
Capacity Issues

By Kerry Pechter Tue, Oct 16, 2012

A new report from Cerulli Associates addresses a big problem for variable annuity issuers: how to grow without exceeding their risk-capacity. The report suggests that SunAmerica is best equipped for growth.

Question: Now that their capacity to issue variable annuities with rich living benefits is constrained, where can major life insurance companies go for growth?

Answer: By redeploying their remaining capacity to lower-risk products—including fee-based VAs without living benefits—and aiming them at the relatively untapped market of registered investment advisors.

That's one of the findings in Cerulli Associates' new report, "Annuities and Insurance 2012: Evaluating Growth Capacity, Flows and Product Trends," an executive summary of which was provided to *RIJ* this week by the Boston-based research firm. (The full report is available for purchase from Cerulli.)

"The major takeaway is that the top 15 carriers don't currently have the ability or appetite to extend their [variable annuity] capacity, they do have an opportunity to redeploy some of that capacity," said Donnie Ethier, a Cerulli senior analyst and the report's principal author.

"This is why fee-based variable annuities are the immediate opportunity. Not only are they a way to redeploy some of that capacity from the traditional space, but we know for a fact that the fee-based channel is growing," he added.

"But is there appetite for annuities among RIAs? We know the channel is growing, but is the appetite really there? We don't know this yet. What we do know is that the guarantees are less important to RIAs than the costs and the underlying subaccounts."

The new Cerulli report, the sixth in an annual series, focuses on the ability of the life insurance industry to meet the rising risk-mitigation needs of retiring Baby Boomers at a time when depressed interest rates and elevated equity volatility limit its capacity to take on new risk.

With so many carriers dialing down VA sales or exiting the market, capacity is a front-burner topic for life insurers. At the recent annual conference of the Insured Retirement Institute, participants in a panel discussion about capacity generally played down the problem, suggesting that any advisor or consumer who wants a variable annuity with a lifetime income rider can find one.

Judging by Cerulli's report, the capacity issue isn't so easily dismissed, nor is the industry taking it as lightly as the panel seemed to suggest. Cerulli puts the VA industry's capacity at \$163 billion. This number "is reassuring as total flows are expected to remain below this figure for several years to come," the report says. "However, this affords the industry with insufficient room for growth."

As Ethier explained in an email to *RIJ*: "Cerulli estimates gross VA sales to increase to about \$164 billion by

2015, about \$31 billion of that being net sales. Therefore, we believe the industry can handle the demand side with little difficulty until then, pending an improvement and stabilization of interest rates and equity markets. In turn, this would increase the capacity, allowing increased guarantees, new entrants, etc.

“Currently, the important take-away: Supply is effectively meeting consumer demand, and we believe this will remain into the future,” he added. “However, it leaves little room for the industry to significantly expand or improve. Which brings us back to the concept of ‘redeploying levels of industry capacity,’ since extending capacity is largely at the mercy of economic factors.”

According to Cerulli, there’s reason to be hopeful about annuity sales in general. Advisors receive more unsolicited requests for information about annuities than any other financial product, Cerulli says (see chart on RIJ’s home page.) Second, the industry can switch its emphasis to other products. But much depends on the industry’s ability to reach the fee-based advisors, including RIAs and parts of the independent channel.

Here’s how an excerpt from Cerulli’s new report describes the opportunities available to life insurers:

“While capacity cannot be extended, there are numerous emerging opportunities to redeploy capacity by means of additional annuity and life insurance solutions, including contingent deferred annuities, fixed-indexed annuities (FIA), and even indexed universal life insurance (IUL).

“The most imperative necessity is to capture the attention of fee-based advisors with I-share VAs. Collectively, or independently, these solutions may assist in easing the stresses of issuing traditional VA living benefits, as well as, increase net sales.

Europe’s Solvency II regulations and their impact on the reserve requirements of large European-domiciled insurers have the potential to exacerbate variable annuity capacity issues in the U.S., Ethier told *RIJ*. Solvency II could create a “domino effect,” he said, where the smaller companies that still offer rich living benefits couldn’t absorb the excess demand from customers that larger VA issuers turn away. To protect themselves from taking on too much risk, the smaller firms—say, Guardian or Ohio National, two mutual insurers that have attractive living benefits—might be forced to de-risk their products or close certain contracts entirely.

SunAmerica, a unit of AIG, is the carrier best equipped to absorb more new business, Ethier wrote:

“SunAmerica represents one of the most optimistic numerical assumptions when calculating Cerulli’s prediction of the industry’s capacity. According to A.M. Best, AIG ranks as the fifth-largest insurer in the world, and number two in the U.S, on the basis of non-banking assets. Furthermore, it’s believed that VA assets make up less than 5% of AIG’s AUM, which is a key factor in forecasting their assistance in alleviating the industry’s capacity concern... Ultimately, over time, Cerulli is confident that SunAmerica has the product solutions, hedging mechanisms, and distribution capabilities to rise to the top of the leaderboard, if rivals make way and AIG aspires to do so.”

The variable annuity industry’s future evidently depends to a large extent on how well it can pivot from a

strategy where wholesalers tried to impress independent advisors with generous commissions and rich living benefits to a strategy that emphasizes the low fees, rich array of investment options and tax deferral that appeal to fee-based advisors.

“Clearly, the traditional pitch of variable annuity wholesalers won’t suffice,” Ethier said. “You can’t go to an RIA and say, ‘We have bigger benefits.’ It’s not that type of sale. Wholesalers need to be more specialized. They’ll need to understand the value proposition of their funds. It may make sense to have a model where wholesalers are CFAs [Chartered Financial Analysts], and have more expertise. But traditional selling will not work with RIAs.”

Ethier points out that Jefferson National has demonstrated that there’s a market among RIAs for a certain type of VA—a flat-fee VA with no insurance riders and lots of investment options. But Jefferson National’s sales, though they now exceed \$1 billion, aren’t large enough to prove that that specific niche has vast potential.

There are an estimated 47,000 advisors in the RIA channel, Ethier said, including about 18,000 who are dually licensed to sell investments and insurance. (The estimate doesn’t include the non-RIA advisors who use the fee-based compensation model.) While the overall financial advisory industry shrank slightly in the past seven years, the compounded annual growth rate of RIAs during that time was 10%, he noted.

According to Charles Schwab’s 2012 RIA Benchmarking Study, released last July, more than 1,000 RIA firms reported in excess of \$425 billion in combined assets under management, with 105 of those firms managing \$1 billion or more. The median participating firm had 186 clients, \$212 million in AUM and \$1.3 million in annual revenue.