Game Changers

A new generation of annuity products reflects the industry's reaction to the financial crisis.

by Angelo John Lewis

There have been a lot of changes in the annuity world since the financial crisis.

Companies such as Hartford Financial Services, Sun Life Financial and ING U.S. have exited the business, while new entrants, many from the ranks of private equity firms, have entered the fray.

Variable annuity writers such as Transamerica and Axa have begun guarantee buybacks, while other VA writers have redesigned their products, and in some cases increased fees, to reduce risk and maintain profitability.

By most measures, the industry as a whole is thriving. According to LIMRA's Secure Retirement Institute, 2013 annuity sales were $230.1 billion, a 5% increase over 2012. The lion's share of growth came from fixed and indexed annuity sales, which grew 17% and 16%, respectively, to $84.8 billion and $39.9 billion. The only category to decrease was variable annuities, which totaled $145.3 billion but was down 1% at year-end compared to 2012.

The reasons for the growth on the fixed side have a lot to do with the graying of the baby boomer generation, 10,000 of whom are entering retirement every day, according to the Pew Research Center.

There are nearly 52 million boomers (ages 50 to 62) close to retirement. According to LIMRA, four of 10 pre-retirees surveyed said they would consider purchasing annuities to help meet their basic living expenses.

"One particular point that really speaks to retirement needs is pension envy," said Dave Simbro, senior vice president of life and annuity products at Northwestern Mutual. "We're seeing an ever-growing realization that baby boomers are struggling with not having what their parents had."

Clients purchase annuities for income creation over complete dependence on other investment options "out of a desire for more certainty. There are a lot of concerns about having their income directly at risk in the equity market or outliving their assets," Simbro said.

On the face of it, it would seem that the prolonged low interest environment would depress the market for fixed annuities.

"Generally, when interest rates are low, fixed products like SPIAs (single premium income annuities) don't do well," said Ken Lombardo, senior consultant of Towers Watson's life practice. "But if you look at sales in the last couple of years with pretty low rates, both fixed-index annuities and SPIAs have done pretty well. FIAs (fixed income annuities) have been hitting new highs in terms of sales and SPIA sales have been slowly drifting up even though rates are historically very low."

The surge of interest in fixed products may have to do with reactions to the events of 2008 and 2009. "Some of it is the financial crisis in terms of people being a little more attracted to something stable," Lombardo said.

Fixed annuities also look attractive when compared to CDs, which are often sold side-by-side in banks and which historically have been the conservative investment option favored by those on the brink of retirement.

In comparing the two, a recent analysis by The Bank Insurance and Securities Research Association found that at the beginning of 2013, the difference, or spread, between CD rates and average

Key Points

▶ **The Situation:** Annuity sales trends have changed significantly since the financial crisis.

▶ **What's Changed:** Fixed indexed annuity sales have increased 70% in 10 years.

▶ **What's Next:** Combined sales of SPIAs and DIAs are projected to double by 2018.

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effective yield on fixed rate annuities was very close, with annuities tracking only slightly higher.

But by the second half of the year, the spread nearly tripled, making fixed annuities more attractive to consumers.

A big part of fixed annuity sales growth is due to new and expanded distribution, including independent insurance agents, banks, broker/dealers and wirehouses.

—Sheryl J. Moore, Wink Inc.

Fixed Annuities Surpass CDs

According to Joseph Montminy, LIMRA's assistant vice president of annuity research, that spread increase was a key driver in the growth of fixed rate annuity sales in the second half of 2013.

"If you need the money earlier than expected, there might be a surrender charge that could apply. But guess what? With a bank CD, an early surrender could possibly trigger a penalty charge. For some consumers, these products make sense if you want to protect principal and earn a higher credited interest."

In recent years, the biggest increase in market share in the fixed category has been fixed indexed annuities. "Ten years ago, the industry was only selling $23 billion of these products," Montminy said. "Since then, sales have grown more than 70%. The product and market have evolved, and the number of companies active in this market has grown."

"A big part of this, quite honestly, is new and expanded distribution systems," said Sheryl J. Moore, president and CEO of Wink Inc., an annuities and life insurance consulting firm.

"Historically, this has been a product that has been distributed 80% to 90% by independent insurance agents and the marketing organizations/brokerage general agencies that they contract through. Now we have banks, broker/dealers and wirehouses that are looking at indexed annuities as a viable product for their representatives and clients."

"Today, I'm seeing close to 12% of all indexed annuity sales coming from banks, which is a huge difference, because historically that number has been closer to around 3%.

U.S. Individual Annuity Sales

2013 Year-End Results

($ in thousands)

Rank	Company name	Total	Company name	Variable	Company name	Fixed
1	Jackson National Life	$23,199,905	Jackson National Life	$20,941,810	New York Life	$6,499,457
2	AIG Companies	17,502,430	Lincoln Financial Group	14,376,215	Allianz Life of North America	6,060,390
3	Lincoln Financial Group	16,554,825	TIAA-CREF	13,929,953	Security Benefit Life	6,053,783
4	TIAA-CREF	13,929,953	AIG Companies	12,305,419	AIG Companies	5,197,011
5	MetLife	12,374,213	Prudential Annuities	11,427,916	American Equity Investment Life	4,212,355
6	Prudential Annuities	12,036,730	MetLife	10,645,327	Great American	3,936,632
7	AXA US	9,716,126	AXA US	9,678,056	Pacific Life	2,904,897
8	New York Life	9,672,995	Transamerica	8,406,000	Massachusetts Mutual Life	2,660,247
9	Allianz Life of North America	9,084,876	Nationwide Life	5,741,200	EquiTrust Life	2,523,305
10	Transamerica	8,556,217	RiverSource Life Insurance	5,230,645	Symetra Financial	2,447,853
11	Pacific Life	7,419,865	Pacific Life	4,514,968	Midland National	2,363,819
12	Nationwide Life	6,896,100	Thrivent Financial for Lutherans	3,174,818	Jackson National Life	2,258,095
13	Security Benefit Life	6,361,781	New York Life	3,173,538	Lincoln Financial Group	2,178,610
14	RiverSource Life Insurance	5,480,773	Allianz Life of North America	3,024,486	Aviva	2,084,013
15	American Equity Investment Life	4,212,355	Ohio National Life Insurance Company	2,363,818	Genworth Financial	1,808,996
16	Great American	3,978,280	Fidelity Investments Life	2,078,599	MetLife	1,728,886
17	Massachusetts Mutual Life	3,567,845	Protective Life	1,868,539	Berkshire Hathaway	1,424,307
18	Thrivent Financial for Lutherans	3,556,494	Northwestern Mutual Life	1,631,541	ING	1,339,244
19	Protective Life	2,563,367	Principal Financial Group	1,113,431	North American Company for Life and Health	1,331,703
20	Symetra Financial	2,539,512	Massachusetts Mutual Life	907,597	Fidelity & Guaranty Life	1,322,979
	Top 20	**179,204,642**		**136,533,877**		**60,336,582**
	Total industry	**229,675,000**		**145,300,000**		**84,375,000**
	Top 20 share	**78%**		**94%**		**72%**

Source: LIMRA SRI U.S. Individual Annuities Sales Survey

That's really driven change in product development, not just through shorter surrender charges but through simpler products."

Additional reasons for FIA sales growth cited by Montminy include the availability of guaranteed living benefit riders and consumer attraction to FIAs' accumulation potential. "If you go back five to seven years, many FIAs didn't have these riders. Today, we see eight out of 10 new indexed sales have guaranteed lifetime withdrawal benefit riders available. When they're available at the time of purchase, seven out of 10 are choosing them."

At the same time, there's been expansion in the number of conservative investors who aren't satisfied with the rates offered by traditional fixed annuities, but are wary of the higher risk of variable annuities despite their income potential.

"As interest rates have increased in the second half of last year, the caps on fixed indexed annuity products have risen," Montminy explained. "That makes the accumulation component of these more attractive because they have more upside potential."

"In addition, in the past year or two, companies have introduced new and unique strategies such as custom indices and uncapped strategies. The uncapped strategies may limit how the money is invested, but there are no caps on what you can earn."

LIMRA projects that sales of income-focused fixed annuity products—SPIAs and the relatively new category of deferred income annuities—will more than double from their combined total in 2013 of $10.5 billion to more than $21 billion by 2018.

(Owners of DIAs postpone payouts until sometime in the future, thereby allowing for interest earnings to accumulate).

Reasons for this growth include that these products appeal to baby boomers entering their retirement years; their expected rise in interest rates and corresponding payouts; and their growing acceptance among distribution firms and advisers.

"When you look at some of the distribution firms out there, we're seeing more of them really starting to embrace and talk about the retirement income story and the need to start focusing on retirement income. And part of that is bringing DIAs and VIAs into the conversation. That is significant because once they start embracing that story, it provides the opportunities for those sales to grow," Montminy said.

Private Equity Firms Buy In

A significant development in the fixed annuity world has been the recent rash of purchases by private equity firms of life insurers and annuity blocks of business.

According to New York State's top regulator, Benjamin Lawsky, private equity-controlled insurers now account for nearly 30% of the indexed annuity market—up from 7% a year ago; and 15% of the total fixed annuity market, up from 4% a year ago.

Lawsky is superintendent of New York State's Department of Financial Services.

The impact of PE on the annuity business is uncertain. (Read "The New Capital" in the February 2014 issue of *Best's Review* for additional perspectives).

"I think they've increased competition. Some of these nontraditional insurance companies have had great success in expanding the market and growing sales," Montminy said.

According to Moore, some private-equity-owned firms are using new product distribution strategies that involve selling their annuities through proprietary arrangements, typically giving exclusive sales rights to a particular marketing group.

"In 2006, 1% of all indexed annuity sales were made through proprietary product arrangements and today it's almost 28%," Moore said.

"That's a tremendous evolution and it really has been largely driven by some of those companies that are owned by private equity firms" such as Security Benefit Life and Athene Annuity & Life Assurance Co.

Variables, by far the largest category of annuities, are the only type of annuities that haven't experienced growth in recent years.

"Sales have bounced back from the financial crisis. But I would argue they haven't bounced back as much as they should have, given how high equity markets are now," Lombardo said. "Usually VA sales tend to track the equity markets pretty well. But if you look at VA sales versus equity markets, the equity markets are right back to where they were but VA sales are not.

"And I think some reasons for that are competition from fixed indexed annuities and some companies limiting VA volumes or exiting the marketplace. The low interest rate environment and potential volatility that companies have from having these products on their balance sheets is limiting the market's capacity for VAs with guarantees."

Cost instability has been a major factor in the exit of major players from the VA business, including

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—Ken Lombardo, Towers Watson

Genworth, ING, Sun Life, The Hartford and John Hancock.

A concern of some writers has been the high cost of funding legacy guaranteed living benefit riders, which in some cases offered consumers bullish returns.

According to a recent A.M. Best Special Report, *U.S. Life/Annuity Review & Preview*, Feb. 10, 2014, "In some cases, companies issued VAs with guaranteed withdrawals of as much as 7% per year for life, and no reinsurance is available for these aggressive—and generally underpriced—riders."

Several carriers have offered policyholder buyout options within legacy blocks in recognition of the potential balance sheet volatility associated with these liabilities.

De-Risking Portfolios

Post-crisis, VA writers have moved to de-risk contracts with guaranteed lifetime withdrawal benefits by decreasing withdrawal percentages (the amount of the income base that a contract owner can withdraw each year), lowering deferral bonuses and restricting investment options.

They've also attempted to reduce volatility by making portfolio allocations dynamically adjust to market conditions.

"To reduce the rebalancing being done on the insurance company side in terms of their hedging program, a fund can dynamically react to market conditions based on a certain target volatility level," Lombardo said.

In its report, *Managing Volatility: Tracking the Growth of an Investment Trend*, Strategic Insight estimated that as of the second quarter of 2013, $129.7 billion in VA assets were in funds utilizing managed volatility strategies.

According to the report, "the widespread use of managed volatility funds in association with VA guarantees accounts for the faster accumulation of assets and generally larger portfolios."

Tamiko Toland, in her role as Strategic Insight's managing director of retirement income consulting, monitors developments in the VA industry.

She cited structured-product annuities, a new generation of income-focused products, and simplified VAs as recent innovations in the space.

Insurers with structured-product annuities use options to duplicate the performance of an index and to buffer a percentage of downside risk, she explained.

"The original product was from Axa [Equitable Life Insurance Co.] and called 'Structured Capital Strategies'," Toland said.

"When the company came out with that in 2010, people thought it was crazy because it wasn't a lifetime guarantee product, which was the focus of everybody else in the industry. Instead it looked more like a structured product on an annuity chassis."

After the product was introduced in 2010, MetLife and Allianz Life Insurance Company of North America followed with similar products.

According to Toland, some of Axa's success with its product had to do with how it was distributed. "Axa ended up targeting a different set of brokers," she said.

"These weren't folks who were already selling VAs, but who were interested in offering structured products to some of their existing clients that didn't really need a lifetime guarantee, but just wanted a greater degree of security."

An additional VA trend is the revival of investment-only products, which Toland characterized as a return to the industry's roots.

"In the early days, VAs were created for investments. This is really a return to the roots of the product. What changed was the tax status of VAs, which is why the industry moved away from 'investment only' to death benefits and then living benefits. And eventually it turned into the GLWB frenzy that we had in the mid- to late-oughts. What you saw in 2008 is not how the industry originally looked."

Toland said the revival of investment-only VAs can be traced in part to the success of Jackson National Life Insurance Co.'s Elite Access, which was introduced in March 2012. "Their stated strategy was to create a platform to sell alternatives. That made it fundamentally different from other products on the market." That product emphasizes tax deferred growth and alternative investments rather than lifetime-income benefits.

Other companies that offer investment-oriented VAs include Axa and Lincoln National Life Insurance Company, according to a recent industry analysis by Strategic Insight.

On the other end of the spectrum is the profusion of companies offering simpler VAs, with no-nonsense and easy-to-understand contracts.

"One of the best examples of this is MetLife's Growth and Guaranteed Income VA, which has a single investment option, a very straight-forward benefit, doesn't have a deferral bonus, and has an annual ratchet. It's not complicated to understand or manage from a risk management standpoint," Toland said.

Similar products are now offered by companies that include Vanguard and Prudential.

After the financial crisis, said Montminy, the biggest change to the VA industry has been its intense focus on risk management.

"VA companies today are very careful about how they manage their risks," Montminy pointed out.

"They try to balance the value proposition to the customer against the risk they're taking with their products." BR