Article from

Product Matters

February 2016
Issue 103

Individual Annuity Sales And Product Trends

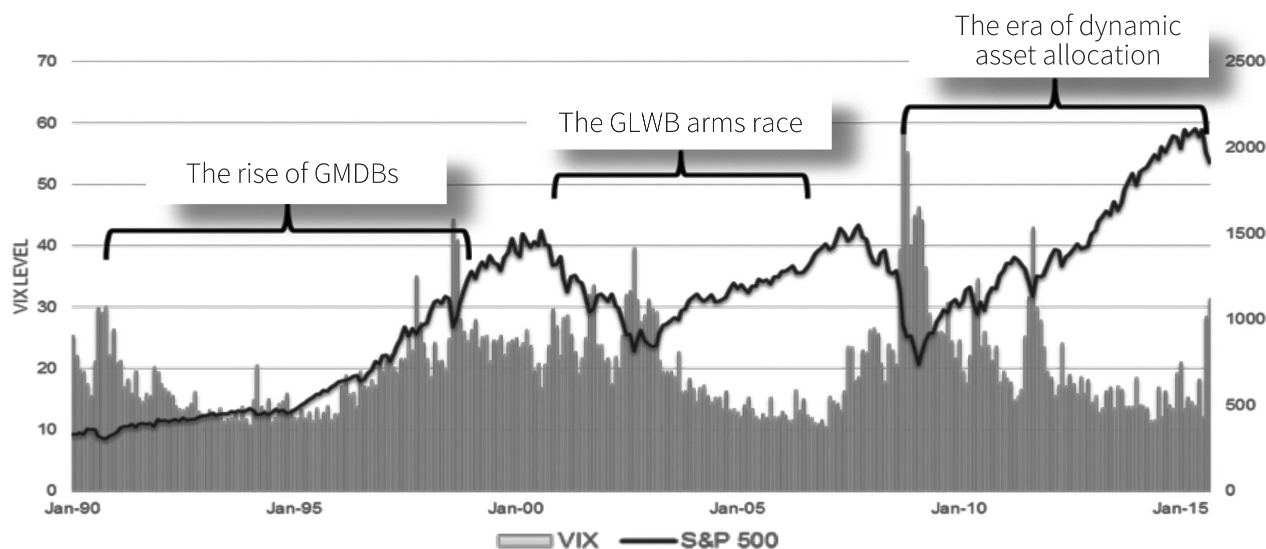
By Simpa Baiye

Thomas Edison was once quoted as saying: "There's a way to do it better—find it." Product innovation in the annuity marketplace is an excellent demonstration of the drive to find a better balance between consumer needs for guaranteed income and sustainable insurer balance sheets. This has taken place against a backdrop of low rates and record-high equity market valuations. In this article, we'll summarize broad trends across the U.S. individual annuity marketplace and focus on variable annuities, fixed indexed annuities and fixed annuities.

MACROECONOMIC OVERVIEW

A review of the individual marketplace is incomplete without an understanding of key economic variables that influence sales and product design. Chart 1 illustrates the evolution of equity market returns (measured by the S&P 500) and market volatility as measured by the VIX index.

Chart 1: Equity Markets and Volatility

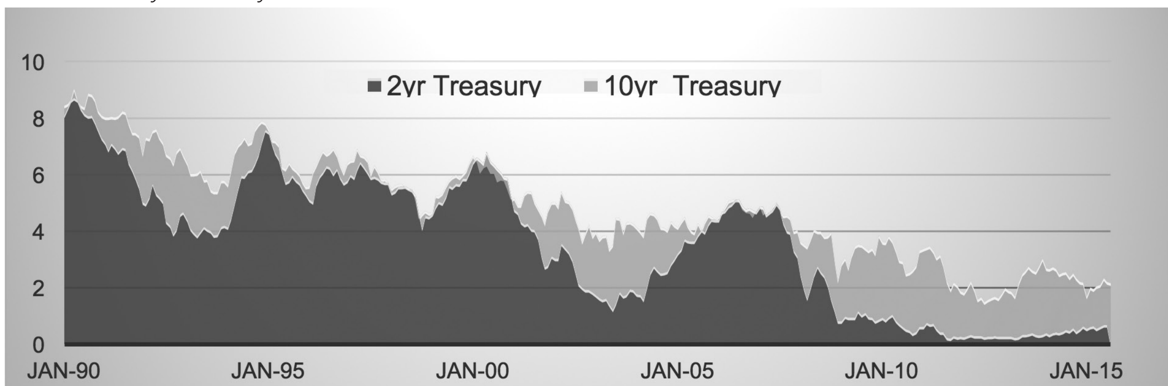


Source: Yahoo.com

Years 2002 through 2007 were marked by an aggressive push by insurers for share in the individual annuity space through attractive Guaranteed Lifetime Withdrawal Benefit (GLWB) offerings. The financial crisis brought about a strategic reset for many insurance carriers as interest rates were lowered and equity volatility rose. Years 2009 and beyond have been marked by both a required asset allocation shift away from equities and the use of dynamic asset allocation. Dynamic asset allocation comprises the use of "portfolio insurance" strategies and risk-control strategies, supplemented by a significant required allocation to fixed income. Managed-volatility risk-control strategies, in particular, were introduced in 2009—a year that marked the beginning of both stellar equity market performance and a drop in market volatility. Notwithstanding the value that managed volatility strategies have brought to the annuity space, a 60 percent equity/40 percent bond balanced fund would have likely performed better than a comparable target-equity-volatility fund from 2009 to the present time. Some in the financial advisory community have taken note of this and now question somewhat—with the benefit of hindsight—the consumer value of managed-volatility risk control.

Interest rate movements are also notable. Chart 2 shows that the 10yr/2yr Treasury rate spread—a proxy for spreads between shortterm and longterm rates—had not historically stayed very wide for more than roughly five years at a time, even in periods of relatively higher rates. However, years 2008 and beyond have been marked by both a historically unusual low rate environment and an extended high rate spread. This has both spurred a shift by consumers to fixed annuities with longer sales charge periods and created opportunities to design products geared for an anticipated shift to a higher interest rate environment. This low rate period has also led to a change in consumer expectations about the level of anticipated retirement income and the length of pre-retiree working years.

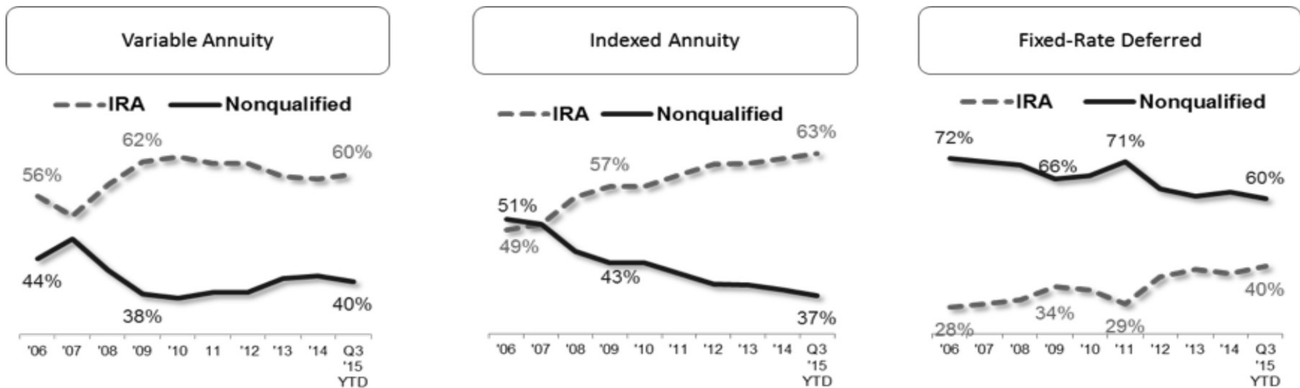
Chart 2: U.S. Treasury Rates by Year



Source: Stlouisfed.org

Broad trends in the distribution of sales across the major annuity types are also revealing. It is clear from Chart 3 that retirees increasingly seek the safety of guaranteed income offered by annuity products. Qualified assets represent much of the current flow into annuity products relative to years past. Chart 3 also shows that indexed annuity sales in particular, are a reflection of that desire for guaranteed income.

Chart 3: Qualified Retirement Assets and Individual Annuities



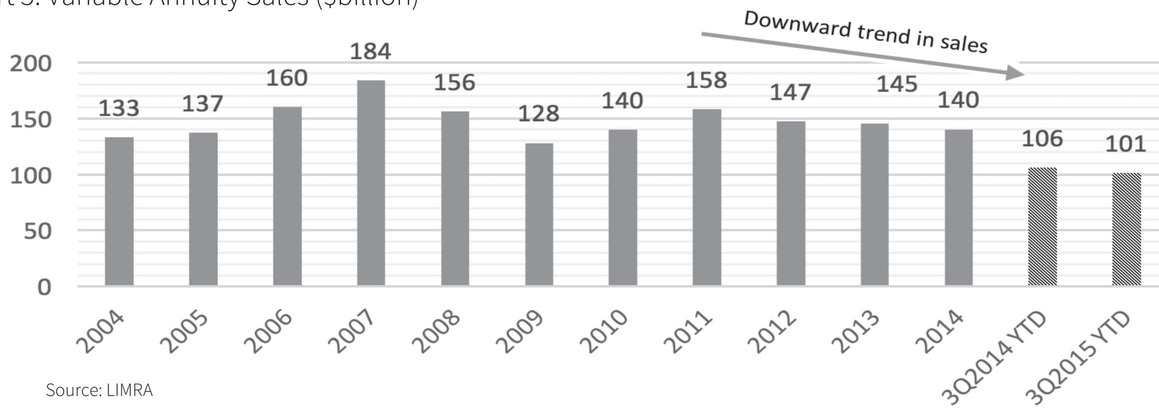
VARIABLE ANNUITIES

Variable annuity sales overall have recovered somewhat from their steep drop in sales with the great financial crisis of 2008. Insurers have "derisked" their guarantee offerings every year since 2008, with 2015 being no exception.

Guarantee offerings with rate schedules that can be quickly changed are more prevalent. Insurers now largely require some form of allocation to managed volatility funds or funds with dynamic asset allocation for GLWB elections. The overall target allocation to equities for variable annuity guarantees has been lowered in order to keep guarantee rider charges more affordable and manage the overall guarantee risk profile for insurers.

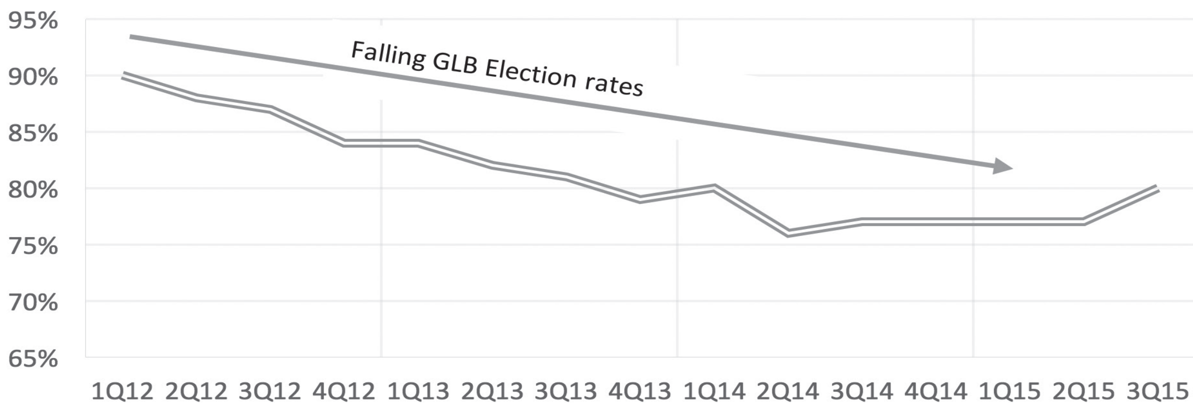
Charts 5 and 6 both suggest that the drop in variable annuity sales is connected to the overall downward trend in guaranteed living benefit elections. Feedback from distributors also suggests that the overall decline in GLWB elections has been driven in part by the drop in perceived value of available GLWBs to policyholders. This new generation of lower-risk GLWBs are much better for the balance sheets of insurance companies, but offer less attractive accumulation opportunities to policyholders. This has led to growth in investment-only variable annuity (IOVA) offerings, which generally offer a much expanded menu of investment choices that allow policyholders to grow their retirement assets until or unless guarantees need to be purchased.

Chart 5: Variable Annuity Sales ($billion)



Source: LIMRA

Chart 6: Variable Annuity GLB Election Rates



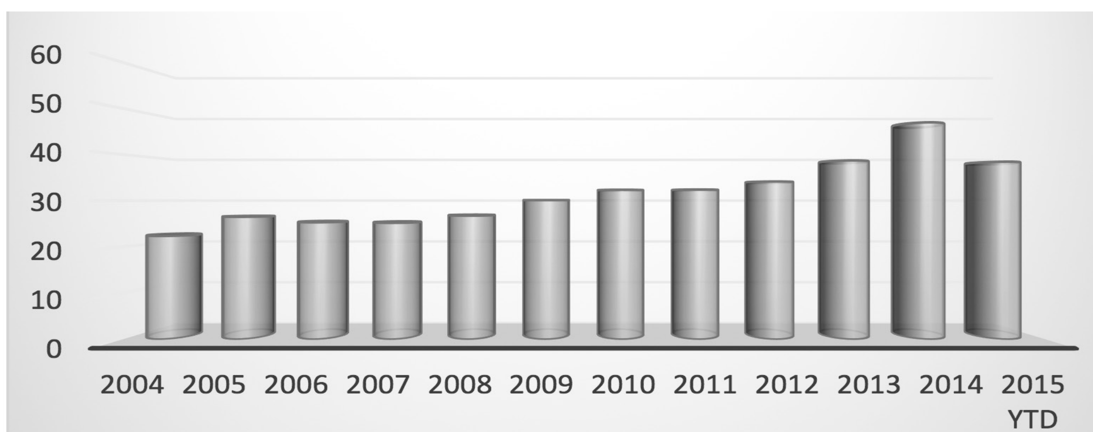
Source: LIMRA

FIXED INDEXED ANNUITIES

Fixed Indexed Annuities (FIA) sales have grown steadily for every year and have experienced significant growth in sales in the past couple of years. Chart 7 outlines this increase in market share for indexed annuities. This growth has been driven by an expansion of indexed annuities within the broker-dealer channel, the proliferation of managed-volatility indices, and the adoption and acceptance of GLWBs across distribution channels. That indexed annuity sales are growing at a time when variable annuity sales have remained stagnant is no coincidence. Securities-licensed intermediaries are increasingly comparing the value of variable annuity guarantees to indexed annuity guarantees near the point of sale in order to determine the best perceived value for their clients. GLWBs on indexed annuities generally offer more guaranteed income at the cost of the possibility that guaranteed income levels will grow. GLWBs on variable annuities, on the other hand, offer lower guaranteed income at the onset but generally offer the higher possibility that contract value appreciation could raise guaranteed income levels when withdrawals ultimately start. This tradeoff of guaranteed withdrawals for contract appreciation can be skewed to the extent that variable annuities are priced much more conservatively relative to indexed annuities.

According to tracking data from LIMRA, election rates for GLWB have risen from about 50 percent in 2010 to just under 60 percent as of 2015. The fact that these election rates are lower than election rates on variable annuities can be attributed to the fact that indexed annuities have historically been seen as conservative accumulation alternatives to fixed annuities and CDs. The increasing adoption of indexed annuities as a viable income generation vehicle should raise the election rates for GLWBs over time.

Chart 7: Fixed Indexed Annuity Sales ($ billion)



Source: LIMRA

Living benefit riders that provide a form of non-underwritten long-term care benefit are becoming more available. These riders offer benefits tied to a guaranteed base amount established at contract inception and require the fulfilment of specific assisted daily living criteria.

FIXED-RATE DEFERRED ANNUITIES

Fixed annuity sales have been impacted by the low rate environment, with sales leveling off or slightly declining in the past three years. Policyholders now generally elect longer rate terms and effectively reach for an attractive yield. Some insurers are now exploring the value of providing guaranteed lifetime withdrawal benefits on fixed annuities, and a number have launched these riders with limited success. The key value proposition of guaranteed lifetime withdrawals on fixed annuities is not the safety of principal (as the insurer already guarantees this balance) but is the opportunity to take guaranteed lifetime withdrawals. Fixed annuities with guaranteed lifetime withdrawals are conceptually closest to SPIA and DIA products that offer liquidity. It is yet to be seen how successful these riders will be in helping grow fixed annuity sales.

DEFERRED INCOME ANNUITIES

Deferred income annuities have grown in sales amongst a limited number of carriers. These products offer significant future income stream in exchange for a modest lump sum deposit and a long wait period before withdrawals start. Sales of deferred income annuities have been somewhat insignificant, with total industry sales in 2014 (according to LIMRA) of approximately $3 billion. Deferred income annuities are still expected to do well in the employer market, with the recent Department of Labor ruling on qualified longevity annuity contracts. Their success in the IRA space is all but certain, given the relative ease with which consumers can obtain both accumulation, decumulation and contingent annuitization in deferred annuities with guaranteed lifetime withdrawal options. For example, a variable annuity contract with a guaranteed lifetime withdrawal benefit of 5 percent can be viewed as an accumulation contract that allows for accumulation and planned withdrawals of 5 percent, with a contingent deferred income annuity of 5 percent per year if or when the contract runs out of money. Advisors looking to sell deferred income annuities will likely have to show their value as part of an integrated retirement solution-relative to deferred annuities with guarantees.

CONCLUSIONS

Product trends in the annuity marketplace point to a much healthier balance between a variety of consumer risk-tolerances and insurer sustainability. For a variety of arguably good reasons, variable annuity have not regained the momentum last experienced before the 2008 financial crisis. Fixed indexed annuities are increasingly seen as the vehicle of choice for guaranteed income and steady asset accumulation. The underlying innovation and shift in product sales have taken place in a period of sustained low rates, low market volatility and a significant equity market bull-run. Managed volatility offerings in both variable and fixed indexed annuities have provided a significant boost to overall individual annuity sales. The next secular change in the financial markets may very well challenge certain aspects of products that have done fairly well from a sales and earnings standpoint. High interest rates, for example, could make it more challenging and costly to retain fixed-indexed-annuity policyholder assets, but may leave insurers without interest rate-hedges on their VA guarantees in a much better financial position. Variable annuity guarantees with interest-indexed withdrawal rates would likely do better in a rising rate environment. In the words of Picasso: "Every act of creation is first an act of destruction." Creative and meaningful adaptation to the evolving financial and demographic landscape will remain an imperative for insurers, as aspects of current income solutions are rendered less useful.

Note: The views expressed herein are those of the author and do not necessarily reflect the views of PricewaterhouseCoopers LLP.

Simpa Baiye, FSA, MAAA, CFA, is director at PricewaterhouseCoopers LLP in New York, N.Y. He can be reached at *simpa.baiye@pwc.com*.

SOCIETY OF ACTUARIES

LIFE INSURANCE & MODIFIED ENDOWMENTS
Under Internal Revenue Code Sections 7702 and 7702A
Second Edition

NEW EDITION

- This new edition provides a comprehensive analysis of the life insurance qualification requirements imposed by the Internal Revenue Code
- It includes a restructuring and expansion of materials presented in the first edition, with over 100 pages of new information, including:
  - Two "student friendly" chapters that present an introduction to the qualification requirements of Section 7702 and 7702A
  - A new chapter dedicated to the qualification requirements of sections 101(g) and 7702B for accelerated death benefits and long-term care riders
  - Expanded discussions on:
    - The adoption of the 2001 CSO mortality tables and the relevant IRS guidance relating to the section 7702(c)(3)(B)(i) "reasonable mortality" requirements
    - The 2008 updates to the IRS correction procedures for noncompliance with sections 7702 and 7702A
    - Numerous private letter rulings and other IRS guidance issued since the publication of the first edition
    - And more…