MICHAEL B. VAUGHAN
is the managing director of the J.G. Wentworth Annuity Purchase Program,™ which has purchased more than $1 billion in annuities and other deferred payment obligations over the past 14-plus years.

Vaughan can be reached at J.G. Wentworth, 40 Morris Avenue, Bryn Mawr, PA 19010. Telephone: 800-535-0195, extension 2387 (direct line 484-434-2387). Email: ***mvaughan@jgwannuities.com****.*

Secondary Market For Annuities

Changes in markets and new opportunities can often trace their origins to seemingly unlikely events. For instance, India's emergence as a global economic power stems from Britain's colonial presence, which left the country with the English language skills to take on outsourced business from the west. Likewise, Dwight D. Eisenhower's interstate highway bill in 1956 gave rise to the modern hotel and home building industries.

Thus, when historians look back at the meteoric rise in the annuity market, to what will they attribute its origins? Likely global trade. As American companies began to compete with lower cost producers overseas, they slashed costs, which more often than not included cutting defined benefit retirement plans. As more Americans took (or were forced to take) more responsibility for funding their retirements, they began to aggressively purchase financial products which offered solutions. As the graph (on page 60) indicates, this trend, combined with the rise of mutual funds and options for variable annuities, made annuities one of the most popular financial products ever.

However, the full story on annuities may not be told yet. An emerging secondary market—that is where investors can sell their annuities—represents a new frontier for the industry. If there are trillions of dollars backing the total annuities now in force, then providing liquidity to annuity holders who are "restless" is a multi-billion dollar market that is sitting in plain view.

Trouble in Paradise

The importance of a secondary market goes deeper. Such a market may unlock billions, perhaps another trillion in new demand. If this seems far-fetched, then consider what would happen to the average daily volume on the New York Stock Exchange if investors could only purchase shares there, but not sell them. The fact is, liquidity drives the sale of financial products and services because it gives investors options.

There's plenty of evidence to suggest that annuities, though popular, need the kind of enhancement that liquidity provides in order to maintain their growth trajectory. The press regularly takes annuities to task. Following are some recent pearls:

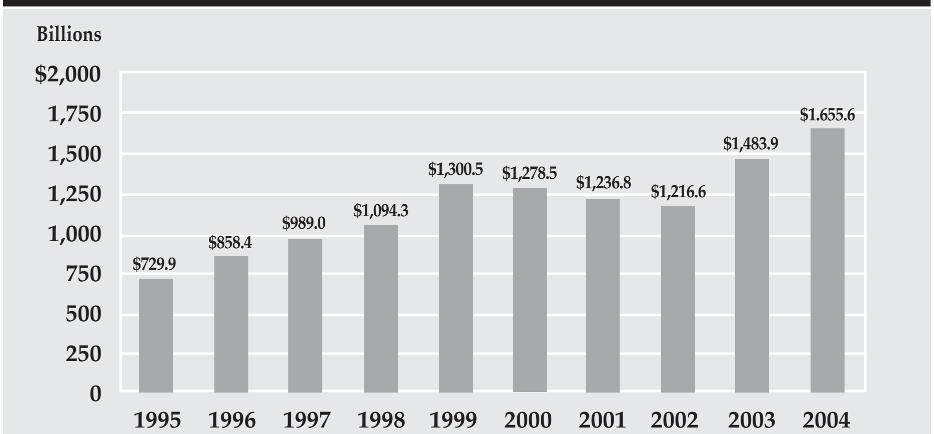
- ✔ "In the end, not very many of us should be investing in annuities at all. Yes, there are reasons why they sometimes make sense, but there are even more reasons why they mostly do not." —*suzeorman.com*
- ✔ "Annuities by and large: are too expensive, offer mediocre insurance coverage, restrict the owner's investment choices to so-so, ho-hum, quasi-mutual fund subaccounts… and lack liquidity." —*The Motley Fool*
- ✔ "I have never been a big fan of variable annuities, and there's been little reason to change my mind…" —Dan Wiener, *The Independent Advisor for Vanguard Investors.*

And it's not just unkind words. Lately regulators have been taking aim at the annuity market, cracking down on insurers and agents alike for sales practices. The

Reprinted from BROKER WORLD November 2005
Used with permission from Insurance Publications

www.brokerworldmag.com
Subscriptions $6/yr. 1-800-762-3387

Total Annuity Assets



Source: NAVA 2005 Annuity Fact Book (NAVA, Morningstar, Inc., and LIMRA Int'l)

root cause of many problems associated with annuities, perceived or otherwise, is the lack of liquidity and the problems this can cause the investors who own them. Thus, a secondary market for annuities is very much in the interest of the insurance industry as a whole because it will aid and abet the continued sale of a profitable product while providing consumers with more options.

The Look and Feel of the Marketplace

At this juncture it's worth noting what today's secondary market actually looks like, and how it works. Though someday annuities may be traded on a floor that looks like the new York Stock Exchange, or through competing market makers like the NASDAQ, today the secondary market is very much a specialty finance product distributed through brokerage general agents (BGAs) and funded by specialty finance firms.

Presently, BGAs provide the optimal distribution channel for secondary market activities. First, BGAs can provide the broad-based education that agents and brokers will need to understand the secondary market for annuities. Second, BGAs can provide promotional and collateral materials that agents and brokers will need to market the program to their clients. And finally, BGAs can perform an important repository function, helping to ensure that the flow of information between end clients and the specialty finance companies which buy annuities is uniform—which in turn is a key element of liquidity.

Parenthetically, it's worth noting that like other exchanges, the secondary market for annuities runs on the capital of its specialists or market makers. But unlike other marketplaces, the total capital of the specialty finance firms that act as principals in transactions is theoretically unlimited. Why? Since annuities are contracts governing current or future payment streams guaranteed by a third party, investors can earn a spread between the yield on annuities and their cost of capital. As long as this spread is positive, debt capital will flow into the secondary market. Because of this dynamic, funding sources can handle the demand for annuity sales, however large the market may get.

This is good news since there may be up to $100 billion in annuity assets annually in which the annuity holder is "restless," a term which refers to factors that might cause an individual to sell his annuity. These factors include but aren't limited to:

- ✔ The inheritance of an annuity where there is significant divergence between the financial objectives of the original annuitant and the heir.
- ✔ A change in investment strategy.
- ✔ A change in estate planning or wealth transfer strategy.
- ✔ The remodeling of a home or purchase of a second home.
- ✔ A sudden and significant medical expense.
- ✔ A regrettable initial decision.

While these factors will continue to drive demand for annuity sales by individual annuity owners in the secondary market, the overall scope of the market is tempered by features of certain annuities.

First, annuities must have a non-qualified tax status to meet the criteria for sale in the secondary market. Those with so-called qualified tax status, i.e., retirement vehicles, cannot be sold.

Second, the sweet spot of the market consists of annuities that have some form of a guaranteed payment option. Immediate or deferred annuities with a period-certain, life with period certain or life only with guaranteed minimum income benefit, cash refund value or installment refund value all represent viable options, in addition to deferred annuities with a guaranteed surrender value.

A Win-Win for Agents

The emergence of a secondary market for annuities is more than a win for insurance companies; however, it also offers substantial benefits to agents and brokers in the area of client recruiting, retention and overall profitability.

With respect to profitability, helping clients sell their annuities offers agents a new commission opportunity from their existing book of business. At first blush, this would seem to be a limited opportunity—only a subset of the annuities in an agent's book. But the market is much deeper because it also includes many of the annuities held by agents' clients that may have been sold to them by other financial services professionals. With more than $1.6 trillion of assets behind annuities now in force, the opportunity to provide liquidity for them is a very large market. Moreover, this is only part of the equation. Additional commissions can be earned when the proceeds from the sale of the annuity are reinvested in other insurance and investment products.

With respect to client retention, a secondary market for annuities offers agents a new opportunity to strengthen relationships with their clients. How is this so? Although selling an annuity is easy with a secondary market in place, making the decision to do so is not. There are several factors to be weighed, and it's a complex assessment. In many cases the client may be unaware that the secondary market for annuities even exists. But it's this complexity which offers agents a perfect opportunity to reach out to clients and help them sort through options.

While in some cases it will turn out that clients should hold on to their annuities, the benefits in terms of the client/agent relationship have already been realized. It's this deeper level of trust and interaction from which other products and services can be marketed.

Finally, marketing with the proposition that you can help clients buy and sell annuities is dramatically different and, for many consumers, is more appealing than one which says you can help them simply select annuities. While the latter appeal is a sales proposition, the former is a full service, solutions-based proposition. Said differently, if your marketing materials say "annuity product specialists," they may never rise above junk mail status among prospects. However, "cash for your annuities now" is new and provocative, and for many consumers the kind of solution they have been looking for.

Beyond these benefits, it's worth noting that getting into the liquidity side of the business is straightforward. There are no licensing requirements. There is no lengthy appointment process. Transactions are quick, completely customizable with purchases of partial payments and/or partial terms and, perhaps most importantly, unlike some of the more Byzantine products out there, they are easily understood by clients.

Getting Down to Cases

How does all of this sort itself out with real people facing real challenges? Below are actual policies and actual quotations with only first names used to preserve anonymity. While each individual was offered several options for their quotation, these mini case studies detail only the option the client ultimately pursued.

Funding Education. David bought a single premium immediate annuity, 30 years period certain, to provide a guaranteed stream of income after selling his business at age 45. Unfortunately, David died prematurely, leaving his wife, Cheryl, with two children about to start college. Cheryl needed to fund their tuition over the next four years. David's annuity was funded with a $600,000 premium and annuitized with a monthly benefit of $2,842.85. Cheryl had been receiving payments from the annuity for 14 years when she decided to sell 10 years worth of payments for $244,844 to fund her children's college education. Cheryl is scheduled to receive the remainder of the unsold annuity payments after that 10 year period.

Starting a Business. Jim wanted to give himself guaranteed retirement income for the rest of his life and purchased an annuity with guaranteed monthly installments for 20 years or the rest of his life, whichever is longer. The $1.2 million premium provided monthly income of $7,865.40. Jim's planning paid off, as his income was well matched to his expenses. But life changes, and unexpectedly Jim found himself in a new business venture with his son, for which he needed $137,000 to fund equipment purchases and leasehold improvements. Jim's situation was complicated by the fact that even though he was working, the start-up nature of his company meant he still needed to draw a monthly income from his investments.

Jim sold five years' worth of payments at $2,713.84 per month for the required $137,000. During this 60-month period, Jim would continue receiving $5,151.56 a month from the annuity, satisfying his need for ongoing income, and then would receive the full $7,865.40 monthly payment after that five-year period.

Getting Out from Under Debt. Susan, 67, looking squarely at retirement, was looking to accumulate high guaranteed returns in a tax-deferred investment product. Susan and her husband had purchased a flexible premium deferred annuity with an annuitization bonus naming Susan as the owner and the annuitant. However, medical and funeral bills associated with her husband's death left Susan with more than $90,000 in debts. The annuity, which was funded with a $90,000 premium, had a surrender value of $83,490.78 and an accumulation value of $112,829.09. The policy could be annuitized at any time, and Susan chose to annuitize it for $1,103.03 a month for 10 years certain, with life thereafter. To meet her objectives, Susan sold 120 payments—10 years' worth—For $95,000. After the 10 year period is up, Susan will receive the full monthly payment of $1,103.03 for the remainder of her life.

These examples clearly demonstrate that annuities provide exactly what most investors ultimately need: a tax-deferred investment vehicle and an option for a guaranteed income stream. However, they also clearly illustrate that when individuals least expect it, their life changes, creating new demands and new challenges for them financially. By agents and brokers offering their clients liquidity options, individuals can sell all or a portion of their annuities so they can confront the financial challenges they face. But the importance of liquidity for annuities goes beyond the impact on individuals and the financial professionals who advise them. Someday in the future, it may be a footnote which historians point to as the primary reason that annuities were one of the most successful financial instruments ever developed.