The Elephant in the Room

By Kerry Pechter *Thu, Sep 12, 2013*

It's difficult if not impossible for anyone to describe the contours and textures of the annuity/retirement income business, or even any particular section of it. But fortunately there are people who try.

The annuity story should be a simple one. In fact, everyone in the business knows one version of it by heart. There will be waves upon waves of Baby Boomers. They crave guaranteed lifetime income. Only life insurers can scratch that itch. Yadda yadda yadda.

If only it *were* that simple. Different insurers emphasize different products, with differing costs, risks, and profit margins, through different distribution channels to different consumers, depending not least on whether the insurers are owned by public, mutual, or private equity companies.

Such differences, along with the essential unpredictability of the economic and regulatory weather, make it difficult if not impossible for anyone to describe the entire the entire annuity-slash-retirement income business with any authority, let alone its future course.

But certain people are tasked with trying to make sense of it all, and who make an effort to illuminate the path ahead. Among the current annuity market analysts are Donnie Ethier of Boston-based Cerulli Associates and Scott Hawkins of Conning Inc., which is based in Hartford, Conn. Cerulli has just published Ethier's latest report, called "Annuities and Insurance 2013: Balancing Shrinking Supply and Increasing Demand for Guarantees."

The view from Cerulli

Looking at the variable annuity business, Ethier sees a bunch of s-curves and switchbacks in the road ahead. The problem won't be shortages in supply, he said. According to Cerulli's data, life insurers have the capacity to sustain about $142 billion a year in sales of variable annuities with living benefits, with an optimistic range of $153 billion and a conservative estimate of $132 billion. Any consumer who wants to buy a variable annuity with a GLWB will be able to find one, Ethier told *RIJ*.

But there's not much room for growth, he added. Life insurers will have to look for other sources of new business, such as selling contingent deferred annuities (CDAs) and VAs without living benefits to the $2.8 trillion managed account market, or picking up defined benefit pension assets as Prudential did with General Motors, or hopping on the deferred income annuity (DIA) bandwagon currently led by New York Life. Six more of the major annuity sellers intend to roll out DIAs, he said, in addition to the eight or nine life insurers that already have.

One potential threat to the industry is the possibility of a reverse arm's race, he said. As major annuity sellers discourage new sales of VAs with GLWBs by shrinking their value proposition, sales could spill over onto smaller issuers, who might react by shrinking their value proposition, thus sparking a downward spiral that further degrades the reputation of the whole industry.

"Protective Life is a great example. As their products became more relatively more attractive, sales went up. But at the end of last year, they said they wouldn't accept any more [1035] exchanges, just new money," Ethier said. He sees little potential for a new arm's race, even if the economy, the equity markets and interests rates reach a more benign new normal—unless it's driven by competition from aggressive new private equity players.

"As the economy and markets stabilize, you have to wonder if the major VA issuers will feel pressured to get back into this space. Being able to say 'we're number one' isn't as important to them as it used to be. But we know that there's private money circling the industry. If they believe they can manage these books of annuity business better, will they enter the market? I don't think that trend [of private equity companies buying life insurers or blocks of annuity business] is over," he said.

A bigger threat, which annuity issuers have tried but not succeeded in defusing, is the ongoing shift of advisors in the independent broker-dealer channel from commission-based to fee-based compensation. Since most variable annuities are sold by commission through that channel, this represents a direct challenge to VA sales.

Insurers should not take solace in the fact that there are still lots of reps at independent broker-dealers who can sell VAs, Ethier said. Many of them are now dually-registered (as both reps and RIAs). In fact, the dually-registered channel is the fastest growing channel, with a 22% increase in assets from 2011 to 2012, or twice the average channel growth rate, according to his data. While many remain with broker-dealers and can still take commissions, they are leaning toward the RIA side. According to Cerulli, dually-licensed advisors expect 62% of their revenue to come from fees by 2015, up from 51% today.

By the same token, annuity issuers have had little success cracking the $2.8 trillion managed account market. The I-share variable annuity, which has the compensation element stripped out of the mortality and expense risk fee, was designed to appeal to advisors in this space. But the I-share represented only 4.2% of total VA sales in the second quarter of 2013 and the biggest seller by far was Fidelity ($607.5 million), a direct marketer.

Contingent deferred annuities were once believed to be life insurers' ticket into the managed account market, but CDAs aren't really out of the starting gate yet. "Some of the insurers say there's no way they'll get into the CDA space until their regulatory status [as securities and/or life insurance products] are determined. Others say they are comfortable with the product but they won't dedicate resources to it until other companies prove that there's a demand for it. But the CDA has a higher probability of succeeding in the RIA channel than an I-share variable annuity does.," Ethier said.

The view from Conning

Scott Hawkins has been tracking annuities and the life insurance industry for years. Conning has just released his report, "Individual Life and Annuity Distribution and Marketing Annual: Analysis and Developments 2013."

Like most financial products, annuities are related to life-cycle events, Hawkins said. "We see the industry as having two bites at the apple. By that we mean two points in time where Baby Boomers will be primed to listen to a discussion about retirement income. The first bite will be at the day they retire. The second bite will be when they reach age 70½ and have to think about taking required distributions from retirement accounts," he told *RIJ*.

In terms of product-related prognostications, Hawkins holds views that many readers will find familiar. "We think SPIAs will hold some appeal for a certain type of consumer," he said. "We think variable annuities will thrive to the extent that insurers will want to write them. We think that there might be a cross-over of insurers wanting to partner with 401(k) plan providers, offering a GLWB or a CDA or a SPIA or whatever the choice of in-plan solution might be."

For clues about the future of annuity distribution in the U.S., Hawkins has been watching the drama over Retail Distribution Review unfold in the United Kingdom. Beginning last January 1, advisors in the U.K. had to begin conforming to more consumer-centric level of conduct. Advisors now have to reveal all fees prior to offering advice and meet higher professional standards. The change has all but broken the commission-based business, because product providers are no longer allowed to influence what an advisor charges a client.

"In the United Kingdom and the European Community, you can already see how the shift away from commission-based sales is affecting sales of retirement income products. Commission-based distributors went to a fee-based planning model, which has limited them to clients who can pay the fees. That will drive distributors toward the ultra-high net worth customers and away from the mass consumer. You can expect similar effects here.

"The independent broker-dealers will need to replace their variable annuity revenue stream. They will have to ask themselves, Do we go only to the high net worth customer? As for the insurers, will that encourage insurers them to go direct to the public, and will the variable annuity need to get simpler?"

Like Ethier, Hawkins believes that life insurers will need to look for growth someplace other than variable annuities. "I'm not seeing any return to a strong appetite for VA business among manufacturers. There's not going to be a new arm's race, unless it's on the fixed indexed annuity (FIA) side," he said.

"Our three-year forecast through 2015 is that VA sales will drift down because of lack of appetite to write new business, less rich guarantees and less incentive for rollovers to new contracts. The manufacturers have also antagonized some of the distributors. We think sales of fixed annuities will drift down unless interest rates recover strongly. We predict that current conditions will continue. FIAs will still have appeal. SPIAs will grow, driven by Boomer retirees."

The good news for life insurers is that the trend is their friend. Though buffeted by headwinds and headaches, a lot of that resistance is neutralized by the tailwind of the Boomer retirement wave. A healthy level of demand is almost inevitable. "Annuities" are currently tied with Roth IRAs as the "most unsolicited product requests made by investors to their financial advisors," according to Cerulli's report. Hawkins told *RIJ*, "We think the retirement market is just beginning." Life insurers may or may not make as big a killing from the Boomer wave as they originally hoped, but they should at least be able to make a living.