The End of the VA Arms Race

By Kerry Pechter *Sun, Jun 7, 2009*

The variable annuity "arms race" is over, a victim of the equity crash, low interest rates, and the destructive effects of competition for market share - mainly among publicly held life insurers. Here's a three-part look at what has happened, why it happened, and what could happen next in the "living benefit" space.

Part I: The Great De-Risking

Part II: Why the Arms Race Ended

Part III: The Future of VA Living Benefits

Part I: The Great De-Risking

The fabled variable annuity arms race is over. The new reality is reflected in the dozens of “de-risked” VA contract prospectuses filed ahead of the recent May 1 SEC deadline. Life insurers have decided to quit making 30-year promises they can’t afford to keep.

In their latest filings, most of the top VA manufacturers have either raised the fees and reined in the benefits of their once-generous guaranteed living benefit riders contracts, or they’ve withdrawn the contracts entirely. Gone are the gaudy seven percent annual roll-ups, the quarterly step-ups, and the aggressive payout rates. (See “New VA Product Filings” stories in this issue of RIJ.)

Why did the VA arms race end? The final blow was the unusual coincidence of a vertical bear market and historically low interest rates. But the deeper reason was that the product spread itself too thin. To satisfy all its stakeholders—issuers, shareholders, contract owners, fund managers and distributors—it needed a sustained bull market.

To compete with fund companies for the trillions of dollars that will roll out of retirement plans in coming years, life insurers (mainly the publicly-held insurers) built a product that seemed to offer Boomers everything: downside protection, upside exposure, guaranteed income, full liquidity and even a bequest.

But in vying with each other for market share, the insurers embraced a features race and price war, raising each other’s exposure to market risk. The products’ doomsday scenario came far sooner than expected, and by late 2008, VA guarantees suddenly outweighed account balances by $240 billion, according to Milliman.

Now there's a vacuum in the formerly go-go retirement income "space." Insurance product developers need new killer-apps for capturing qualified plan rollovers. Boomers need new options to cure their retirement blues. Whether fixed annuities, income annuities, or indexed annuities can fill the void remains to be seen.

A fast fall starting last fall

The VA arms race took a dozen years to heat up but only a few months to go stone cold. It started with Jerry Golden's guaranteed minimum income benefit (GMIB) at The Equitable in 1996, and climaxed in 2008 with double-your-money roll-ups on guaranteed lifetime withdrawal benefits (GLWBs).

Then, last fall, the retrenchment came fast, broad and deep. "I'm seeing kind of a reverse arm's race [in living benefits] right now, except nobody's declaring that there's a reversal. Features are being scaled back quietly," Moshe Milevsky, the York University finance professor and author, said in April. In early 2007, Milevsky had written about the under-pricing of living benefit, but the warning was ignored.

At least 20 insurance companies have taken some 40 VA contracts with living benefits off the market, according to Sue Saip, a VA analyst at Milliman. Among those companies were some of the biggest VA marketers, including AXA/Equitable, MetLife, Prudential, Principal Financial, Nationwide, Jackson National, Lincoln Financial Group, Sun Life Financial, The Hartford and Pacific Life. (See accompanying story, "VAs with No More Shelf Life.")

In March, for example, Allianz Life put out the following obituary: "Effective April 1st we will suspend sales of the C-share option and all living benefits (Lifetime Plus, Lifetime Plus II, Lifetime Plus 10 and Target Date 10) on these products; the optional death benefit will remain available. Removing the living benefits is a bold step, but given these tough economic times our first obligation is to ensure that we continue to meet the promises we've made to our customers."

"A lot of insurers have de-risked their variable annuities," Saip told RIJ. "Withdrawal rates have gone down by as much as one percent on every age band. Roll-ups that had been seven percent a year for 10 years have come down five percent or six percent, and double-your-income-base rollups are going to 12 years from years" or disappearing entirely.

"Quarterly ratchets are becoming annual ratchets," she added. "Rider fees are up 10 to 50 basis points across the board." In addition, asset allocation restrictions have been tightened or eliminated and in-force policies are no longer taking additional premiums.

A review of GLWB (guaranteed lifetime withdrawal benefits) at several of the 25 largest individual annuity insurers by Conning Research showed an average increase of 30 basis points—a 40% hike from the original price, in some cases. "Some insurers altered their product line, reducing benefits or removing them from products. The use of investment restrictions is a common approach to reducing the increased investment risk in guaranteed benefits," the Conning report said.

The VA business is now a drag on insurers instead of the growth engine they'd hoped for. Hartford Financial, to choose one example, has had to shut down its VA businesses in Japan and the United

Kingdom, VA deposits fell to only $702 million in the first quarter of 2009, from $2.5 billion a year earlier. VA cash flows were a negative $2 billion, from a positive $1.2 billion a year earlier. The value of VA assets fell over 40%, to about $70 billion.

"Product development has come to a standstill if not gone backward, both from a product feature and a risk management perspective," said John Yamauchi, former vice president at Nationwide. "This is a perfect storm, and at this point most companies would rather not be in this business. If they're in it, it's to maintain a presence. Companies are hunkering down and saying 'How can we make it through this?''

Read Part II: Why the Arms Race Ended