The End of the VA Arms Race – Part III

By Editor Test *Sun, Jun 7, 2009*

The guaranteed lifetime withdrawal benefit will survive by attaching itself to a new product, such as managed accounts, or by finding a new market, like workplace retirement plans.

Part I: De-Risking

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Insurance company executives have tried to put a positive spin on the end of the VA arms race. Some believe that the stock market will eventually revive and that account balances will grow enough so that most contracts will be able to finance their own guarantees. Some observers have pointed out that the 2008 market crash proved the value of the living benefits, and say GLWBs should be more popular than ever as the stock market recovers.

“The guarantees were doing what they were intended to do, and that might be another marketing hook,” said Milliman’s Saip. “I don’t think [VA living benefits] will go away. Obviously there’s been retrenching, but there are a few companies that don’t seem to have scaled back, such as Prudential. I’ve heard that MetLife is continuing to forge ahead with their product development efforts. We probably won’t see all the rich enhancements, but if the markets come back, who’s to say?”

But with fees going up across the board, the VA value proposition is arguably weaker now than before. High fees were one of the biggest drawbacks to VAs even before last year’s market crash. (Although income rider fees were known to be underpriced, the total expense ratio of a GLWB variable annuity, including the M&E fee and fund management expenses, often topped 4%.) High fees act as a drag on accumulation, making it unlikely that the account value will hit new highs and thereby lead to a rising annual payout during retirement.

“If the features continue to de-escalate, if the hedging costs and the reserve requirements are higher, at some point you have to say, ‘Maybe this just doesn’t make sense. Maybe we should allocate some money to longevity insurance. Maybe we should use income annuities to provide guaranteed lifetime income.’ If you want upside potential, take a flier in the stock market. But don’t risk the money that you absolutely need for income,” Moshe Milevsky said recently.

An advocate of dull-but-reliable income annuities, Milevsky doesn't think life insurance companies should have bet their future on stocks in the first place. "It's interesting that the insurance companies that stayed away from this business of GLWBs and GMIBs are doing well now relative to the ones who got into it," he said. "The wire houses are putting their products back on their shelves. They don't have stock prices that are dropping.

"The companies that got into the living benefit business aren't willing to admit that this was probably something they shouldn't have done," Milevsky added. "I look at it as if they are selling long-dated puts, partially unhedged. Long-dated puts are very volatile assets. It's expensive to maintain the infrastructure for them. That's what investment banks are about. Why don't the insurance companies go back to basics?"

Others agree the current trend toward higher fees can't last. "If you raise the fees and reduce the benefits, it will just get uglier," said Garth Bernard. "The fees for the VA are getting as high as 400 to 450 basis points. An EIA [equity-indexed annuity] would be better than that. The GLWB isn't going to go away. But it will have to be restructured to make more sense for the investor and manufacturer. That will happen if you lower the fees, not raise them."

The most sustainable formula for GLWB products may be the one used by Prudential in its Highest Daily 7 product. Using a technique called daily rebalancing, Prudential automatically shifted VA contract assets to a fixed return account when the stock market declined. This meant lower account value growth during the bull market, but smaller losses—for the investor and for Prudential shareholders—since last September. Others, like Transamerica, have since adopted daily rebalancing for GLWBs.

The former MassMutual executive who created the first VA living benefit, Jerry Golden, believes that the product became too marketing-driven and not actuarially sound. He thinks living benefits have a future, but not in their present form. "Rational designs—designs that produce [predictable outcomes], designs that align the interests of the advisor, the client, and the issuer—are still possible. But you have to go back to designs that are rational and can stand up to the test of time.

"These didn't pass the test of time," said Golden, who also invented MassMutual's Retirement Management Account, a rollover IRA that allows advisors to create ladders of income annuities. "It's not impossible to imagine a design that works, it's an issue of whether the distribution will allow it. The goal should be to manage the outcomes. If that were the criteria, instead of who had the best 60-second marketing pitch, then you wouldn't have had this race to the bottom that we've seen."

The 'SALB-ation' of the GLWB?

The fate of companies that sold lots of GLWB riders hinges in part on the future behavior of current contract owners. Insurers hope that relatively few will trigger the lifetime income guarantee and take lump sum withdrawals in retirement instead. But Bernard thinks that insurers should expect the worst. He thinks account owners and their advisers will exploit the income guarantee to full advantage.

"Reps are trying to figure out how to reposition the contract benefit base when it's $100,000 and the account balance is, say $75,000," he said. "They'll tell the client, 'Let's start taking the income at $5,000 a year, pay the tax on it, and put the money into stocks as the market goes up. Now we're dollar-cost averaging into this [equities] engine, and that will go on for life.'

"So you'll see utilization rates on variable annuities go through the roof. It's not what the pricing actuaries expected," he added. He does not expect the market to recover soon enough to help get insurers get out of the hole they've dug. "Some companies will be hard-pressed to stay afloat."

Gross VA sales could fall dramatically in 2009. That's because as much as 80% of all VA sales in recent years have been 1035 exchanges, in which the owner of an existing contract trades up to a contract with better options. Such exchanges generally take place near or after the end of the contract surrender period, when withdrawal penalties have expired.

But exchanges in the near future are unlikely, because contract owners with in-the-money guarantees won't want to trade out of their existing contracts. They would lose the guarantee and possibly incur a surrender charge. Any broker or agent who promoted such a sale would likely be in violation of the SEC's suitability rules.

It's possible that the guaranteed lifetime withdrawal benefit will survive by attaching itself to a new product or by finding a new market. Such an evolution is presaged by the emergence of GLWBs in qualified plans (e.g., Prudential's IncomeFlex) and the appearance of stand-alone living benefits, or SALBs, which hang a GLWB on a managed account.

The Phoenix Companies was first to market with a SALB, partnering with Lockwood Asset Management. Phoenix has as yet uncompleted plans to offer a living benefit to clients of a large Registered Investment Adviser in southern California. Nationwide and Smith Barney are said to have a similar partnership in the works.

"There's certainly a value to putting guarantees on products other than annuities," said Tamiko Toland, editor of *Annuity Insight*, an industry newsletter, and a close follower of the SALBs market. "The appeal of the product has to do with not having to reallocate the assets [in order to add an income guarantee]."

Indeed, that was a big part of the GLWB's appeal from the beginning. It didn't upset the status quo. The insurance industry's core motivation for pursuing the GLWB, despite the risk, may always have been the fact that the rider gave investors and their advisors longevity insurance without requiring them to migrate out of mutual funds. It staved off the financial service industry's worst nightmare: the prospect of millions of Boomers liquidating their stocks.

Comeuppance or bad luck?

Ultimately, VAs with living benefits were a bull market play. They couldn't deliver value to all of their stakeholders—contract owners, shareholders, asset managers, and executives at insurance companies—without more or less steadily rising share prices.

Everything might have been different if not for the low interest rate policy prescribed by the Fed after 2001. That policy created a real estate and stock market boom, but it also deprived retirees and insurance companies of the reasonable low-risk returns on which they historically rely, and drove them into equities.

If the stock market defies the naysayers and reinflates itself, the GLWB could make a big comeback. (Investors are forgetful.) But, even if it did, VA issuers will probably never allow themselves to make the kinds of bold promises they made last time around.

“My sense is no, it won’t come back,” said John Yamauchi. “Insurance companies have long memories. They’re run by a different type of person than asset management companies. They’re more backward-looking. They’ll say, ‘See what happened? We have to change.’ That’s the nature of that part of the [financial] industry.”

“A lot of people see it as a comeuppance for the guaranteed lifetime withdrawal benefit,” said Toland. “But really it’s an unfortunate turn of events for the entire annuity industry.”