The View from the Variable Annuity Trenches

By Editor Test *Wed, Jul 25, 2012*

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The variable annuity industry, like the rest of the economy and the government, is in a state of suspense in the summer of 2012.

On the one hand, low interest rates are forcing yesterday's sales leaders to trim withdrawal rates, raise prices and moderate sales. On the other hand, ongoing Boomer demand for guaranteed income is creating new sales opportunities for smaller VA issuers, who didn't gorge on risk during the boom years.

Roughly speaking, VA issuers are a little like homeowners in the wake of the financial crisis: some carry a lot of risk and can do nothing but wait for the market to turn around; others still have a lot of equity and can enjoy the blessing of low-rate refinancing.

But what does the VA market look like to the people who wrestle with it every day? To find out, *RIJ* talked to three veterans in the field: Eric Henderson of Nationwide Financial, Dan Kruse of Securian Financial, and Bruce Ferris of Prudential Annuities. Here's what they had to say.

Eric Henderson, senior vice president, individual products and solutions, Nationwide Financial Services.

Nationwide, one of the largest variable annuity issuers in recent years, has reduced the maximum roll-up on its Destination Navigator 2.0 variable annuity to 7% from 10%. It is partnering with Morgan Stanley Smith Barney to introduce a contingent deferred annuity to fee-based clients.

"The CDA works almost identically to the VA with the GLWB, in terms of what you're guaranteeing. It's just a different legal structure. With the VA, the insurance company chooses the fund, but in the CDA, we cover [outside assets] with guarantee. [The insurers] have to price it differently, partly because we see no income from the investments. As a result, you'll see guarantees on the CDAs being less rich [than VA guarantees].

"Also, the variable annuity is commission-based, so over the long haul the insurer will see more income than from a fee-based product. That's one reason you don't see 'rollups' in the CDA: you don't have that extra margin. In the CDA world, you don't want to over a certain fee level. A few years ago, they didn't want you to go over 100 basis points [for the unbundled living benefit]. Now there's leeway to charge a little more for the benefits, but there's still pressure to keep fees from getting too high in that world.

"If you want to deal with a [large wirehouse like] Morgan Stanley, hooking up all the plumbing is expensive. The fee-based advisors will be on the platform, and all of their reporting will be there. So if I add a CDA, the advisors have to have the same level of reporting capability. Typically, all the calculations take place on the platform and the platform provider feeds the data back to the insurer. The provider will want to do the calculations, but the information still has to come back to us because we're buying and selling positions in order to hedge appropriately. The cost of offering the [CDA] benefit is primarily around hedging and a little around administration.

"If you're dealing with a large wirehouse, it's probably a one-to-one transaction between the insurer and the wirehouse. If you're dealing with a smaller firm, it's their platform that gets involved. Sure, a fee-based advisor can still buy a fee-based variable annuity, but it's a relatively short step for us to say, we can insure funds you already have, versus saying the [fee-based] advisor must take his assets and move them to a variable annuity with a completely different set of funds. When [a CDA writer] deals with a Morgan Stanley Smith Barney, or any other large wirehouse, we go with the funds that they have. We might wrap a subset of what's on the platform. If the wirehouse has 1,000 funds, there might be only 200 we can wrap. Platforms typically already have asset allocation models that we can wrap. That's the key to the CDA. You work with the funds and the models that are already there.

"At the moment, everything is on hold. There's the regulatory stuff. And, interest rates being where they are, it's just not a good time to offer new products. We launched our CDA in the middle of the financial crisis. We won't know until we get into a more normal interest rate environment."

Niche player with a 'catchy' new product: Dan Kruse, second vice president and actuary, Securian Financial.

Securian Life and Minnesota Life are small, diversified mutual insurers that recently launched the Ovation II lifetime withdrawal benefit, which includes a 6% roll-up and a 200% accumulation if no withdrawals are taken in the first 10 contract years.

"You didn't see us out in front in trying to build AUM or in pushing the envelope [on product design] over the past three to five years. So that puts us in a somewhat different spot than some of the other players who are taking significant action [in the variable annuity space right now].

"Our Ovation II rider is a catchy step up from the original Ovation that we launched last September. As interest rates dropped we knew there would be changes, but we're not sitting on the type of legacy book of business that forces other players to [retreat on benefits]. We didn't try to lead in the past, so we're not sitting on in-force benefits that are in the money. You see some filings where some companies are trying to buy out those benefits. We don't have that. [The current environment] allows us to pick our spots. We've delivered on what we promised all along. We provide a rational product. It's not that we're becoming more aggressive today, it's that the rest of the industry has fallen back.

"We're more upbeat that you would have found us a few years ago. The marketplace is priced more rationally today. We pushed down our market share even in key distribution channels for a couple of years, but we knew we wanted to compete a little harder with Ovation. We put the cost of the original Ovation joint rider at 165 basis points with a 5% payout at age 65. When interest rates dropped, the biggest change in Ovation II was the curtailed joint benefit. We dropped the withdrawal percentages by 50 basis points and dropped the price to 120 basis points.

"In general, the big move this year [in variable annuity benefits] has been the withdrawal rates. With the GLWB, the withdrawal rate is the biggest lever you can pull. [Regarding investment restrictions,] there were a bunch of companies going for the directed allocation solution, to create a [automatic asset transfer] formula like Prudential's. But we're more interested in volatility-controlled funds. I've added the TOPS funds. These funds start to control volatility before they get to our balance sheet, so that there's no in-house black box. We will add more options like these and we will start to direct money into them.

"We don't want to rush out and try to become a top ten provider of individual annuities. According to the LIMRA data, we hang in at about 33rd or 34th in sales. If we could be the 30th largest seller, that would satisfy us and our distribution partners. I'd like to find more partners, but I don't want to be on shelf with 25 other carriers. I'm looking for distributors that appreciate our pursuit of security for the long run, who understand that we'll be here for the full cycle. We believe that this business can be good for the distributor, the manufacturer and the consumer. We don't believe in the 'feature fest.' We don't believe in the shiny lure approach."

The glass-half-full perspective from an industry leader: Bruce Ferris, head of sales and distribution, Prudential Annuities.

After dominating the variable annuity world with its Highest Daily contracts, and weathering the financial crisis with the help of its automatic asset-transfer mechanism, Prudential has gradually cut back its benefits and now speaks often about CDAs, a market it has not formally entered yet.

"[Regarding contingent deferred annuities,] It's good that people [in the variable annuity business] are looking at and focusing their efforts on unprotected asset classes, whether they are mutual funds, managed money, fee-based businesses, SMAs, or wrapped mutual funds. Obviously, that's a pool of trillions of dollars. We believe CDAs are very important, and they represent one example of the creative ways that Prudential can innovate in the guaranteed retirement income space.

"I'm frustrated that our industry sees its glass as 'half empty.' I think it's half full. Demand has never been greater. Capacity has been constrained, but to me that spells opportunity. Everyone has pointed to 2007 and said that was the high water mark in gross sales. The reality is that net sales in 2011 were back at highest level, up 28% year over year. Total industry assets were $1.6 trillion. Our assets under management were at their highest ever. My premise is that assets are stickier than ever, because the investor owns something of value.

"We get no credit as an industry for surviving a 100-year event, or for continuing to weather a 30-year bull bond market. Everyone points to the headwind of interest rates. Yet, despite the headwinds and volatility, insurance companies have met every responsibility. The overall financial health of the industry has never been better.

"Constraint number one is the interest rate environment. Companies are deploying capital where it's best for shareholders. That results in some level dislocation in terms of consistency of providers. We talk about equity volatility, but we also have manufacturing volatility. Some companies are viewing this environment as an opportunity. Companies like Sammons, Symetra and Forethought. These are examples of new entrants, new creativity, and new products. There’s also a back-to-the-future element with a re-emphasis of tax deferral plays. There’s evidence of using alternative asset classes that are not correlated [with the performance of conventional asset classes] for diversification. We [at Prudential] view the [CPPI-like] asset risk transfer mechanism, in one form or another, as being a critical component [in future product design].

“Where the industry may deserve some criticism is when it allows itself to be viewed as a zero-sum game. Can the product be good for the investor and good for the shareholder over time? We believe the answer is yes. Sales aren’t good unless they’re profitable. [Annuity issuers] are quick to compare ourselves with each other and within our own companies, and we allow the advisors to say that our products aren’t as good as they used to be. But, ‘not as good’ compared to what? And, as much as we view the interest rate as a near-term headwind on the manufacturer side, it’s nothing compared to the tailwind we’re getting on the consumer side from the Boomer retirement wave.”