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Recent Developments in the Annuity World

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The annuity marketplace continues to operate in a dynamic environment that is impacted by demographic, strategic and environmental changes. Through it all, annuities have continued to evolve and solidify their position as a key financial security product for the entire population.

The discussion which follows focuses on recent developments in the major sectors of the annuity market—variable annuities, fixed annuities, equity-indexed annuities and immediate annuities.

Variable Annuities

Variable annuities have continued their rebound in sales from the declines of the bear market. This sales rebound has been driven primarily by guaranteed living benefits (GLBs). Such benefits are unique to variable annuities.

By now, most people are familiar with the three major types of GLBs:

- Guarantee Minimum Income Benefits (GMIBs)
- Guarantee Minimum Account Balances (GMABs)
- Guarantee Minimum Withdrawal Benefits (GMWBs)

We will not attempt to redefine them again here.

However, what has been interesting in the market has been the shift in focus within carriers as to the preferred variety of GLB to develop and offer. Today, the GLB of choice is the GMWB. A number of companies are on their second or third version of such a design. New designs generally charge 35 to 60 basis points annually for the benefit. More and more feature an incentive for policyholders who do not initiate withdrawals within a specified timeframe. These incentives include waiver of GMWB charges for life after that threshold point, or reduced charges prospectively. Other GMWBs allow for a benefit reset feature at defined intervals.

The second most popular GLB in terms of new development is the GMAB. Today's GMABs are characterized by relatively long waiting periods (10+ years), asset allocation requirements and annual charges between 25 and 100 basis points.

GMIBs, the original GLB, continue to be designed and sold, but have slowed in terms of new development. This slowdown can be attributed to greater pricing uncertainty (e.g., policyholder behavior), concerns over market conduct issues, and challenges in competing against a couple of strong market leaders. New designs tend to have seven-to-nine year waiting periods, and benefit bases equal to premiums rolled up at 5 percent or the maximum anniversary value, if greater.

In general, the prices of GLBs are increasing. Some of this is due to the lack of widespread reinsurance availability, impending NAIC capital requirements and pent-up market competitive forces trending in this direction. Of significant note is the fact that insurers have redirected their risk management approach for GLBs from reinsurance to dynamic hedging. Most of the top 20 variable annuity carriers now operate or outsource a hedging program to support their sales of GLBs. Future GLB products will become more heterogeneous than they are today, as hedging becomes a driver of new design ideas.

Death benefit guarantees on variable annuities have stabilized over recent times, with the greater of a premium roll-up and the maximum anniversary value typically the most generous death benefit. A few companies have introduced new death benefits with strong initial levels in excess of account value, which are effective in 1035 Exchange sales situations.

Other key topics in the variable annuity world today include the continued displacement of C-share (no front or back-end loads, but annual charges) sales with L-share (back-end surrender charges lasting two to four years) sales. L-share product compensation is continuing to creep up, in some cases approaching B-share (back-end surrender charges lasting five to nine years) sales. In 2003, 20 percent of variable annuity sales came from L-shares. Also, regulatory concern over market timing, late trading practices and suitability issues has consumed large amounts of time of many variable annuity carriers. It remains to be seen whether such areas are problematic for many life insurers, but the time and expense spent in research and regulatory response for such topics today is high.

Fixed Annuities

Fixed annuity sales dropped in 2003 after a very strong performance in 2002. This is explained primarily by the rebound in the equity markets and the continued downward pressure on interest rates.

In the fixed annuity market, carriers have struggled to maintain targeted profitability levels. This has been due to interest rate compression relative to regulatory minimums.

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In reaction to recent interest rate levels, the market has tended to move back into one-year rate guarantees instead of multi-year rate guarantees. Few reps and customers want to lock in current rate levels for multiple years at recent low levels. The implication of this trend has been that market value-adjusted sales dropped substantially in 2003. In recent months, market rates have increased materially, raising the prospect for a shift in new product focus in the future.

Other outgrowths of the recent rate patterns include a general drop in sales rep compensation levels. This has played out differently in different distribution channels. Wirehouse distribution has seen significant compensation declines, independent agents have seen moderate declines and the bank distribution only small declines.

Certain design "untouchables," such as return of principal guarantees, have received renewed looks as the cost of the guarantee in sacrificed credited rate is assessed. Bailout provisions have been re-explored as a mild alternative to a true multi-year guarantee.

Fixed annuity designs with rising rate guarantees or the potential for such rate increases have been popular. Five-year rate guarantees with stair-step rate increases such as 15 basis points per year have been popular with banks. Additionally, products with credited rates linked to the performance of an outside index or benchmark (e.g., Treasuries) provide some level of certainty to the customer that they will enjoy a return that keeps pace appropriately with market movements. Either design requires some sacrificing of the initial first year rate to allow for the locked-in future increases.

Bonus rates payable in the first year continue to be used to enhance the attractiveness of the product in the initial sales process. Such bonuses are typically modest, 100 or 200 basis points at most.

Finally, a recent development emerging in fixed annuity products is the construction of multiple value tiers which are available to the policyholder as the result of specified contingent events. The basic tier (say, a 3 percent interest rate credited tier) may be available for elective withdrawals, a 4 percent tier available upon life annuitization, a 5 percent tier available for nursing home confinements, etc. A number of options can be devised to provide substantial flexibility to the fixed annuity.

Equity-Indexed Annuities (EIA)

This variety of fixed annuity has strengthened its claim to a segment of the annuity market. More and more companies are in the EIA pipeline, even some variable annuity writers.

The new direction in the EIA market is characterized by lower sales compensation and simpler products. The distribution of the products is still dominated by independent agents and brokers, but banks and wirehouses are beginning to make some room for EIAs in their offerings.

The EIA variation of choice today is the annual ratchet product. Multi-year point-to-point products and high water designs still

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exist, but these are not the areas of intense development. Annual ratchet designs are appealing to producers and customers because of their "similar feel" to standard fixed SPDA products. They also appeal to policyholder desires to see some index credit every year.

The S&P 500 Index without dividends continues to be the index of choice for the EIA line, although a few products feature the Dow or NASDAQ indices. Other moving parts which drive the calculation of index returns are caps, averaging, participation rates and spread fees. Today, annual caps with or without averaging dominate. Participation rates are advertised as 100 percent under such designs. Simple binary designs, in which the policy's annual return credit is either X percent (if the S&P increases) or 0 percent (if the S&P decreases) are also being seen.

Nearly all EIAs are nonregistered products, largely justified as such on the basis of minimum cash value floors which equal or exceed the minimum SNFL floor. Under the new SNFL, EIAs may be permitted to guarantee a lower credited rate floor than declared rate fixed annuities and still comply with the requirements. This extra allowance is a recognition of the EIA's unique place as an index-driven fixed annuity. Some EIAs include a market value adjustment, which may move the contract into a security classification if the MVA is unbounded.

In the future, we anticipate continued creativity in EIA design, with a special focus placed on simplicity. Given the current level of complexity seen in some current products, we believe that plenty of room exists to simplify these products. Rising interest rates should provide a lift to the EIA product line, as the option budgets available to support index credits will enlarge.

Immediate Annuities

The year 2003 was rather disappointing for the immediate annuity market. Variable immediate annuity (VIA) sales dropped significantly, as policyholders looked for guarantees. Fixed sales (SPIA) rose moderately, although some of the SPIA sales were linked to funding programs for life insurance programs.

Many companies are eager to sell more SPIA business and are looking for a pricing edge or investment edge. SPIA products are not typically sold on the basis of features or creative design, such that lowest price tends to rule. Some companies follow distinct protocols for pricing larger cases (e.g., $1 million +), characterized by lower compensation and lower mortality.

Some carriers have begun to explore sales of immediate annuities to annuitants with modestly impaired health. Under reasonably conservative mortality assumptions, such annuitants could expect 10 to 15 percent higher benefits than would be offered under standard healthy life pricing. Clearly, carriers must be cautious not to bifurcate their overall pricing mechanism in approaching the impaired health market.

Certain products offer special wrinkles, such as liquidity for life contingent benefit types, increases in benefits after issue in the event of specified contingent events (e.g., disability), or enhanced early death benefits. Equity-indexed immediate annuities (EIIAs) also are getting a second look by some companies.

Summary

This article merely scratches the surface of a very active U.S. annuity market. As our world and industry change, annuity developments will occur as they always do, and carriers with the quickest and most insightful reactions will succeed. □

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