Retirement Income
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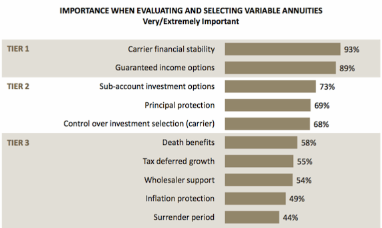
The “Evolution of the Annuity Industry”

By Kerry Pechter *Wed, Nov 30, 2011*

Like the Ford Mustang in 1965, the variable annuity with a lifetime income rider seemed like the right Boomer product at the right time in 2006. Then came the Crisis. A new survey by Cogent Research and the Insured Retirement Institute looks at where the VA is today and where it's headed.



Only a decade or so ago, variable annuities were still perceived almost exclusively as vehicles for deferring taxes on investment gains over long time horizons. Unique among tax-favored products, they could accommodate virtually unlimited after-tax contributions. While contract owners always had the right to convert the assets to lifetime income (penalty-free after age 59 1/2), very few owners took advantage of that capability.

With the advent of living benefits during the Bush bull market, the VA product itself and its marketing story changed dramatically. VAs with lots of investment choices and income riders were often described as a vehicle for risk-averse investors to stay in equities during retirement while still protecting their nest egg from ruin.

Then came the global financial crisis. It shook out the VA industry, driving some carriers out of the business entirely and forcing the rest either to “de-risk” their products, limit distribution and/or find a way to share more of the risks and costs with the customer.

Now here we are in the fall of 2011. But where are we, exactly?

That’s the implicit question behind a new study co-sponsored by the Insured Retirement Institute (prior to October 2008, the National Association of Variable Annuities), which lobbies for the retirement industry in Washington, and Boston-based Cogent Research. (The proprietary study is available to IRI members for $7,500.)

The study, titled “The Evolution of the Annuity Industry,” was based on surveys of and conversations with 11 annuity manufacturers and broker/dealer “gatekeepers” (those who pick annuities for the b/d shelves), 359 advisors who sell (and 10 who don’t sell) annuities and 304 consumers, half of whom owned some kind of annuity and half of whom didn’t.

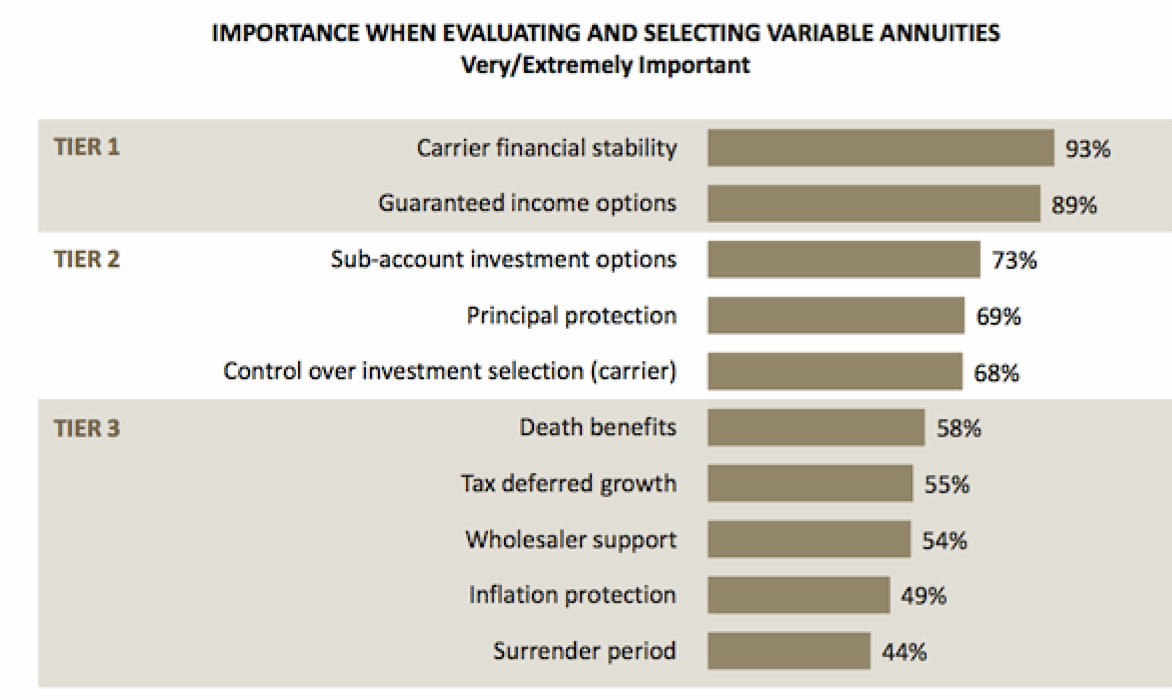
Cogent and IRI have concluded, based on their research, that the annuity sales “story has changed to one that highlights guaranteed retirement income.”

“All of the audiences we talked to brought up the idea that there’s been a paradigm shift, a change in focus from the accumulation phase to the need for retirement income,” said Cogent’s Steve Sixt, one of the report’s authors. Added co-author Marie Rice, “It used to be about accumulation. Now it’s about income.”

Yet the report's executive summary suggests that broker/dealers, advisors and consumers continue to voice the same objections to variable annuities that they have for at least five years. The "complexity" issue, for instance, remains a dilemma.

On the one hand, the study showed that distributors still complain about "constantly changing product features" that require "additional training requirements." Yet the study also reported that "advisors are not seeking simpler annuities that contain fewer bells and whistles; they are looking for annuities that can be easily explained and understood."

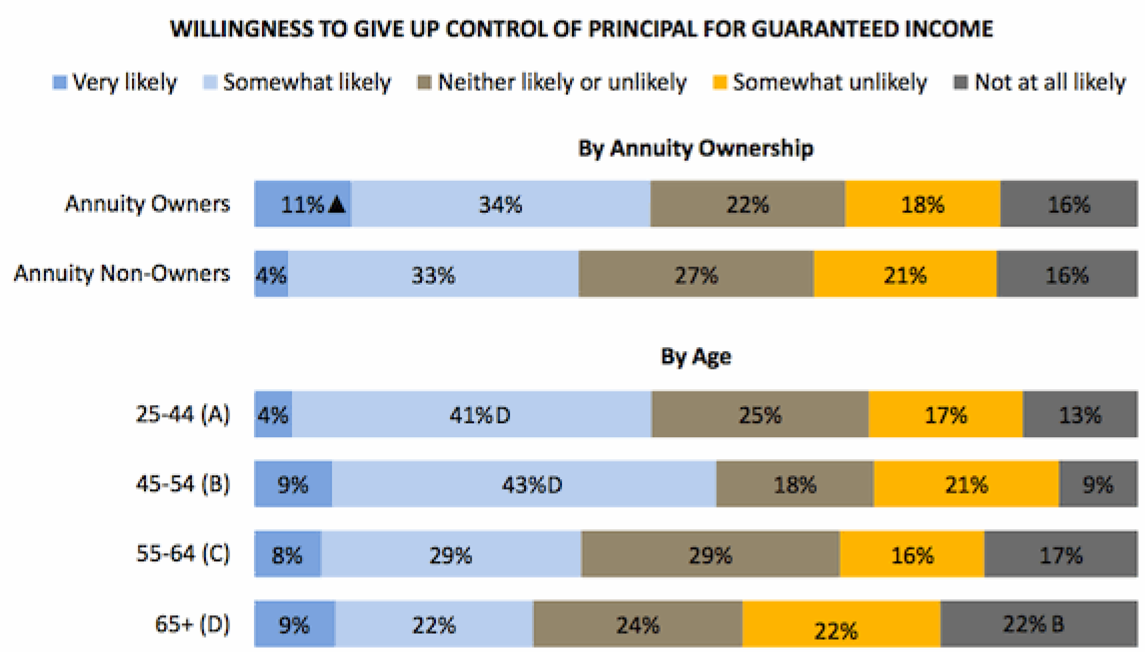
Broker/dealers and advisors are also still apparently concerned that the annuity sales process is more cumbersome than the process of selling mutual funds—despite years of work by annuity manufacturers on what was called the "Straight Through Processing" initiative. (It might be pointed out that as long as annuities are less liquid and more closely regulated than securities, the sells process will always be relatively cumbersome.)



(Chart source: Cogent Research and IRI.)

"The technology of the annuity sales process is behind the times," said Sixt. "It's true that they're still talking about the same difficulties the industry was talking about four or five years ago. But now there are more ideas about how to deal with the barriers. There's a lot of conversation, for instance, around standardizing the sales process among carriers."

The authors pointed to a couple of findings that they believe are encouraging for the retirement industry. First, advisors are now more concerned about a variable annuity's income options and the issuer's financial strength than about the contract's investment options (see chart above). Advisors expect both of those issues to gain importance in the next five years. Second, younger consumers—those in the 25-44 and 45-54 age groups—are substantially more likely than older people to say they are willing to give up some control over their investments in return for guaranteed income (see chart below).



As for consumer attitudes toward annuities, the data in the summary seemed inconclusive. Only a third of annuity owners—owners of variable or fixed deferred annuities, mainly—said guaranteed income was their main reason for buying an annuity. Over a third of non-owners said they were at least somewhat likely to buy an annuity in the future. Less than half of annuity owners said they were "at least somewhat knowledgeable about the specific features and benefits" of the first annuity they purchased.

The report includes several "strategic implications," including:

- Broker/dealers and intermediaries should focus on the capturing the money that rolls over from 401(k) plans into IRAs.
- Simple stories that can help sell VAs should be documented, recorded, and distributed to advisors.
- Carriers should develop annuities whose riders can be updated without switching contracts.

The Cogent/IRI report coincides with a frustrating period for the variable annuity industry. In 2006, the VA with a lifetime income guarantee seemed like the Ford Mustang when it first appeared in 1964 or 1965: the perfect product at the perfect time for the Baby Boomer generation. But, given the financial crisis and a low interest rate environment, the VA's most appealing features have been increasingly expensive for insurance companies to offer. Indeed, at least three publicly held insurers reported huge charges to shore up their VA guarantees in the third quarter of this year.

VA issuers are now scrambling to find ways to offer contracts that are simultaneously exciting (with upside exposure) and low-risk (with downside protection). It has been observed that, to compete for the attention of the independent advisors who sell a plurality of its contracts, VA manufacturers must dream up ever more attractive products that must also, in many cases, satisfy the demands of several other constituencies, such as customers, shareholders, regulators and accounting standards boards. But the inevitable complexity of those something-for-everyone products can itself make them harder to sell. Even in the best of times, it’s a challenging business.