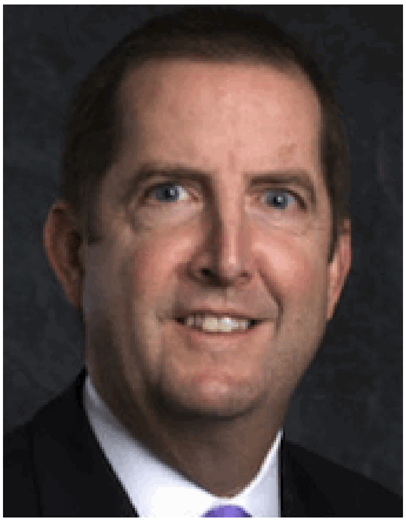
Closer to Where You Belong

By Kerry Pechter *Fri, Jul 26, 2013*

Whither the variable annuity business? We asked Bruce Ferris of Prudential, Liz Forget of MetLife, Eric Henderson of Nationwide Financial, Dan Herr of Lincoln Financial Group, Richard Moran, formerly of Symetra, Alison Reed of Jackson National Life Distributors, and Cathy Weatherford of the Insured Retirement Institute.



Everyone knows where the variable annuity business has been. First came the boom, then the bust. Then, in no particular order, came the de-risking, the buy-back offers and the industry shakeout. But where will the VA business go next? That question is a lot harder to answer.

Interviews with VA product managers at life insurers who remain "committed" to the variable annuity business show little consensus. They each experienced the financial crisis in a different way, and they all face the future with different strategies.

They agree, however, that variable annuity isn't going away. It will continue to be a go-to vehicle for tax-deferred accumulation. And demand will continue to exist for the "optional income" that GLWBs provide.

But, even after interest rates normalize, several industry leaders believe, the VA is likely to concede shelf space to other income vehicles, like deferred income annuities (DIAs), fixed indexed annuities (FIAs) and single-premium immediate annuities (SPIAs).

Clearly, product diversification will increase. It's something that was probably inevitable, with or without the financial crisis. Close observers of the Boomer retirement phenomenon have always said that decumulation is more complex than accumulation. Retirees need customized combinations of income and investment products, not one-size-fits-all remedies. So, while getting to this point hasn't been easy, annuity issuers might be a step closer to where they belong.

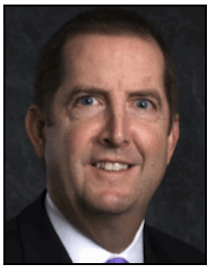
Here, in their own words, is what some prominent annuity product managers told us about the directions of their businesses:

Bruce Ferris, head of sales and distribution, Product Management and Marketing, Prudential Annuities

"To paraphrase Mark Twain, the rumors of our death are greatly exaggerated. The answer to questions about the value of variable annuities is: Compared to what? Given the capital market backdrop today, what other choices do investors and advisors have? The demand for our products and services, for guaranteed retirement income, has only continued to increase.

"A recent LIMRA survey showed that there are 42.5 million retirees today and that there will be 64 million in 2025 and more in 2050. For years we talked about the pig in the python. It's no longer the pig. It's the python. There's a dislocation of supply, but that lack of supply only spells opportunity for companies with the right skill sets and the right capitalization.

"We're a young industry. We've learned a lot. We've gone through big challenges. We've weathered the storm. Now it's up to us to deal with the capital markets environment. We have no control over it and we don't know how long it's gong to last. But, at Prudential, we see opportunity. We have a diversified growth strategy in responding to consumer needs.



"It's more challenging than ever for individual investors to meet their needs in retirement. The golden rule of 4% withdrawal no longer applies. There are some who now say that the rate at which you can withdraw from a balanced portfolio without risk of running out of money may be as low as 2.8% a year. So when I hear people say that VAs aren't as good as they were, I acknowledge that. But I also say that they are better than some of the alternatives, such as systematic withdrawal or fixed income or laddered bonds.

"The feedback we get from the distribution is that they are interested in continuity of supply and good solution sets. What's most concerning to them is that the insurer will sell a product up to its capacity limit and then go to the sidelines. To that, I point to our track record of uninterrupted supply. We've changed products but we haven't withdrawn them without providing a replacement solution. That's the great thing about the new Prudential Deferred Income (PDI) product.

"One thing that's important to our future is to respond more nimbly to capital market changes. The product development cycle is six to nine mons, when you consider the state regulatory filings. With the PDI, we can respond virtually immediately to changes in capital market scenarios, up or down. That allows us to maintain supply and manage risk. We determine the withdrawal rates based on the contract issue age, so we're not as exposed to client behavior in terms of when they exercise income."

Liz Forget, head of individual annuity sales at MetLife

"We're still in the VA business, but sales this year will be lower than in 2012, which were lower than in 2011. We're comfortable with the risks of the product that we're selling today, however, and we like the demographics. You're seeing an industry at an inflection point. People are trying new ideas. All of us are trying to feel our way around, anticipating what the next decade will bring, wondering how we can be relevant, how the guarantees will be manifested and what people will want. The arms race wasn't good for our industry. It was one-size-fits-all; if you wanted an annuity it had to be a variable annuity with a guaranteed lifetime withdrawal benefit.

”We’re spending a lot of time on product development. We’re trying to create a better balance of products sales. The variable annuity dwarfed everything else; we would like to see a better balance. The Shield product is a new focus. We’ve refreshed our SPIA. Rates are creeping up a bit, so there’s more marketing effort around that.

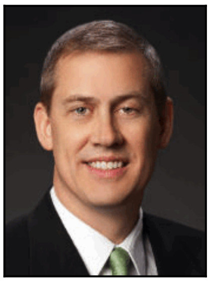
“We’ve launched a non-lifetime living benefit on a variable annuity. It’s aimed at the mid-50s investor as opposed to the 65-year-old investor. It says, ‘Here’s a guarantee that will get you to retirement, and then you can decide whether to use it for income. We’re selling it as a ‘bridge’ to retirement. MetLife invented longevity insurance; we’re now refreshing our product. In its current form, it’s not a modern product. If you look at the New York Life DIA, it has income acceleration features; you can pick the age at issue. We like that market, and we’re still selling the old one. But we’re modernizing it.

“Instead of hawking product features, we need to focus on how people understand these solutions. If you combine the GAB with the DIA, for instance, you can get a heck of a lot more income for life. We have the broadest distribution of anyone in the market. We have a 5,000-member career agent force, which generates a big percentage of our sales. We’re in every channel in the third-party business, including unique relationships with Primerica and Fidelity that gives us a wide reach.

“What have we learned from the financial crisis? The industry got the fact right that clients want guaranteed income for life. From an innovation and creativity standpoint the industry has responded well. I think that the crisis taught people to re-evaluate pricing and to anticipate what increased regulation will do to reserve requirements and hedging costs. But the retirement mega-trend is still out there. People need to insure a portion of their assets and only insurance companies can help them do that.”

Eric Henderson, senior vice president of life insurance and annuities, Nationwide Financial

“Today you’re seeing capacity constraints, mainly because of low rates, and we don’t know if that will change much in the future or not. But you will see more balanced [product] portfolios. That’s what we’re doing here. In the past, the vast majority of sales involved the variable annuity with the guaranteed lifetime withdrawal benefit. Today, we’re seeing immediate annuity sales growing faster than VAs, and we’re getting into the indexed annuity space, which we think will be a significant growth area for us. We’re seeing faster growth in the sales of variable annuities without living benefits. So our mix of business has shifted considerably.



“Risk management isn’t only about making a product that’s less risky for the insurer, it’s also about selling other products whose risks are uncorrelated with the first product. [In terms of lifecycle, mortality/longevity insurance hybrids] We’ve got a couple of products that focus on the ‘income replacement’ story in test right now, and another design that’s not quite ready for market testing. But it will be awhile before we bring something to market.

“Our mutual ownership structure has allowed us to take a long-term view. In 2012, when we made some product changes because rates dropped, we knew that our sales would drop as a result, and we were OK with that. The distribution said, ‘you’ll be hurt,’ and we knew we would be, but we’ll be there in the long run, and that has turned out to be true. The distribution partners now understand.”

Dan Herr, vice president, Product Management, Annuity Solutions, Lincoln Financial Group

“Yes, we gained market share in variable annuities over the last year, but a lot of that had to do with shifts in the marketplace that gave us a stronger benefit than we had in the past, relative to others. Jackson National had pulled back the terms of their joint-life rider and we hadn’t. But we made adjustments to correct that in May. We don’t manage according to market conditions, and we don’t want to make hard rights or lefts. We want to grow the business on our terms and we try to manage the products that way.

“Guaranteed lifetime income is our industry’s franchise. The living benefits business will continue, but the spectrum of income products will change and grow. We don’t see any product as a silver bullet. We’ve seen, for instance, the growth of the deferred income annuity. We don’t have a product like that right now but it is certainly on our radar. We’ve had tremendous success with the i4Life variable annuity. That’s one of our biggest differentiators. That provides our value in the marketplace. We’ve been able to avoid the arms-race mentality. Unlike the living benefit, the i4Life [variable income annuity] is a pure income feature and it’s priced accordingly.

“We’re very confident around our assumptions for that product, as we are with all of our products. The payouts are far more certain than in the WB; there’s much less noise around them. Every month, we know how it can adjust. Of our VA sales, about 15-20% are i4Life and the rest are the WB. There’s just more certainty with the i4Life. We’ve had outside consultants help us with utilization studies on the living benefit. We’ve always understood that there’s a segment of contract owners that will never use it.

“We’ve been offering the fixed indexed annuity since our merger with Jefferson Pilot. About half of our FIA sales are with a GLWB rider. We’re not in a scale-back mode on the FIA, but we’re also not looking to compete against the new companies [Guggenheim Partners and Athene Holdings] that are trying to purchase new business. Our strategy has been to take a disciplined approach and sell on our terms.

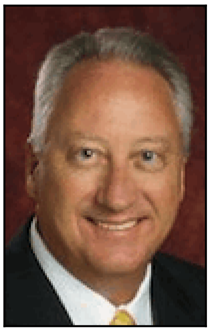
“Some time back we introduced a long-term care annuity combo [where interest on deferred fixed annuity assets pays for long-term care insurance and the annuity assets finance a large deductible if the insurance is exercised]. We're still trying to grow the distribution of that business. We also have a feature on the variable annuity that accelerates the payout for long-term care expenses.

"It's been a long haul getting approval through the states, but we expect that business to grow. It's for retirees who have covered their income needs. The assets are there if you need them for long-term care coverage. It's not use-it-or-lose-it like regular long-term care insurance. It's just repositioning assets.

"We always look for opportunities to partner with key distributors. We had a fixed indexed annuity relationship with Primerica and when the opportunity came to partner with them on variable annuities, we took it. In May we launched our ChoicePlus variable annuity through Chase Bank. That's our first time distributing variable annuities through them."

Richard Moran, former head of retirement products distribution at Symetra

"Most of the carriers are stepping back and making a case for the features that sold the variable annuity 20 years ago, which were tax deferral, access to professionally-managed subaccounts and a death benefit. That no-GLWB product hasn't sold tremendously well, with the exception of Jackson National's products, because of their superior distribution and fund selection. But most carriers, not so much. The executives I talk to are not planning to get back into the VA business anytime soon. They view is as a long-in-the-tooth business. They see capital as best deployed elsewhere in the insurance company. They failed miserably at pricing the products. They simply didn't account for the level of tail risk that the market showed them.



"Did the sales have to do with the high compensation? "Absolutely. Frankly, for some financial advisors, the level of commissions offered on the variable annuities motivated them to put them first and foremost in front of their clients. I don't believe that's the case for the majority of advisors. The overwhelming majority are clean sales, and most advisors care very much about their clients. What's been challenging has been the level of complexity in the product. They're difficult for even the diligent advisors to understand. Nonetheless, when a lot of advisors are looking around and see a 7% up front commission, that's a lot of motivation for an advisor to introduce a variable annuity to a client.

"I do believe that [advisors and registered reps] are learning more about immediate annuities and that they are more willing to put those products in front of clients today. But Americans can't look to annuities alone to generate income. The past dozen years have taught us that it's silly to put all your money into one type of product. Looking forward, I see a more balanced approach. A component of your money might be in a fixed or variable annuity. But people will still be using a systematic withdrawal program from mutual funds. I think more people will gear their portfolio toward higher dividend-paying investments.

"A lot of folks are also recognizing that retirement income is partly about after-tax returns. People are forced to think through their drawdown strategies to minimize the tax drag. When the rich living benefits were available, there was a disproportionate amount of client portfolio dedicated to the variable annuity. It worked out OK, but there could have been a different set of circumstances where it didn't. The clients who bought those products benefited enormously. At the peak of the crisis, they could have pulled the trigger and gotten a huge income stream off of them. But those living benefits are gone and they're not coming back, and that will compel the advisor to work more closely with the client."

Alison Reed, senior vice president, Product and Investment Management, Jackson National Life Distributors

"Going back to the pre-crisis era, Jackson National was always committed to a diversified book of business. We always had fixed, fixed indexed, and variable annuities and life insurance, and that provided us with great natural offsets from a hedging perspective. Going into the financial crisis, we were priced more appropriately than the competition was. Our pricing for insurance riders was in some cases 30 basis points higher, so we were in a better position to weather the changing market environment.

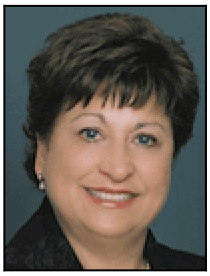
"Since the crisis, we've committed more resources to product innovation and product expansion. We're still committed to our original products, but wanted to expand into new products like our Elite Access variable annuity. It's less capital intensive than the living benefit product and it focuses on unique alternative investment options at a low price point for the retail market. We launched Elite Access in March 2012. Our total 2012 variable annuity sales were $19.7 billion, and in the last nine months of 2012, Elite Access sales were $1.35 billion. Through the first quarter of 2013, we had $835 million in Elite Access sales, so momentum is strong. We're still selling more of the GLWB product, but we've found strong interest in Elite Access among the non-annuity producers. They can take the product and build a complete portfolio, with access to alternatives and risk-managed options at a lower price point. You see reps who may not have sold VAs with living benefits selling that product.

"At this point, we do not have a deferred income annuity product. A SPIA is part of our diversified portfolio, but because of the rate environment we've chosen not to focus on certain products. So far our distribution hasn't had a strong interest in the DIA. We're monitoring the market to see if that gets more traction, but we haven't seen the traction we'd like to see. At the same time, sales of the variable annuity with living benefits remain a critical aspect of our success. We remain committed to the fixed indexed annuity market, but we have purposely not sold as much as we could or would like to, given the interest rate environment. We definitely like the business, but we've elected to lower our caps and guarantees so as not to increase sales."

Cathy Weatherford, president and CEO, Insured Retirement Institute

"We've been through the 'great reset.' We've seen some companies exit the business that were at the top of the variable annuity leaderboard. We're seeing the rebirth of the industry with brand new entrants like

Forethought. They can benefit from some lessons learned, and they're not carrying a legacy book. Others who were at the top of the leaderboard are retooling and recalibrating their products. There have been over 500 product changes over the last five quarters. This is definitely not the variable annuity business of the past. It's a new industry with a larger shelf space as opposed to one or two products.



"Another new thing is the growth of Jefferson National, which came in with tax deferral for the client. I sat down with our new chairman [to be announced in September] yesterday. We talked about increasing and growing our identification and support with financial advisors. We're providing education, research, practice management tools and client documents that FINRA has reviewed. Our members are asking us to be more engaged in advocacy. We have gone through an unprecedented era of regulatory activity. We're seeing how the ongoing implementation of that regulation is affecting the balance sheets of our members. We want to be the objective voice that helps provide understanding about retirement in the mainstream media as well as the financial media. We're very much at the front end of the next stage. We're not there yet. It's going to be a great industry to watch."

Executive at mutual life company that sells both VAs and DIAs [speaking not for attribution]

"Among Boomer retirees and near-retirees, there are two income markets, not one. There's a market for *guaranteed* income and there's a market for *optional* income. The GLWB goes after the optional income market. It says, here's a guaranteed income that you don't have to take. But that option costs money to write. I'm a big believer that optional income is a need, and that a meaningful market will continue to exist for the lifetime withdrawal benefit, in whatever flavor it comes in. A significant portion of the market doesn't need guaranteed income but does need optional income.

"In the VA/GLWB products, before the financial crisis, you saw under-pricing relative to the guaranteed market. Since the crisis, that under-pricing has rationalized to a new status quo that looks more like normal pricing. As that happens, we think, the relative values of immediate and deferred income annuities, the SPIA and the DIA, have increased significantly. Our average customer, who used to get 30% more income than a GLWB client, now gets closer to 50% more income."