# The Four Most Common Questions about VAs

By Editor Test *Wed, Sep 28, 2011*

*Investors have been asking Moody's if variable annuity issuers have made their products safer, and how Moody's evaluates the safety of VA guarantees. For answers, Moody's turned to the issuers themselves.*

In its annual survey of top variable annuity issuers this year, Moody's Investors Service included the four questions that it receives from investors about variable annuities. Moody's published the issuers' answers in a Special Comment on September 7.

The four questions were, according to Moody's:

- How "de-risked" are the new VA products?
- Among companies with material exposure to secondary guarantees, which have the best hedging programs?
- Are companies still shifting risk to reinsurance captives and how does Moody's assess capital adequacy for VA risk?
- How does Moody's stress test for VAs?

Here is a summary of the issuers' answers:

**How de-risked are the new VA products?**

Moody's noted that the three big variable annuity sellers have all de-risked to some extent this year. Prudential dropped its Highest Daily roll-up to 5% from 6%, MetLife raised its 5% roll-up to 6% but restricts investment choice, Jackson National "has recently made changes (i.e., less competitive features) to some of its most popular products in an effort to curb sales and diversify its suite of offerings," and AXA "linked its guaranteed withdrawal benefit amount to the current interest rate."

Certain embedded risk-management mechanisms like Prudential's and AXA's "can substantially reduce tail risk," Moody's said, but added that the recent level of de-risking won't neutralize all the risks associated with VAs.

"While the new products are materially de-risked, their profitability is still linked to the vagaries of the equity markets, interest rates, policyholder behavior and the effectiveness of a company's hedges. Furthermore, companies need to manage statutory, GAAP and economic objectives simultaneously, which can be challenging when VA blocks are sizeable," the report said.

Moody's speculated that reductions in product richness by the three top sellers of VAs could allow other issuers to gain market share.

**Which companies have the best hedging programs?**

While acknowledging the benefits of an elaborate hedging program, Moody's pointed out that the need for such a program by a VA issuer is "credit negative." In other words, conservative product designs that don't need much hedging inspire more confidence than generous product designs with aggressive hedging.

Moody's cited Ameriprise and Lincoln National as two companies with strong hedging programs. Both had hedge programs that "targeted the economics." With its moderate benefits and controlled growth, plus hedging, Ameriprise came through the Financial Crisis in good shape. Although Lincoln National required TARP money in the Crisis, its VA program wasn't the main source of weakness, Moody's said.

**Are companies still shifting risk to reinsurance captives and how does Moody's assess capital adequacy for VA risk?**

Many companies still manage tail risk of VA guarantees by using onshore or offshore reinsurance captive companies, Moody's said, but in many or most cases, those reinsurers are not capitalized to CTE 98 levels (Conditional Tail Exposure 98, or the financial resources a company would need to cover the average of the worst 2% of market scenarios).

By that measure, Moody's believes that captive reinsurers are undercapitalized by a collective $10 billion, although most insurers are well capitalized on a consolidated basis. Nonetheless, given that, in Moody's opinion, the modeling required by state insurance regulators under VA CARVM (the U.S. statutory reserve standard for VA living and death benefits) and C3 Phase II (an approach to calculating U.S. regulatory capital requirements for VA secondary guarantees) doesn't capture "adverse movements in interest rates or extreme policyholder behavior," the capital shortfall may be greater than $10 billion.

**How does Moody's stress test for VAs?**

Moody's standard stress scenario for variable annuities is a 25% to 30% equity market decline, the report said. If a company appears likely to suffer losses during those conditions, Moody's would incorporate the vulnerability into current ratings so that a less abrupt downgrade would be required during a crisis.

In assessing the strength of an insurer, Moody's also considers the capital position of its reinsurance captive as well as its adjusted RBC (risk-based capital) and the company's assumptions about policyholder utilization of "in-the-money" guarantees, where the clients' current assets don't cover the potential liability.