RESPONSES AND OBJECTIONS

OF

ALLIANZ LIFE INSURANCE COMPANY OF NORTH AMERICA

TO THE

MARKET CONDUCT EXAMINATION REPORT

AS OF DECEMBER 31, 2005

BY

VERMONT DEPARTMENT OF BANKING, INSURANCE, SECURITIES AND HEALTH CARE ADMINISTRATION

I. INTRODUCTION

Allianz Life Insurance Company of North America ("Allianz" or "the Company") has carefully reviewed the Market Conduct Examination Report as of December 31, 2005 ("the Report") by the Vermont Department of Banking, Insurance, Securities and Health Care Administration and is hereby responding to the Report. As an initial matter, Allianz is committed to serving consumers and complying with state insurance laws and regulations. Allianz has implemented, and continues to improve, compliance practices that meet or exceed Vermont's insurance law requirements.

Allianz respectfully disagrees with a number of the findings, conclusions and recommendations contained in the Report. As further discussed below, a number of the examiners' findings, conclusions and recommendations are not based on facts, are factually inaccurate, constitute unsupportable opinions or conclusions, or seek to impose obligations not found in Vermont law.

The most significant flaws relate to the Report's overreaching, unsupported assertions about the value and suitability of annuities for seniors generally, assertions which serve as the foundation for other conclusions about the Company's compliance and distribution structure. Much of the Report rests on the vaguely stated and misinformed assumption that "many of the advantages of annuities are realized only after a long period of time." The Report relies solely on this assumption to summarily conclude that annuities have a "higher probability of unsuitability" for senior consumers and "more care is needed." This assumption and conclusion, combined with the fact that the Company sells annuities to seniors, then serve as the primary rationale for the Report's conclusion that the Company knew or should have known that unsuitable sales were taking place and that the Company was deficient because it did not directly control and supervise its producers, all of whom are independent.

The examiners' use of factually unsupported assumptions prevents a meaningful and fact-based analysis of (1) suitability as to each (or any particular) sale and (2) the Company's knowledge of allegedly unsuitable sales. The sweeping nature of the assertions, and the examiners' strong reliance upon them, fundamentally undermines the Report's findings and conclusions. This is particularly true in the face of the limited amount of actual evidence of suitability issues in Vermont. As we previously informed the examiners, our review reveals a total of only five Vermont suitability complaints during the four-year examination period (2002-2005).

The examiners' views ignore many features of Allianz's annuities that appeal to and serve the goals and objectives of consumers age 65 and older. Indeed, recent market turmoil has reminded financial experts and consumers of the advantage of the guaranteed benefits of annuities. At the time of purchase and throughout the duration of their annuities, seniors can rest assured knowing that their contract values will not decrease due to market losses and that their annuities offer a guaranteed stream of income, providing protection against the risk of living past the "average" life expectancy.[1] David Babbel, a Professor of Insurance and Finance at Pennsylvania

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[1] The Report's suitability conclusions fail to consider the increasing longevity risk of the population. According to a report published by the Society of Actuaries in 2006 a woman who is age 65 has a 75% chance of living to 80 and a 37% chance of living to 90; a man age 65 has a 65% chance of living to 80 and a 23% chance of living to 90; and there is a 91% chance that at least one member of a 65-year-old couple will live to be 80, a 52% chance that one of

University's Wharton School and an expert on longevity risk and financial products, has called living too long the "major financial risk of the twenty-first century."[2]

In bull markets, fixed index annuities have been inappropriately criticized and measured against indexed mutual funds and other securities investments. Again, recent market turmoil exposed the shortsightedness of the critics – today it clear that the value of guarantees associated with fixed annuities is real and immediate. This lesson was not lost on the many seniors who saw the market value of their retirement assets decimated.

For the 83% of senior consumers who value guaranteed income more than above-average gain,[3] Allianz annuities have held their ground, safely protecting consumer premiums and ensuring guaranteed income while offering an opportunity for additional interest when the stock market is increasing. At the same time, non-guaranteed investments in or tied to stock market gains and losses have gone on a roller coaster ride. Since January 1, 2002, the beginning of the examination period, the fifth-longest bull market in American history occurred. On October 9, 2002, the Standard and Poor's 500 Index ("S&P 500") closed at a low of 776.76. On October 9, 2007, the market reached a high of 1565.15, a 101% increase over 60 months. Between the October 2007 market peak and the March 2009 closing low, the S&P 500 declined 888.62 points or 57%. As of December 2, 2008 (before the S&P hit 11-year lows in 2009), the Urban Institute reported losses of $2.8 trillion dollars in workplace retirement plans for the previous 14 months.[4] And, because equities account for about half of assets in the typical account of households age 50 and older, older Americans have suffered from and continue to be subject to substantial declines in the value of their retirement portfolios.[5]

The following graphs offer examples of the significant risk of loss of principal and accumulated gain facing investors in nonguaranteed securities products and the comparative absence of such risk to purchasers of fixed index annuities. These graphs, which do not incorporate any dividend benefits accruing to securities investors, illustrate three different Allianz fixed index annuities issued at different times during the examination period.

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them will live to at least 90, and a 6% chance that one of them will live to be 100." Key Findings and Issues, Longevity: The Underlying Driver of Retirement Risk," Society of Actuaries at www.soa.org, July 2006.

[2] David Babbel, "Investing Your Lump Sum Retirement," Wharton Financial Institutions Center at fic.wharton.upenn.edu/fic, Aug. 14, 2007.

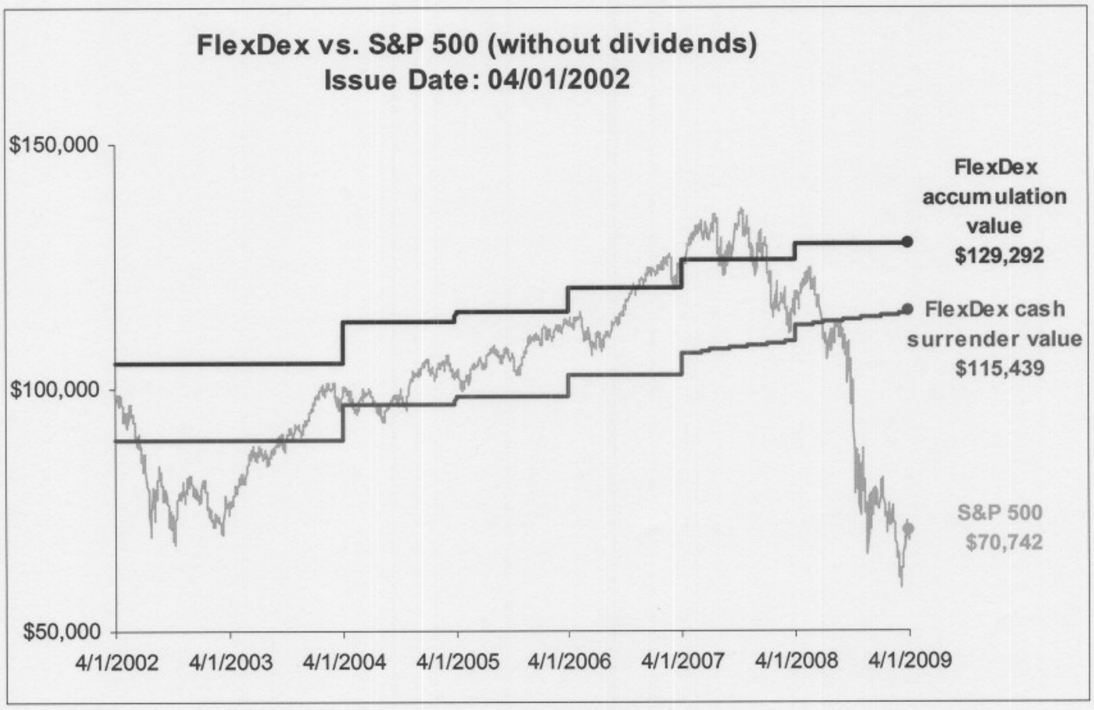
[3] In a study commissioned by Fidelity Investments, Mathew Greenwald & Associates, a market research firm, reported that "for 83% of investors aged 55-70 served by an independent registered financial advisor (RIA), guaranteed income is more important than above-average gains." Mariana Lemann, "Fidelity Shuts Down Guaranteed Annuity Product," *Ignites* at www.ignites.com, Apr. 6, 2009.

[4] Mauricio Soto, "How is the Financial Crisis Affecting Retirement Savings? December 3, 2008, Update," The Urban Institute at www.urban.org, Dec. 3, 2008. *See also* Jennifer Levitz, "Workplace Retirement Plans Suffer $2 Trillion in Losses," Wall Street Journal at wsj.com, Oct. 8, 2008.

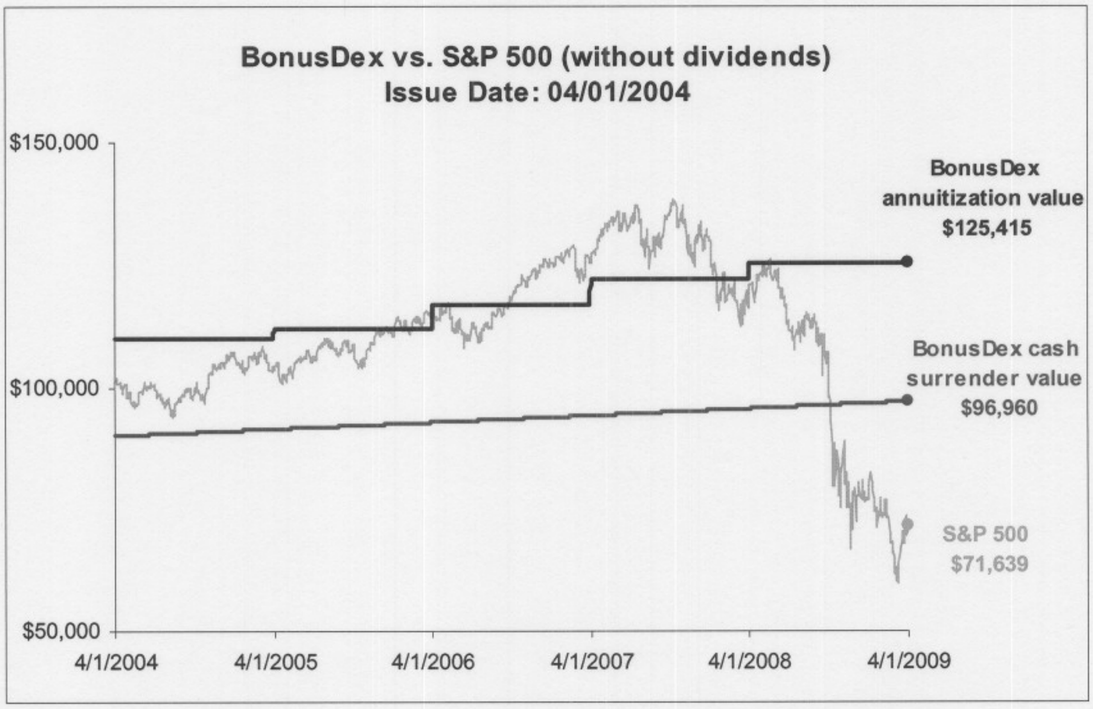
[5] *Id.*

- Graph One shows the performance of a FlexDex annuity during the seven-year period from April 1, 2002 through April 2, 2009.
- Graph Two shows the performance of a BonusDex for the five-year period from April 1, 2004 through April 1, 2009.
- Graph Three shows the performance of a MasterDex 10 annuity for the four-year period from April 1, 2005 through April 1, 2009.

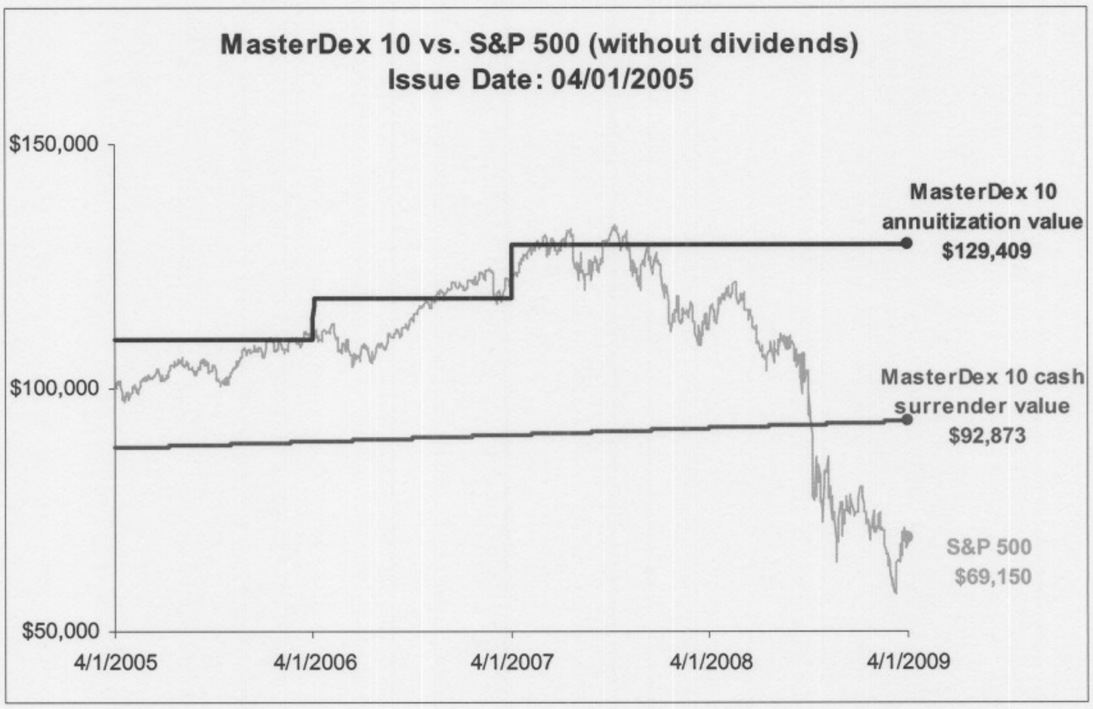
Graph One



Graph Two



Graph Three



One of the longest bull runs in American history occurred during the period under examination (2002-2005) and during the period of examination by the Department. However, since that time and as a result of the recent financial crisis, many important lessons have been learned. One lesson, as vividly demonstrated by the above charts, is the real and immediate value inherent in the guarantees provided by fixed index annuities.

With respect to other aspects of the Report, the Company acknowledges some violations of certain Vermont insurance laws and regulations and it has, as noted in the Report, already taken remedial measures to prevent such violations in the future. However, the Company disagrees with a number of the Report's other allegations of deficiencies and with the examiners' recommendations to address them, in part because the Company in fact complies with the relevant Vermont insurance laws or regulations. Moreover, as further described below, Allianz has developed and implemented enhanced practices, including practices related to suitability and replacement, that meet or exceed Vermont's insurance laws and regulations, as well as the NAIC Suitability in Annuity Transactions Model Act.

Notwithstanding Allianz's objections to a number of the recommendations not presently required by existing laws or regulations, the Company would welcome further discussions with the Department. Indeed, the Company would appreciate an opportunity to provide more detail about its current policies and practices, which are outlined below, because it believes they address the concerns expressed by the examiners.

II. ALLIANZ'S ENHANCED CONSUMER PROTECTION PRACTICES

Allianz is committed to helping consumers purchase products that fit their financial goals. As explained below, Allianz has developed and implemented programs to help consumers make informed decisions about the features, risks, limitations, and benefits of Allianz products.

A. Suitability

Ensuring that consumers, including seniors, purchase financial products that meet their financial needs is a key objective of the Company. This objective has driven the development of and continuous enhancements to the Company's Suitability Review Program.

Planning for Allianz's Suitability Review Program began in early 2004. On October 1, 2004, the Company initially launched the Suitability Review Program in four states. In July 2005, the Program was expanded to transactions involving consumers of all ages in all states. From its inception, the Suitability Review Program required that all producers, except registered representatives whose sales are supervised for suitability by a broker-dealer, submit a Product Suitability Form with every annuity application. The Company used the information found on the Product Suitability Form to identify suitability red flags, which would trigger a manual review of the accompanying application.

Although Allianz's initial program was already more expansive than what was required by state insurance laws and regulations and the NAIC Suitability in Annuity Transactions Model Regulation ("NAIC Model Regulation"), Allianz continued to evaluate and improve its Suitability Review Program.

In 2007, Allianz implemented three significant enhancements. First, beginning in March 2007, Allianz stopped allowing consumers to opt-out of providing information relevant to suitability. In contrast, the NAIC Model Regulation is less rigorous, permitting consumers to opt-out of providing suitability information and, in such cases, excusing producers from assessing suitability. In addition, Allianz introduced new measures that facilitate producer and Company analysis of the suitability impact of surrender charges associated with replacements. Finally, in the fall of 2007, Allianz enhanced the process by which it evaluates and improves the Suitability Review Program by appointing a Chief Suitability Officer.

Enhancements continued in 2008. In the spring, Allianz implemented a nationwide policy to call new fixed annuity policyholders age 75 or older to verify policyholder understanding of key features of the product just purchased. In addition, the Company recalibrated its red-flag tests, increasing the number of annuity applications qualifying for elevated suitability review.

The Company's Suitability Review Program exceeds regulatory requirements. This was true even before Vermont began its examination. The Suitability Review Program implemented on a limited basis in late 2004 and nationwide in July 2005 was based upon the NAIC's Suitability in Annuity Transactions Model Regulation. Notably, the Company applied its Program to transactions involving consumers of all ages in all states almost a year before the NAIC Model Regulation was amended in 2006 to apply to all transactions. Moreover, the July 2005 nationwide roll-out occurred prior to the date that many states adopted the NAIC Model Regulation, which Vermont and some other states still have not adopted.

B. Replacements

As reflected in the Report, Allianz implemented a new system to facilitate compliance with the replacement items noted in the Report. Allianz has also incorporated into its Suitability Review Program and producer education and compliance programs various features to address replacements. For example, features included in the Suitability Review Program include heightened focus on replacements involving significant surrender charges and replacements involving applicants age 75 and older.

After planning that began in early 2006, Allianz implemented a formal and systematic process for monitoring producer replacement activity on January 1, 2007. Each quarter, a report is generated that identifies each producer whose sales of the Company's annuities through replacements exceed certain thresholds that Allianz established based upon a producer's total number of replacements and a producer's replacement ratio (i.e., the percentage of sales that involve replacements). If listed on the report, a producer's sales activity for that quarter is examined and it is noted if the producer appeared on a prior report. A combination of action may be taken based on evaluation of replacement activity, including the issuance of a warning letter, mandated education, and termination of appointment. This replacement monitoring data is currently integrated into Allianz's Agent Oversight Program.

C. <u>Producer Education and Compliance</u>

Allianz has consistently worked to educate its independent producers about Allianz products and compliance expectations. And, although Vermont laws and regulations do not impose on Allianz supervisory requirements as to independent producers, the Company's compliance program has grown from a focus on analyzing and addressing complaints to spotting and resolving compliance issues at an earlier stage. More importantly, Allianz remains committed to enhancing these processes.

1. Producer Education

While Allianz's annuities are distributed through independent producers, the Company has maintained a program for educating these independent producers about the Company's annuity products and regulatory and internal compliance requirements.

During the examination period, the Company used multiple means to educate producers about the terms and features of its products. Among other things, the Company distributed and made available a variety of written materials and media for educating producers about the terms and features of each of the Company's annuities. Allianz employees knowledgeable about the products also regularly engaged producers in individual and group settings to provide education on Allianz annuities or address product questions. Allianz promoted attendance at these sessions through Field Marketing Organizations ("FMOs") and by direct invitation from the Company via facsimile, mail, e-mail, and the Company's producer-only website. And any launch of a new product involved extensive efforts to educate about the terms and features of the product.

The Company also had regular producer and FMO conference calls and video conferences with FMO employees, where it addressed product features. And during the exam period, it began offering web-based seminars ("webinars"), often addressed to product terms and features. The Company also maintained a well-advertised and utilized toll-free number for producers manned by staff who were well-trained to answer product-related questions.

At the outset of any appointment, the Company informed all new producers of its expectations on compliance in its "Compliance Guide to Successful Business." The guide has been updated as Allianz has enhanced its compliance and education processes, including those addressing suitability requirements.

Allianz has regularly improved its independent producer education processes. These improvements include enhancing educational content and technology, and increasing the frequency of educational opportunities. In material generated for producers, the Company addresses compliant sales process issues, including the importance of and details about Allianz's Suitability Review Program. In addition, in 2006 the Company developed the "Agent Guide to Annuity Suitability." The Guide provides an easy-to-understand description of how to complete and assess information provided on the Product Suitability Form. Webinars are also a key component of education efforts. Since 2006, the Company has offered approximately 50 webinars per year. The number of webinars is growing and they are now available on the producer website, allowing producers to access educational offerings whenever they need.

In January 2008, Allianz further enhanced producer education by launching the Allianz Partnership for Consumer Trust (PACT). Under PACT, to continue selling the Company's annuities, producers are required to read and sign the "Allianz Code of Best Practices." The Allianz Code of Best Practices details producer responsibilities in four separate areas: suitability, replacements, disclosure, and compliance with other Allianz policies (e.g., compliance with our Agent Guide to Annuity Suitability and Compliance Guide to Successful Business). To further facilitate producer compliance with PACT, Allianz developed interactive eLearning modules addressing suitability, replacement, and disclosure.

In addition to more formal educational initiatives, the Company's Suitability Review Program operates in a way that facilitates regular one-on-one product and suitability education. The Program involves a regular dialogue between the producer and the various members of the Suitability Review Team about facts relevant to the suitability assessment, the product, and the producer's analysis of suitability. Additional producer interaction will often occur if additional levels of suitability review are warranted, including the results of any action by the Advanced Review Committee. The thousands of producer calls made during the suitability review process provide producers insight on how to better assess the suitability of Allianz's products and reinforce the Company's suitability expectations. The Company also follows up with consumers — every approved annuity sent to a consumer includes a form confirming the suitability details upon which the sale was based.

2. Compliance Review

During the examination period and in addition to the education activities discussed above, the Company reviewed producer activity for compliance issues. For example, the Company regularly reviewed FINRA (f/k/a NASD) disciplinary actions and, where appropriate, took action if an independent producer appointed by Allianz was involved. In addition, the Company monitored written complaints about producers (received by the Company directly or through the Department), including complaints about misrepresentation or improper replacements. Each complaint triggered a review of the allegations and, when appropriate based on the evidence, remediation to the consumer and action against the producer. Allegations of fraudulent or otherwise serious producer misconduct were reviewed by the Company's Special Investigation Unit.

As in its other areas of operations, the Company has sought to strengthen policies and procedures designed to effectuate producer compliance with suitability and other regulatory and internal standards. For example, beginning in 2007, additional quality control measures were implemented for the Special Investigation Unit. A manager of the SIU reviews investigation files on a quarterly basis to ensure appropriate action was taken. In addition, the SIU collects and monitors SIU metrics on a quarterly basis to identify trends.

The Company also developed an Agent Oversight Program which was implemented at the beginning of 2008. The Agent Oversight Program complements other aspects of the Company's review of producer compliance issues by aggregating producer-related data, including data related to suitability and replacements, in a manner that allows the Company to better assess the overall adherence by producers to Allianz compliance requirements and expectations. The Agent Oversight Program consists of a dynamic data monitoring process and an Agent Oversight

Committee, which meets weekly to assess whether sanctions or other actions against producers are warranted. Those sanctions may include termination, referral to the Special Investigation Unit, mandated education, and customized remediation. The Committee also has procedures for requiring additional monitoring of producers based on criteria developed by the Company.

D. Continuing Disclosure Initiatives

Allianz is committed to ensuring that consumers fully understand its products and has taken numerous steps over the years in furtherance of this commitment. During the examination period, Allianz required producers to use, at the point of sale, a Statement of Understanding for its products. The Statement of Understanding details key annuity features, and Allianz requires the producer to review the Statement of Understanding with the consumer and have both the producer and consumer sign the statement. Over the last several years, the Company has thoroughly reviewed the system and standards used for sales materials approvals, which has resulted in improvements in the clarity of various materials, including addressing how the particular annuity product can meet various consumer needs. In addition, the Company developed a new Advertising Compliance Manual and a new Advertising Disclosures and Guidelines Manual.

Under the new Advertising Compliance Manual, the Company formalized and strengthened the process by which sales material is assigned an "expiration" or "sunset" date. Any sales material that reaches its sunset date is no longer approved for use and must be pulled from distribution until and unless the material has been re-approved. Under the new Advertising Disclosures and Guidelines Manual, the Company updated the system and standards for ensuring that all sales materials contain required disclosure language. Both manuals are regularly updated to ensure compliance with the most recent legal requirements.

III. SPECIFIC RESPONSES AND OBJECTIONS TO THE REPORT

A. Sales and Marketing – Allegedly Misleading Advertising (Report pages 15-18)

1. "Bonus" Plan Advertising (Report pages 15-16 and Recommendation 1)

The Company disagrees with the Report's finding that the promotional piece (850545-VT) regarding the PowerDex Elite annuity and similar materials (the brochures) are misleading in violation of 8 V.S.A. § 4724(13). In order for there to be a violation of Section 4724(13), the brochures must be found to "mislead or to fail to adequately disclose to the public ***the true nature of the [PowerDex Elite annuity]***."[6]

To determine whether the brochures are misleading or fail to adequately disclose the true nature of the PowerDex Elite annuity, the correct standard is to review all the information given to consumers and assess the overall impressions given to consumers from that information.[7] In

[6] 8 V.S.A § 4724(13) (emphasis added).

[7] *See generally Nissan N.A., Inc. v. Jerry's Nissan, Inc.* 853 A.2d 40 (Vt. 2004).

other words, the examiners should have considered the brochures, along with the contract summary and Statement of Understanding. Materials given to the consumers should be reviewed in their entirety, like a mosaic, and not in separate pieces.[8] The marketing of annuities, like the marketing of other financial products, is an iterative process involving not only written brochures, contract summaries, and Statements of Understanding, but also product explanations by the producer and the opportunity for the consumer to question the producer about the product and the accompanying material.

The examiners, however, focused only on the brochures and only on the phrases in the brochures that refer to the bonus as immediate. From this narrow perspective they contend:

> the bonuses do not give the policyholders an <u>immediate</u> gain. The fact is that the cash value does not include <u>any</u> extra amount in recognition of the bonus . . .[9]

The brochures never state that the bonus is credited to the cash value or that it is immediately available to be withdrawn in cash. To the contrary, the brochures clearly disclose in several places that the bonus is credited to the annuitization value. Importantly, the term "immediate gain" does not stand alone in the brochures. Rather, as reflected in the Company's prior responses, the brochures clearly state the conditions that must be satisfied to receive the annuitization value. Accordingly, a fair reading of the brochures — one that appreciates the clear disclosures and full context — strongly refutes the claim that consumers are misled by the brochures. And, taken as a whole, the brochures adequately disclose the true nature of the PowerDex Elite annuity. Moreover, these disclosures are reinforced in the contract summary, Statement of Understanding, and the policy. Accordingly, in addition to the discussions with the producer, consumers are given extensive documentation that discloses the true nature of the PowerDex Elite annuity.

Allianz also strongly disagrees with the Report's conclusion that consumers do not receive an immediate gain from the bonus feature of the PowerDex Elite annuity. For example, the bonus is immediately credited (i.e., credited on the day the policy is issued) to the annuitization value, which is used to determine the guaranteed annuitization payments. Thus, the guaranteed annuitization payments immediately and continually benefit from the compounding of the enhanced starting annuitization value. Moreover, the bonus and accumulated interest reflected in the annuitization value cannot be decreased by stock market fluctuations, as it could be if a consumer chose to invest assets in securities or other indexed instruments not supported by guarantees.

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[8] *Id.*

[9] To the extent that the examiners' findings and recommendations extends to promotional materials for the Company's single-tier annuities, these findings and recommendations are factually incorrect for an additional reason. For its single-tier products, the bonus is credited to the accumulation value, and as a result to the surrender value. The surrender value is equal to the accumulation value minus a surrender charge. From day one, the bonus increases the surrender value of a single-tier annuity.

In any event, the recommendation in the Report is unnecessary because Allianz entirely ceased using consumer brochures with the language at issue June 15, 2007. As a result, no further action by the Vermont Department is necessary.

2. **Promotional Pieces – PowerDex Elite Annuities (Report pages 17-18 and Recommendation 3)**

The Company disagrees with the Report's finding that PowerDex Elite annuity mailer pieces that contain the language "lock in gains – assures your highest value in the future" are misleading in violation of 8 V.S.A. § 4724(13). This finding does not consider the piece in the overall sales context — any consumer who decides to purchase an annuity after consultation with a producer will necessarily receive substantially more information about the product.

The examiners focus solely on the language "lock in gains" and fail to consider: (1) the language "in the future"; and (2) all of the other information given to consumers. Accordingly, the examiners fail to assess the overall impression given to consumers from that information.[10] The hypothetical example referenced in the Report, as well as current market conditions, reinforce the accuracy of the language used in the promotional piece; both reinforce the fact that gains are, in fact, locked-in and consumers are guaranteed the highest value in the future. A purchaser who has witnessed the recent stock market declines can rest assured that within the next five years, the purchaser's PowerDex Elite annuity can be annuitized based upon a value determined prior to the recent crash.

Moreover, as previously raised by the Company, the Report's description of the death benefit available under the PowerDex Elite annuity is incomplete because it fails to consider that a spouse beneficiary is entitled to decide whether to continue the contract, annuitize it or surrender it any time thereafter. Thus, the spouse is entitled to benefit from the locked-in gains.

Finally, it is important to understand that the promotional piece discussed in the Report is merely an invitation to inquire. Once a consumer indicates an interest in the PowerDex Elite annuity, the consumer will meet with a producer who is directed to review with the consumer a Consumer Brochure for the PowerDex Elite annuity, as well as a Statement of Understanding which further explains the mechanics of the PowerDex Elite annuity. The Statement of Understanding must be signed by the consumer and accompany the annuity application.

Accordingly, Allianz disagrees with Recommendation 3.

B. <u>Trade Practices – Suitability (Report pages 20-21 and Recommendation 4)</u>

Allianz disagrees with the examiners' finding that it was in violation of 8 V.S.A. § 4724(16) prior to July of 2005, as well as with a number of the specific statements and conclusions made in this section of the Report. Allianz also disagrees that the examiners have sufficient bases for their recommendations.

[10] *See generally Nissan N.A., Inc. v. Jerry's Nissan, Inc.* 853 A.2d 40 (Vt. 2004).

Section 4724(16) of Vermont's Insurance Trade Practices Act prohibits "issuing a policy when the person . . . issuing the policy has reason to know or should have reason to know that the policy is unsuitable for the person purchasing it."[11] Thus, 8 V.S.A. 4724(16) is violated only if: (i) the issuer issues an unsuitable policy to a purchaser and (ii) the issuer knew or should have known that a particular issued policy was unsuitable for the purchaser.

As evidence that Allianz knew or should have known that a policy being sold to consumers in Vermont was unsuitable, the examiners relied on four propositions: (i) their unsubstantiated presumption that annuities are less likely to be suitable for those age 65 and older; (ii) vaguely defined allegations about annuity features; (iii) the Company's reliance on appointed producers to perform the suitability determination and (iv) an assertion that Allianz lacked information to determine if contracts were suitable. As further described below, these propositions are faulty and not supported by the record, and the Department will not be able to prove the examiners' claim that Allianz has violated section 4724(16) by selling annuities to seniors.[12]

1. The Report Contains No Individual Analysis on Suitability

The most troubling statements made by the examiners, and the ones that appear to be the primary if not sole foundation for many subsequent conclusions, are that "many of the advantages of annuities are realized only after a long period of time" and that "annuities are less likely to be suitable products for much of the elderly population." As discussed in sections below, these statements are factually unsupported and erroneous. They also do not meaningfully address suitability, which requires individual examination of the product and the circumstances of the consumer considering it.

The objective of suitability review is to determine whether the features of an annuity product fit the particular financial circumstances and objectives of the consumer. Suitability, therefore, must be determined on an individualized basis. For example, a consumer may want to protect paid premium from market volatility and use the funds for retirement savings and income; another consumer may be focused on passing funds to heirs.

Because suitability is determined on an individualized basis, blanket statements as to whether an annuity is suitable for any group of consumers, such as senior consumers, are fundamentally flawed. Accordingly, determining the suitability of the two thousand forty-two (2,042) fixed indexed annuities sold in Vermont during the examination period requires an individual analysis of the circumstances of each purchaser. No such individualized inquiry was conducted by the examiners.[13]

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[11] 8 V.S.A. 4724(16).

[12] The usual standard of proof in state administrative adjudications is a preponderance of the evidence. *Huddleston v. Univ. of Vt.*, 719 A.2d 415, 417 (Vt. 1998).

[13] And, any proceeding assessing the suitability of these annuities would require evidence to be submitted of the individual circumstances of individual purchasers that existed at the time of the particular sale to prove that the sale was unsuitable.

2. The Report's Conclusion about Allianz's Knowledge of Unsuitable Sales Rests on Vague and Misinformed Assumptions about the Products and Annuity Purchasers Age 65 and Older

The initial premise for the Report's suitability conclusions is that "many of the advantages of annuities are realized only after a long period of time." There is no basis or support for this premise in the Report. This unfair sweeping characterization of annuities prevents a meaningful and supportable suitability analysis.

No only does this premise rely on an misinformed generalization of the characteristics, needs, and objectives of annuity purchasers age 65 and older, it is evidence that the examiners failed to consider the needs and objectives of each individual consumer — the fundamental factors in any suitability determination. There are many reasons why a consumer age 65 or older may purchase a financial product that requires payout over a period of time. Lifetime income may be particularly valuable for those who want insurance against the risk of outliving their assets. And, consumers often do not need this income right away; they may want to take advantage of the tax deferred growth at a fixed or indexed rate while simultaneously protecting paid premium and accumulated interest thereon.

As discussed above, the recent financial crisis has proven that the advantages of annuities immediately benefit all consumers, particularly the 83% of senior consumers who value guaranteed income more than above-average gain.[14] At the time of purchase, the Company's annuities guarantee seniors no loss of paid premium and all interest credited to their contract value if they comply with the terms of the contract. In other words, even if interest is tied to the positive performance of a stock market index, consumers know that their contract values will not decrease even if there is subsequent market crisis. It is clear that fixed indexed annuities are often suitable purchases for seniors with sufficient short-term liquidity who seek conservative financial products that moderately increase in value. Accordingly, there is no basis to assert that, because consumers age 65 or older purchased more than one-third of the annuities issued by the Company in Vermont, the Company had a reason to know that any policy it issued in Vermont was unsuitable for the person purchasing it.

3. Other Asserted Evidence of Suitability Violations

Although the primary rationale for the examiners' conclusions about suitability violations appears to be unsupported general assumptions or opinions about the product and seniors, the Report also, somewhat circularly, references other sections of the Report as support for the proposition that the Company has violated section 4724(16). A careful examination of these sections, however, reveals a stark lack of evidence of unsuitable sales that would translate into a basis for Allianz's knowledge of unsuitable sales.

The Report cites to the section on Complaints and on Free Look Grievances as Complaints. As discussed in this and prior Company responses, our review of complaints and free looks reveals a total of only five Vermont suitability complaints during the four-year examination period. This represents less than three-tenths of one percent of all sales and cannot fairly be characterized as

[14] Note 3, *supra*.

placing the Company on notice that a substantial number of unsuitable sales were taking place in Vermont. It certainly was insufficient to put the Company on notice of problems warranting remediation or a change in business practices.

The Report further references the section on Supervision and Control of Producers. In this section, the examiners allege that the Company was deficient in its supervision and control of its producers and references their replacement findings. However, it simply does not follow that, just because the examiners allege there were issues in one area (e.g., replacements), the Company was put on notice that unsuitable sales were taking place in Vermont. It is unclear how replacement statistics can be converted to conclusions about suitability, much less findings sufficient to constitute credible evidence that allegedly unsuitable sales were taking place in Vermont.

Finally, the Report references the section on Investigations. The Report documents the Company's investigations with respect to certain producers and certain annuity sales. There are no allegations of suitability concerns with respect to annuity sales documented in this section. There is documentation of certain producers' sales to seniors. Evidently, by referencing the volume of sales to seniors made by some of these producers, the examiners are asserting that Allianz knew or should have known that unsuitable sales were taking place because the examiners believe annuities are less likely to be suitable for seniors. As discussed above, there is no basis to assert that because consumers age 65 or older purchased annuities issued by the Company in Vermont, the Company had reason to believe that any policy it issued in Vermont was unsuitable for the person purchasing it.

4. Producers Determining Suitability

The Report also asserts that Allianz violated 8 V.S.A. § 4724(16) because it relied upon its producers to determine suitability, and did not on its own have sufficient information in its files to determine whether or not annuity contracts issued prior to July 2005 were in fact suitable for persons for whom they were written. This argument seeks to impose retroactively a legal requirement not found in Vermont law.

Section 4724(16) prohibits "issuing a policy when the person . . . issuing the policy has reason to know or should have reason to know that the policy is unsuitable for the person purchasing it."[15] There is nothing in Vermont law or any regulation or published interpretative guidance that prohibits a company from relying on its producers to ensure that suitable products are sold. The Vermont Department has issued a single bulletin regarding 8 V.S.A. section 4724(16), Bulletin 129. Notably, it is dated January 1, 2001, one year prior to the beginning of the examination period. More importantly, it is addressed only to insurance producers and not to insurance companies. Thus, it appears that the Vermont Department, like Allianz — and Allianz believes the vast majority (if not all) of the other companies selling fixed annuities in Vermont — viewed producers who are face-to-face with consumers as the persons best situated to make the suitability determination. Thus, it follows that had the Vermont Department believed that issuers

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[15] 8 V.S.A. 4724(16).

would also need to independently review the producer suitability determinations, it would have also addressed the bulletin to insurance companies.

Section 4724(16) does not require that an issuer collect information and separately determine whether the annuities issued were in fact suitable. Predicating a violation of Section 4724(16) based upon the fact that Allianz did not collect such information would impose an administrative policy or interpretation not previously expressed in any official and explicit agency determination, adjudication or rule. To impose such a requirement on the Company would constitute unlawful rulemaking not in accordance with the procedures of the Vermont Administrative Procedures Act.[16]

5. Allianz's Suitability Program

As discussed in greater detail in Section II.A on page 5, Allianz began developing its Suitability Review Program in early 2004. On October 1, 2004, the Company launched its comprehensive Suitability Review Program in four states and, beginning in July of 2005, Allianz adopted its nationwide Suitability Review Program. Under this program, all producers not subject to a broker-dealer's supervision for suitability are required to submit an Allianz Product Suitability Form with every fixed deferred annuity application and Allianz performs a red-flag review analysis of each such Form. Since that time, the Company has further enhanced its Suitability Review Program and has appointed a Chief Suitability Officer who is charged with monitoring and improving the Suitability Review Program. Allianz' suitability review program has exceeded and continues to exceed the requirements of the NAIC Suitability in Annuity Transactions Model Regulation.

The Company's suitability program also exceeds the requirements of Vermont's insurance laws and regulations. As stated previously, Allianz would appreciate an opportunity to further explain its suitability program and believes that upon learning more, the Department would agree that the examiners' suitability concerns have been addressed.

C. <u>Monitoring of Producers (Report pages 22-28 and Recommendations 5 and 6)</u>

Allianz also respectfully disagrees with the Report's assertion that the Company's system of supervision and control is deficient and does not comply with Vermont's statutes and regulations. The examiners assert that because there were issues regarding replacements, the Company lacked any supervision and training of the Company's producers. It appears that the examiners were influenced by the fact that the "Company does not maintain direct control over its agent(s)/registered representative(s)" and that the "agent/registered representative relationship is controlled by a contractual arrangement between the agent/registered representative and the FMO/BD."

As the Company has pointed out in its responses to the examiners, while its producers are contracted through field marketing organizations or broker dealers, it has always maintained and continually improved its education of independent producers on Company products and

[16] *In re Diel*, 158 Vt. 549, 555 (1992).

compliance expectations. It has also implemented enhanced systems for reviewing producer activities for legal compliance. These programs, which include suitability requirements and education, the Company's disclosure review initiatives, its PACT program, its Agent Oversight Program, and its enhancements to complaint handling and the Special Investigations Units, are described in detail in Sections II.A, II.B, and II.C beginning on page 5.

Allianz also understands its obligations under 8 V.S.A. section 4813c.(c), which the examiners cite as support for the recommendations and conclusions. That statute, however, does not require the Company to maintain any supervisory procedures. Section 8 V.S.A. 4813c.(c) states: "Every insurance producer or limited lines producer acting as an agent of an insurer, who sells, solicits or negotiates insurance of any kind shall, ***in any controversy*** between the insured or his or her beneficiary and the insurer, be regarded as representing the insurer and not the insured or his or her beneficiary for whose acts the insurer will be responsible."[17] This section contains no training or supervision requirements for producers. Moreover, the Report failed to cite and we are not aware of any Vermont insurance law, regulation or other interpretative material generally requiring an insurer to develop "an adequate plan of supervision and training of its agency force." Accordingly, to the extent that Vermont Division of Insurance enforces this recommendation, the Division would be imposing an administrative policy or interpretation that was not previously expressed in any official and explicit agency determination, adjudication or rule. Imposing such a requirement on the Company would constitute unlawful rulemaking not in accordance with the procedures of the Vermont Administrative Procedures Act.[18]

Again, Allianz would appreciate an opportunity to further explain its suitability, education and monitoring practices. The Company believes such a dialogue will convince the Department that Company actions have addressed the examiners' concerns.

D. Trade Practices – Monitoring Producers Replacement Activity and Replacements (Report pages 29-30; 32-47 and Recommendations 7 and 9)

As discussed with the examiners and in the Report, and consistent with Allianz's practice to address issues as identified, Allianz has adopted a new system designed to address the alleged deficiencies identified in the Report. Moreover, Allianz introduced a producer replacement monitoring system (discussed in Section II.B of this response) which has now been incorporated into its Agent Oversight Program. In addition, under its Suitability Review Program, the Suitability Review Team routinely reviews replacement transactions and frequently reviews with producers the rationale for replacement transactions. Through this process, Allianz believes that producers' understanding of the suitability of a replacement transaction is enhanced because it is based upon an actual consumer's needs and circumstances.

As indicated previously, Allianz would welcome the opportunity to further explain its Suitability Review Program, producer education program, and producer monitoring program, including its adoption of an Agent Oversight Program that includes monitoring of replacements, and believes

[17] Section 8 V.S.A. 4813c.(c) (emphasis added).

[18] *In re Diel*, 158 Vt. 549, 555 (1992).

that upon learning more about these programs, the examiners' concerns will be addressed. The Company, however, is concerned about a number of the replacement-related recommendations in the Report. These recommendations are simply not required by Vermont law. Accordingly, to the extent that Vermont Division of Insurance enforces these recommendations, the Division would be imposing an administrative policy or interpretation that was not previously expressed in any official and explicit agency determination, adjudication or rule. Imposing such a requirement on the Company would constitute unlawful rulemaking not in accordance with the procedures of the Vermont Administrative Procedures Act.[19]

E. Buyers' Guide (Report pages 38-39 and Recommendation 10)

Allianz has enhanced its practices with respect to maintaining signed copies of the Buyers' Guide by implementing additional quality control mechanisms. Allianz, however, believes that because Bulletin 110 has not been adopted pursuant to the Vermont Administrative Procedures Act, there is no basis to bring any type of action against Allianz as to its compliance with Bulletin 110.

F. Claims Practices and Procedures – Life Claims (Report pages 42-43 and Recommendation 13)

The Company would appreciate the opportunity for further dialogue with the Department to clarify this recommendation and ensure compliance.

G. Complaint Records (Report pages 46-54 and Recommendation 15)

Allianz believes that the criticisms and recommendations in the Report are based on a miscommunication between the Company and the examiners about how the examiners wished to review the complaint register and notes that the information sought by the examiners was available, contrary to the Report's conclusions. The Company notes that the complaint register is reviewed quarterly to ensure that any deficiencies are identified and corrected. Accordingly, the Company does not agree with the criticism and recommendation in the Report.

H. Other Responses

For those items not specifically discussed in this response, the Company refers to its prior responses to the examiners.

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[19] *In re Diel*, 158 Vt. 549, 555 (1992).