales is to obtain an annual certification of annuity suitability compliance. Many companies obtain these certifications through CEFLI's Annuity Suitability Clearinghouse.

The Survey also sought to examine annuity suitability review practices at various companies. Most companies indicated that they use "red flags" (as determined by the company) to identify specific cases that may warrant "heightened review." Companies also rely heavily upon complaint activity as a primary means to identify possible unsuitable sales.

In the event a specific transaction may require "heightened review," the decision as to whether to escalate such a transaction generally lies within the Compliance department. However, as the Survey results indicate, company practices vary.



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The Survey asked questions to discern the areas of focus and types of information sought by state insurance examiners conducting examinations to determine compliance with annuity suitability requirements. The Survey findings indicated that most states are focused on having insurers provide documentation to support the transactional suitability determination.

We also are encouraged to see that many companies have taken steps to raise awareness of potential cognitive impairment of senior customers. Several companies reported developing training programs to raise awareness of these issues with their producers.

CEFLI would like to thank all compliance and ethics professionals from CEFLI Member Companies as well as non-CEFLI Member Companies who responded to the 2012 CEFLI Annuity Suitability Benchmarking Survey for offering your insights and perspectives. We hope that all Survey respondents find this information to be useful. CEFLI also would like to thank its Member Companies and Affiliate Members for their financial support of the 2012 CEFLI Annuity Suitability Benchmarking Survey.

THE FORUM THAT CONNECTS.



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