RIJ's Annual Variable Annuity Review

By Kerry Pechter *Fri, Jul 18, 2014*

Every July, RIJ assesses the VA market. This year, we look at the "investment only" or "IO" VA, the structured VA, and the VAs with novel income options. All address the public's need for growth and safety without costing a lot or threatening to backfire on the issuer.

The variable annuity has been with us since 1952 and, barring dramatic changes in U.S. tax laws, it will be with us in 2052 and beyond. The VA lets investors defer taxes on as much after-tax money as they want; it generates considerable revenue for broker-dealers; and, not least, it gives life insurers exposure to the ecstasy (and agony) of equities.

At the moment, the VA business continues to sort itself out. The aftershocks of the financial crisis are still palpable. Once-loyal advisers are still confused, if not alienated, by contract buyback offers. CEOs are directing capital to other lines of business. Closed blocks of VA business remain vulnerable to market volatility and mortality shocks.

But, in our ever-turning world, all is never lost. Adversity has bred some nifty product innovation in the VA space. Life insurance actuaries and product developers have ingeniously packaged risk exposure and risk protection into new kinds of bundles. The pace of product variations this year has been incremental but steady.

Every July, *RIJ* re-considers the state of the VA market. This year, with the help of expert observers, we assess the three main types of VA innovations that have appeared: the "investment only" or "IO" VA, the structured VA, and the VAs with non-living benefit income options. In one way or another, all address the public's need for growth and safety without costing a lot to manufacture or threatening to blow up in an issuer's face.

If these new packaged solutions do well in the marketplace, it may signal that Boomers can live without harder, more expensive guarantees. On the other hand, the public's sensitivity to risk—and desire for more serious risk transfer—could spike at the next major downturn.

Old is new again: IOVAs

IOVAs, of course, are generating the most buzz. The acronym "IOVA" is used slightly ironically, because until the late 1990s all VAs were "IO." Unlike the old IOs, these products typically offer dozens of subaccount options, including the "alternative" investments (real estate, hedge funds, emerging market debt, arbitrage and commodities) that institutional investors use.

Compared to the VA with living benefits, they're also cheap. When sold without living or death benefits, they don't require hedging or significant capital. The mortality and expense risk fees are low and merely fund the acquisition costs. ("IO" is something of a misnomer; annuitization options are, by definition, available on all annuity contracts.)

Jefferson National is sometimes credited with discovering a market for the low-cost, accumulation-oriented alternative-heavy VA among registered investment advisers (RIAs). But sales of its Monument Advisor contract are relatively tiny ($180.8 million in the first quarter of 2014.)

Most people point to Jackson National as the company that turned the IOVA into a "category." A significant proportion of the advisers who have sold Jackson National's Elite Access are said to be first-time VA sellers. Sales of Elite Access B share sales were just over $1 billion in both the last quarter of 2013 and the first quarter of 2014.

Elite Access and Monument Advisor no longer have this market to themselves. There's the Nationwide marketFlex II VA, introduced in 2012, the AXA Investment Edge, the Protective VA Investors Series and the Prudential Premier Investment VA.

The ability to own high-turnover actively managed funds in a tax-deferred cocoon is the main selling point of these products. But to the extent that they offer alternative investments, managed volatility funds and guided portfolios, they also provide an implicit form of downside protection.

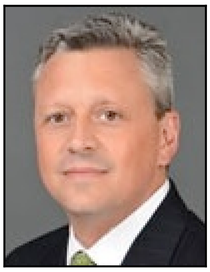
The protection comes from the hedging strategies in the managed volatility funds and the diversification provided by the alternatives, whose performance generally isn't correlated with the performance of U.S. stocks or bonds. This type of protection arguably addresses the investors' expectations of an insurance product while costing much less than guarantees.

"You're going to see a further proliferation of managed-risk funds in VAs," said Colin Devine (right), an independent insurance company analyst. "In addition to being a requirement for living benefit options, they will begin showing up in the IO products. There are two reasons for that.

"One, people don't like losing money. Two, and this is the most important reason, managed risk strategies can be very helpful to people who are using systematic withdrawal strategies to fund their retirements. It will protect them down markets. People will say, I know that managed risk funds won't guarantee me income for life. But there's a better chance that my portfolio will last my whole life."

"We'll see more entrants into that product space," agreed Steve Saltzman (below left), of the Charlotte-based consulting firm Kehrer Saltzman. "We'll also see more death benefits as alternative options on those products in an attempt to provide an insurance feature."

Without a death benefit, he said, these products are considered unsuitable for funding with qualified money, because qualified investors already have tax deferral. "Different firms have different standards. Some will allow funding IOVAs with qualified dollars if the product offers unique access to investment



options," he added.

At a recent industry roundtable discussion, an annuity product manager from one broker-dealer said his compliance department rejects sales of IOVAs to certain older clients, because the client's investment horizon is too short to make tax deferral valuable enough to justify the purchase. "And when there's pushback, it gives the financial adviser a bad impression of VAs in general," he said.

The distribution channels are still figuring out where IOVAs fit. "We're working right now on a report on IOVAs," said Tamiko Toland, managing director of Retirement Income Consulting at Strategic Insights (below right). "They have low capital requirements, they're cheap to maintain and they're a simple product category for issuers to get into. But I'm finding that there's some confusion in the markets about IOVAs.

"There are things that look similar, like the Jefferson National Monument Advisor and the Jackson National Elite Access, that are actually quite different. Jefferson National targets RIAs, who are not insurance-licensed, while Jackson National targets existing producers who are licensed." There's also some confusion about the meaning of alternatives," Toland said.

"Initially, there was a lot of talk about alts, and Jackson National's marketing was heavily geared toward alts. On the one hand, alts are a component of modern investment policy. They're part of the global view of diversification. But alts can be many different things. We don't know exactly what slot they fit in or what role they play. That may be why you see the embedded advice piece in the IOVA: advisers can't learn alts overnight," she added.

"There will be a continuation of interest in IOVAs—investment-oriented products with large numbers of fund options, including exotic or sophisticated 'alternative' investment options, and with streamlined death benefits," said Timothy Pfeifer, a consulting actuary at Pfeifer Advisory in Libertyville, Illinois.

Income without a living benefit

There's a reason why variable annuities were given the privilege of tax deferral, and it's not to facilitate ownership of high-turnover funds. It's because they're expected to deliver retirement income. But is there a way to do it without living benefits and without the sudden loss of liquidity associated with conventional annuitization?

Four products suggest that it can be done, using either non-guaranteed (but tax-efficient) payouts or deferred income annuities with variable accumulation periods. For instance, two accumulation-driven VAs, the AXA Investment Edge and the Lincoln Investor Advantage have variable payout options (Income Edge and i4Life, respectively) that allow non-qualified contract owners to convert their assets to what resembles a period certain annuity, but with liquidity.

AXA and Lincoln Financial products both sought and received private rulings from the IRS (Lincoln over a decade ago, AXA this year) allowing them to offer the exclusion ratio on non-annuity distributions as long as the contract owner takes regular taxable distributions over a specific period.

The Guardian Investor ProFreedom and the Principal Pivot VA (which is not yet approved by the SEC) are a bit different. They offer clients the option to gradually move all or part of their account balances to a deferred income annuity. (In certain ways, they resemble the New York Life Income Plus Variable Annuity of a couple of years ago, the Symetra True Variable Annuity of 2012 and the pre-crisis Hartford Personal Retirement Manager.)

For non-qualified contract owners who are concerned about tax efficiency during decumulation, all four of these contracts offer something that living benefits and systematic withdrawals don't—the ability to use the so-called exclusion ratio to spread the deferred taxes on the unrealized gains across a period certain or over a lifetime of income payments.

"The next big thing will be VA products that are distribution-oriented," Devine told *RIJ*. "We'll see products that compete with i4Life.

Like the IOVAs, these products provide a service that people have come to expect from VAs, but at much less risk to the issuer than products with living benefits. With the IOVA, that service was volatility management and protection from sequence risk. With the VAs described in this section, the service is provision of steady retirement income.

The embedded DIAs in the Guardian and Principal products do involve a transfer of longevity risk to the insurer. But, unlike the old guaranteed minimum income benefit (GMIB), they don't require the issuer to put a floor under the amount that will be annuitized.

The non-guaranteed payouts in the AXA and Lincoln products provide retirement income without exposing the issuer to investment risk or longevity risk. The investor accepts variations in the annual payments and the income is paid out over a fixed number of years, not over the investor's lifetime.

"If a company has decided to back away from the GLWB, this type of product allows them to appeal to the GLWB audience and meet the income need with less risk to the company," said Joseph Montminy, assistant vice president at LIMRA.

The indexed variable annuity

There are now four companies—Allianz, AXA, MetLife and CUNA Mutual—that have introduced so-called "structured" VAs. These accumulation-oriented products work a lot like fixed indexed annuities, with one important difference. Contract owners don't get 100% protection from downside loss and, as compensation for assuming more risk, they get a higher performance cap. Generally, the more downside protection the client chooses, the less upside potential he or she gets.

CUNA Mutual's Member Zone VA works a little differently from the other three entries in this category. The Allianz, AXA and MetLife products absorb the first 10%, 20% or 30% of losses over an interest crediting term (depending on the option chosen); the investors absorbs losses beyond those thresholds. The Member Zone product, which is more straightforward (perhaps because CUNA distributes through credit unions), leaves the investor exposed to *up to* a 10% loss in any given year. The issuer absorbs any loss that exceeds 10%.

"The 'structured' VA was a way for VA-focused companies that were critical of the FIA concept to offer an indexed product and handle risk a bit differently. Companies of that ilk will be the next ones to move into structured VAs. There's a lot of design flexibility in those products," Pfeifer told RIJ.

"So far we've seen the first generation of structured VAs. I see more of those in the works, and they should get a lift, especially with the equity market potentially peaking," he said. "That's just my own opinion about the market, but there are technical signs that the stock market is decelerating. If you look at net flows in the market, more institutional money is going into bond funds and individual or consumer flows into the stock market have been growing. That trend typically appears when the market is about to correct."

Looking ahead

The arrival of these new products doesn't mean that variable annuities with living income benefits are going away. Supply has dropped, because of the declining risk appetite of the issuers, but Boomer aging continues to drive demand for flexible sguaranteed income. A Cerulli Associates analyst predicted in a March 2014 report that net flows into VAs would reach $22 billion by 2018.

In 2013, according to LIMRA, sales of variable annuities with GLWBs totaled $61.7 billion, up from $61.2 billion in 2012. In 2013, investors purchased an additional $20.7 billion worth of indexed annuities with GLWBs, up from $19 billion in 2012. In addition, $10.5 billion was invested in income annuities (either immediate or deferred), up from $8.7 billion in 2012. Sales of VAs with GMIBs dropped from $18.1 billion in 2012 to $11.9 billion in 2013.

In the current year, VA sales are expected to dip moderately. First quarter 2014 sales were $33 billion (Top ten = $26.3 billion), down from $35.3 billion in the fourth quarter of 2013. That trend is expected to continue. "For variable annuities, sales in the second half of 2014 should be down slightly from second half of 2013," said Todd Giesing, senior analyst at LIMRA SRI Annuity Research. "There are a lot of headwinds on the supply side of the business.

"Last year we saw MetLife and Prudential pull back. This year we're looking at the changes that Jackson National [the top annuity seller] made in April, reducing commissions and suspension of death benefit options on the Perspective II VA. They said the changes could affect 30% of their business,” he added.

But Giesing believes that annuity issuers are doing what they need to do to take advantage of the Boomer retirement wave. “The popularity and demand for guaranteed income is still there,” he told *RIJ*. “For insurance companies there have been some headaches in that area, but they’ve learned form the financial crisis, they’ve de-risked, and now they have a better perspective on managing the risks in these products so they can be beneficial to both the insurer and the consumer.”