FIA: Unofficial MVP of the LIMRA Conference

By Kerry Pechter *Thu, Apr 23, 2015*

Fixed indexed annuities will "increase their dominant position in the individual U.S. annuity market" and "approach variable annuity sales levels over the next five years," predicted actuary Tim Pfeifer at the Retirement Industry Conference in Arlington, Va., last week.

The annual Retirement Industry Conference, held near Washington, DC, last week, covered many topics, including annuities, retirement plans, advisors, regulation, big data, economic forecasts, the affluent market and so forth.

Nothing unusual about that. It happens every spring, like the return of baseball. It was unusual, however, to see so much attention given to fixed indexed annuities at this year's event, which was sponsored as always by LIMRA, LOMA and the Society of Actuaries.

FIAs are the most valuable products in the retirement league right now. Variable annuity sales keep trending down. Income annuities are still mainly a niche market, dominated by a handful of mutual insurers. Sales of in-plan annuities and CDAs (contingent deferred annuities) haven't reached critical mass.

That leaves FIAs. These hedged fixed income products tend to thrive in low interest climates, when their link to equity indexes allows them to out-yield CDs and fixed-rate annuities. Developed in the U.S. in the mid-1990s, the category sold well during the yield-droughts following the dot-com bust of 2000 and since the Financial Crisis of 2008.

FIA sales showed hockey-stick growth in 2014, according to data from the LIMRA Secure Retirement Institute. Sales for the industry as a whole jumped 23% in 2014, to $48.2 billion (including new sales and contributions to existing contracts).

FIA sales have nearly doubled since 2007, thanks in part to investments in the FIA business by private equity firms, notably Guggenheim Partners' 2010 purchase of Security Benefit Life. FIAs with lifetime income guarantees have helped fill the sales vacuum left by receding VA sales in brokerage firms and banks.

The perennial FIA sales leader has been Allianz Life, which entered the market by purchasing FIA specialist Life USA Holdings in 1999. A unit of Allianz SE, Allianz Life has a 28% share of FIA sales, most of it in the independent agent channel. Excluding sales by Allianz Life, FIA sales overall would have increased only seven percent in 2014, not 23%, according to LIMRA.

VAs are still the overall annuity sales leader, with $140.1 billion in sales in 2014. But that figure, a five-year low, is 11.4% below the post-crisis peak of $157.9 billion in 2011, according to Joe Montminy, assistant vice president of the LIMRA Secure Retirement Institute. VA sales once reliably rose with the equity market, but the correlation ended after the financial crisis, as VA issuers made riders more conservative. Supply of VAs slumped as several issuers curtailed, halted or even reversed sales.

Alternative indexes

In a conference breakout session, Milliman actuary Tim Hill talked about the hottest trend in FIA product design: the use of so-called "alternative" indexes. Most FIA product designs generate yield by buying options on the S&P500 with a bit of the interest earned on the contract's bond holdings. An alternative index typically combines two or more other indices; it may be volatility-controlled, and often features a cash component. Contracts that uses alternative indexes now account for about 28% of the FIA market, according to *Wink's Sales and Market Report, 4Q2014*.

The use of an alternative index can make an FIA look more attractive. As Hill explained, today's low bond returns give issuers a smaller budget for purchasing options on equity indexes. Depending on the crediting method, that can reduce the degree to which the issuer can participate in index gains (if any) or it may result in a lower cap on the maximum interest that will be credited to the contract. On most contracts, the cap is now historically low—between 2.5% and 4.5%.

That's where an alternative index can help. All else being equal, if the alternative index is less volatile than the S&P500, the options will be cheaper (because the option seller has a lower risk of loss), and the result will be a higher maximum participation rate or a higher cap. (A participation rate method would offer a portion of the entire index gain, while a cap method would offer 100% of the gain up to a certain cap.)

But there's an obvious tradeoff. The potential returns of an alternative, volatility-controlled index will be lower than the returns of the S&P500, so the two strategies may end up offering about the same value. (Ten percent of five is the same as five percent of ten, for example.) The higher rate sounds better, however, which makes the product more appealing to producers and clients.

"When you dial back the volatility, you can have a higher cap or even go uncapped and use a spread," Hill said. "That's the driver of this space right now—the ability to offer a higher return than the pure S&P500 story. The cap levels are especially important for advisers in the broker-dealer channel." Investment banks are now eager to create custom volatility-controlled indexes for FIA issuers, he added.

The future of FIAs

The use of alternative, and sometimes custom indexes by FIA issuers can cause headaches for broker-dealers. "We sell 26 products from 18 carriers. A lot of them look alike, but now the carriers are differentiating themselves with proprietary indexes. So it's hard to compare the indexes," said Johnna Chewning, a vice president of fixed annuity sales at Raymond James, the national broker-dealer.

Within Raymond James Insurance Group, fixed annuities now account for 40% of revenue, she said. Rising FIA sales are filling the revenue vacuum left by declining VA sales. She added that, because of today's ultra-low crediting rates, advisers are selling most of their FIAs on the strength of the lifetime income benefit riders.

In his presentation on the future trajectory of the annuity business, independent actuary Timothy Pfeifer made several predictions about indexed annuities. Regardless of the interest rate environment or equity market returns, he said, they will "increase their dominant position in the individual U.S. annuity market" and "approach variable annuity sales levels over the next five years."

Drivers of the growth include the competitiveness of the products, that fact that FIAs are not securities, the expansion of FIA distribution into the banks and broker-dealers, the entrance of new carriers into the business, the lower accounting volatility of FIAs, and the appeal of upside potential with principal protection, he said.

Pfeifer also predicted that an indexed version of a deferred income annuity would become a qualifying longevity annuity contract (QLAC), but the indexing will only be applied during the deferral period, not during the benefit period. He also expects to see indexing applied to single premium immediate annuities and non-QLAC deferred income annuities.