The End of the VA Arms Race – Part II

By Editor Test *Sun, Jun 7, 2009*

VA living benefit issuers were not simply passive victims of the stock market debacle. They were playing a dangerous game, and knew it.

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Part II: Why the Arms Race Ended

The VA arms race ended because the living benefit guarantees became much too rich to support. To plug the leaks in the trillion-dollar Titanic of the VA business, life insurers had to stop selling the faulty products.

While dynamic hedging programs buffered some of the damage, the hedges themselves eventually became too expensive to maintain. The combination of market volatility, falling equity prices, and government-mandated low interest rates drove the cost of options to levels that risk managers hadn’t foreseen.

“For GLWBs, there are two important factors involved in risk management,” **John Yamauchi**, a former **Nationwide Insurance** executive, told RIJ. “There’s the cost of hedging based on VIGGs [volatility index], and there are the interest rates. Volatility is normally in the 20s, but it went to 80, or four times more volatile than people were assuming.

“When it leveled off in the 40s and 50s, people said, ‘That’s OK, it has settled in. But then interest rates went from four percent to one percent. And that, from an options pricing perspective, had an even bigger impact that volatility. In the Black-Scholes [option pricing] formula, there’s an inverse correlation between the interest rates and option prices,” he said.

“In hindsight, I don’t think anyone could have truly priced in the possibility of a protracted bear market environment occurring at the same time that interest rates went down,” Yamauchi added. “Market declines are usually inversely related to interest rates.”

Falling equity prices played the most obvious role in bringing the living benefit business down, just as falling home prices brought down the subprime mortgage business. When equities prices fell, the values of the separate accounts fell below the contracts' guaranteed income base.

Although the rider fees were usually pegged to the income base, which did not fall when account values did, the carriers' income from mortality and expense risk fees also fell. To make matters worse, insurance company assets—in the form of collateralized debt obligations (CDOs)—had fallen sharply, weakening balance sheets. The shares of publicly held carriers plummeted.

But VA issuers were not simply passive victims of the stock market debacle. They were playing a dangerous game, and knew it. Fighting for market share, they held rider prices below cost, hoping to subsidize them with revenue from other parts of the product, such as mortality and expense risk fees and revenue from fund management. To attract advisors, they also allowed the riders to cover equity-rich portfolios, creating further exposure.

"The problem was overreaching and under-pricing," said **Garth Bernard**, a former **MetLife** vice president who is now a principal in RISE Enterprises, a retirement income training company for advisors. "The companies will never say it was their own fault," Bernard added, but they understood the gamble.

"A company would come out with an enhancement but not raise the price," he said. "Eventually they were giving it away. They were betting that the market would never go down in our lifetime. That's the bet everyone was taking. They were doing the same thing in the real estate market—betting that the prices of real estate would never go down.

"When a carrier hedges these living benefits, it must add the hedge premium to the fees. But this drives up the fees. When the fees go up, it's more likely that the benefit will go into the money. So they have to add another hedge premium. It was a vicious cycle."

But even if they foresaw the dangers, insurers may have felt that they had no choice. With income annuities unpopular and annuitization of deferred annuities negligible, the variable annuity with a guaranteed income or guaranteed withdrawal benefit was the insurers' best hope in the battle for a share of the Baby Boomers' retirement savings.

"From a growth perspective, all the companies wanted to be in the asset-gathering game, whether the mutual fund or variable annuity business, in order to capture the rollovers. Everyone was looking at that retirement income pie, with $17 trillion in assets, and some people were willing to make some bets to gain a foothold in the market," Yamauchi said.

"The guarantees were a way to make the variable annuities more attractive, because the value of their tax deferral feature was on the decline. There was no reason, for instance, to put a VA in an IRA, or IRA assets into a VA [because either already provides tax deferral]. Now, with the GLWB, there's a reason to put a variable annuity in an IRA."

The seeds of the failure of the VA arms race could arguably be traced back to the de-mutualization trend of the 90s. After insurance companies went public, their fortunes, for good and for ill, became inseparable from the fortunes of the stock market. Stoking a stock price required meeting aggressive earnings goals, which meant creating higher-margin products. That inevitably meant going up in risk.

“The goal of mutual companies isn’t necessarily to show increased profit, it’s to show increased wealth and to return unused premiums to customers in the form of dividends. Public companies are more apt to use retirement accumulation products such as annuities because they’re trying to show the kind of profitability from fees that Wall Street appreciates,” Yamauchi said.

Yamauchi believes that many people who bought GLWB contracts didn’t fully understand the distinction between the contract’s account balance, which is the cash value, and the guaranteed income base, a notional amount that never drops below the premium but which is accessible only in five percent or six percent increments during retirement. He anticipates a backlash when they realize the difference.

Read Part III: The Future of VA Living Benefits