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Why Indexed Annuity Sales Are So Strong

By Kerry Pechter *Thu, Apr 4, 2019*

Many factors are driving the increase in indexed annuity sales: More manufacturers, better products, more distributors, competitive commissions, aging boomers, and relaxed regulation. But does the bubble contain the seeds of its own deflation?

For Jim Fahey, an Ameriprise advisor in Center Valley, PA, 2018 was a hockey-stick year for fixed indexed annuity (FIA) sales. "FIAs were roughly 25% of my business in 2017. But in 2018 they represented 50% to 60%," he said this week. "I still have variable annuities on the books but I don't think I sold any last year."

Fixed indexed annuities, he found, appeal to jittery clients who want to lock their equity gains into a vehicle with more pizzazz than short-term bonds. "We took profits out of the market, quite frankly," Fahey told *RIJ*. "When you start seeing a company like Apple, for instance, selling at nosebleed levels, you have a conversation with clients about taking some marbles off the table."

In 2017, uncertainty over the status of proposed new federal regulations chilled FIA sales. But after the so-called fiduciary rule was swept aside by the Trump administration and a Texas federal appeals court, sales rebounded in 2018 to new records of $19.2 billion for the fourth quarter of 2018 (up almost 41% from the same quarter in 2017) and $68.4 billion for the year (up 26.8% from 2017).

Relief from regulation may not be permanent, however, and it explains only part of the FIA surge. FIAs, as they typically do during low interest rate periods, enjoyed a yield advantage last year over certificates of deposit; that helped. The aging of the baby boomers and their need for safe and/or income-producing financial instruments continued to provide some demand tailwind—but that doesn't explain much. Accumulation FIAs have actually been selling better than income FIAs in recent years.

More fundamentally, the supply of FIAs has risen as many life insurers de-emphasize the sale of hard-to-hedge, capital-hungry variable annuities in favor of less volatile indexed annuities. The number of distribution channels for FIAs has increased as well, now extending beyond independent agents to independent broker-dealers and even, via no-commission platforms, to registered investment advisors.

"Part of [the increase in FIA sales] is carrier driven," said a full-service national broker-dealer executive who could speak to *RIJ* only on background. "You have many insurers coming into the FIA space. They came in part because the volatility management strategies that insurance companies were putting into variable annuities after the financial crisis didn't work as well as anticipated. We continued to see strong sales for the Jackson Nationals of the world" [who offered less restrained investment strategies.] But insurers who focused on volatility management strategies pulled back."

Drivers of the sales rebound

"There was a large demand for indexed annuities in 2018 for two main reasons: Volatility in the markets and continued low interest rates on fixed money instruments such as CDs and fixed annuities," Sheryl Moore of the annuity sales tracker, Wink, Inc., told *RIJ* in an email this week. "Eighteen of 20 indexed annuity manufacturers had increases in sales from the prior year.

"CDs were crediting an average rate of 1.69% (per BankRate.com) in 2018. Fixed annuities were crediting an average rate of 2.89% in 2018. Indexed annuities were much more competitive, offering average annual point-to-point caps of 5.37%—and 'uncapped' products yielded even greater potential returns. Sales were down in 2017 because of the DOL's rule distracting product manufacturers and distributors. So a 26.82% increase in sales was easier-to-achieve," she added.

"Indexed annuity sales increased for all channels, but none more than the wirehouses [full service national broker/dealers], which increased 21.14% in the fourth quarter of 2018 from the third quarter of 2018. But this channel still accounts for the least sales (except for the direct-to-consumer channel, which accounts for almost no sales). The independent agent channel increased sales only 5.77%, but took home 54.24% of the sales."

[At the LIMRA Retirement Industry Conference in Baltimore yesterday, one life insurance executive said that recent growth has been stronger among accumulation-oriented FIAs than among FIAs with lifetime income benefits. A few years ago, about 70% of his sales involved income-oriented contracts, he said; that percentage is down to about 50%—possibly because bank advisors and broker-dealer reps want the highest crediting rates. Accumulation-driven FIAs typically offer higher crediting rates than income-oriented FIAs.]

Scott Stolz, president of the Raymond James Insurance Group, told *RIJ* in an email: "March was a record month in indexed annuity sales for us. We also did far more fixed annuities than this level of interest rate would typically create. Here's what we think is going on:

- The baby boomers are older and are therefore getting more conservative. Many of them just can't take the risk of another 2000-02 or 2007-09. They like the idea of getting 4-5% on average with no downside risk. I asked one of our advisors why he was now selling indexed annuities instead of variable annuities. His answer was simple: 'My clients are older now.'
- Every time the market corrects, we get another spike in both fixed and indexed sales. When the market recovers, indexed sales fall off a little, but remain above the previous levels thereby creating a new plateau.
- Indexed annuities have performed as advertised over the last 10 years. Clients (and therefore advisors) have had a good experience and are more comfortable using them. The products have gotten better, with shorter surrender charges and better caps and participation rates.
- More traditional annuity companies have introduced products, thereby adding to the credibility of the product as well as the marketing. More financial institutions are offering the product (and actively marketing it to their advisors)."

More 'digestible' for issuers

At the manufacturer level, the rise of FIAs reflects in part a retreat from VAs, whose problems during and after the financial crisis drove many life insurers out of that business entirely. Several surviving VA issuers tried managed-volatility subaccounts to shift risk onto the contract owner, but those strategies backfired, in a sense, when the stock indices steadily rose.

"The FIAs are clearly more digestible for the insurers than VAs with managed volatility," said the wirehouse executive. "The volatility management strategies just didn't perform as well as expected during the V-shaped stock market recovery from the financial crisis. "Even if VA issuers were 100% hedged, they could have encountered situations where the subaccounts underperformed. And they had to reserve for that potential loss. After that experience, they said, 'we don't want to take on that risk anymore.'

"So as an advisor you ended up with an anticipation issue. Clients said, 'I should have gotten 12 when the market went up 20. So why did I get five?' Advisors were having a lot of conversations that they didn't want to have about how these VA volatility strategies worked. The black box approach of FIAs is easier to explain to a client than the black box of volatility managed funds in VAs."

"The FIA is a sweet spot for insurers," said Scott Hawkins, an analyst at Conning, a consulting firm that tracks life insurer profitability. "FIA is not as risky as a VA. It requires a little less capital than a fixed annuity, which requires a bit more capital than a VA. And there are a lot of distribution opportunities with an FIA. They started out being sold by independent insurance agents, but now many broker-dealers sell them and they're accessible in no-commission form to registered investment advisors (RIAs). You don't need to own a broker-dealer to sell FIAs, so that increases the number of life insurance companies that can sell them."

Too much of a good thing?

But Hawkins thinks that life insurers might have trouble putting all that new FIA premium to work in the bond market, where it might be difficult to find sufficiently high returns at acceptable risk levels. If not, they might have to exercise their annual right to lower the caps or participation rates of in-force contracts, which would hurt sales.

"We see a potential headwind or fallout from this increase in sales," Hawkins told *RIJ*. "Insurers have to put large sums of money to work and they have to find safe assets to invest in that don't reduce their overall portfolio yields. That creates a potential margin squeeze. They might promise 3% to the client on the assumption that they'll earn 5%. But what happens if the company can only earn 4.5%?

"We track the changes in asset allocations and risk profiles of the insurers and we have seen a shift in both quality and duration of the bonds. They're adding investment risk to generate more yield. For example, my colleague looked at the difference between the insurers' average yield and the 10-year Treasury yield. In 2007, the difference was 132 basis points. In 2017, the difference reached 214 basis points." To beat the safe return by that much, they had to take more risk, Hawkins said.

Another potential headwind: a new round of regulation. "One of the major factors [in the indexed annuity sales rebound], was that the regulation battle settled," Hawkins added. "But now the SEC is looking at a new 'best interest' rule, and the states are getting involved. The DOL fiduciary rule was the first shot across the bow in terms of increased regulation, but it won't be the last. Life insurers will need to continue to respond to that issue with the development of no-load annuities and life products."

Clients lead themselves to the product

The wirehouse executive who spoke with *RIJ* believes that FIAs will continue to sell well. "As advisors get more holistic, it will undoubtedly lead to broader utilization of the products," he said. "There have also been advances in the ability of the planning software to illustrate the benefits of annuities. The software is getting better at quantitatively optimizing the annuity in the portfolio.

"Historically, advisors would leverage annuities as part of a core-satellite strategy. They would have annuities off to one side. But the software now enables them to manage annuities as an asset class inside a broad portfolio." It's also easier to compare FIA crediting rates than to compare potential VA returns, he added. "So the flows naturally go to the most competitive solution. That gives issuers a clear incentive to compete on product quality." His company intends to start selling no-commission FIAs later this year.

To be sure, FIAs aren't quite selling themselves. Annuities are still sold, not bought. "The client isn't coming in and asking for an FIA; it has to be put in front of them," said Jim Fahey of Ameriprise. "Usually the clients lead themselves to the FIA. Once they express the purpose of a certain portion of their money, they're amenable to the product."