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Variable Annuity & Index Annuity Market Growth Parallels

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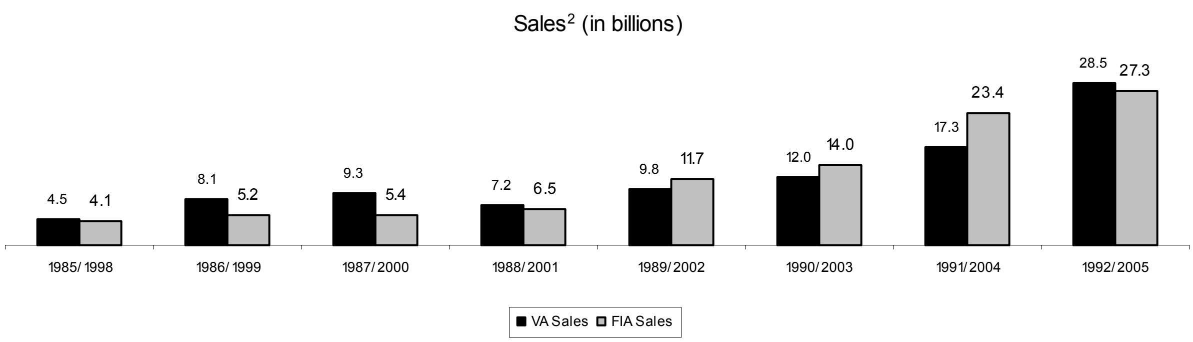
The index annuity industry in 2006 appears a different one from that hatched in 1995. Instead of a few carriers offering index annuities there are now over fifty. New riders and new wrinkles are appearing in products on an almost monthly basis. And the regulatory and litigation environment is generating unwelcome attention. There are also ongoing changes in market share and sharp disagreements over the future direction of the industry. But all of these index annuity issues remind me of another industry I have followed for the last 20 years.

Although variable annuities have been around for decades sales only began to take off in the mid '80s. The VA industry has also experienced an explosion of vendors, rapid sales growth, ongoing product innovations, and was forced to face challenges from the regulatory world. It seemed to me that in many respects the index annuity industry was writing a similar story to that of the variable annuity one. This article attempts to look at some experiences and issues in the VA world and note any similarities with the index annuity one.

Sales Curves

Even after a decade and a half of growth VA sales had only reached $4.5 billion by 1985[1]. By contrast, even though the first index annuity sale happened in February 1995, sales were over $4.0 billion only four years later. If we use these similar sales starting points we see both industries enjoyed generally similar rising sales stories over their respective eight year periods



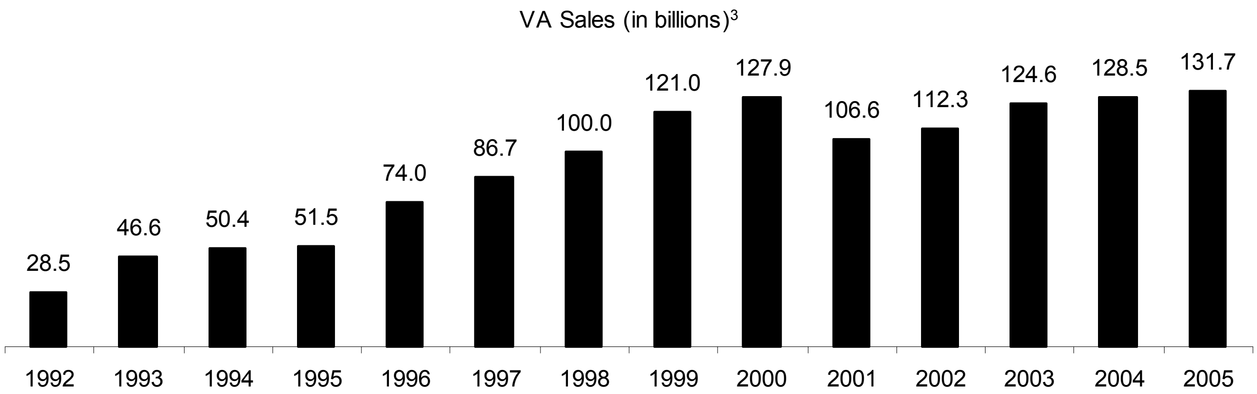
Although the future sales for index annuities have not yet been written we do know what happened to VA sales – They exploded in the 1990s.

VA 1992 sales tripled in the next five years and prompted forecasts of 2000 sales hitting $182 billion and then growing ever higher[4]. We have seen similar hubris in the index annuity world wherein seers extrapolate one year's growth pattern into the future without regard for market forces and realities. However, much of the rapid growth in both industries appears to have resulted from distinct and cyclical forces.

Market Share

Although the top players in variable annuities shift position, no one really has a commanding share of the market. Back in 1990 Prudential was the largest carrier with 9.68% of the market. In 2005 TIAA-CREF was the leader with a market share of 10.25%[14]. In recent years Hartford, TIAA-CREF and MetLife seem to swap around places, but all have very similar market shares.

In the index annuity world Allianz has held a 30% share of the market for four years and been the market leader for six. Although the positions of the rest of the top ten are very fluid no challenger has come close to toppling the leader.



Exchanges

In 1994 91.6% of VA sales ($46.2 billion) were from new non-1035-exchange dollars[6]. In 2005 new money VA sales were $18.9 billion or 14.4% of total sales[7]. In other words, in 2005 over 85% of VA sales was the result of moving from one annuity carrier pocket to another and new money sales were a third of what they had been a decade previously even though total sales had more than doubled.

What drove this growth in 1035 transfers? Indications are it was upfront premium bonuses. Although Prudential came out with one in 1989, the first big media mention of a premium bonus was in 1990 on the new American Skandia 5.5% "exchange credit" designed to offset the effect of old contract surrender charges[8]. Interest in premium bonuses was modest until the later half of the last decade, at which time concerns of possible abuse rose to such a level that the SEC and NASD stepped in – by 2000 each had segments on their web sites warning consumers about their being "no free bonus"[9].

At the beginning of 2001 fewer than 10% of index annuity sales involved a premium bonus and, coincidently, I estimated that over 90% of the sales were new money to the industry – not the result of an exchange. By contrast in 2006, based on my conversations with carriers and an analysis of the percentage of sales involving upfront premium bonuses, I estimate that 50% of the index annuity premium received is coming from other annuities.

The regulators have not, as of yet, focused their attention on index annuity bonuses. From my conversations I believe this may be because they are unaware of the level of exchanges.

Innovations

A problem for both variable and index annuities is that no carrier has a sustainable competition advantage. Any new product, new concept, new procedure can be quickly stolen and implemented by competitors. The only thing that is left is the loyalty of your distributing agents. I have been told that producer loyalty is worth about a half percent of commission or higher yield. What this translates into is a never-ending cycle of meaningful and meaningless innovations.

In the early '90s innovation was technology based with telephone transfers and automatic allocation introduced, and the next wave was VA carriers cramming more and more subaccounts into the VA chassis[10] even though giving a consumer too many choices can decrease sales [see May 2006 Index Compendium]. American Skandia was amongst the most innovative VA carriers in the business. They pioneered the use of using independent fund managers rather than insurance company employees, they introduced trailing commission to improve policy stickiness, and they gave away investment software that made financial advisors look smarter in front of their clients[11]. Even so, American Skandia wound up selling their VA operation to Prudential Financial in 2003.

A round of innovations that began during the late '90s centered on riders designed to reduce risk. Variable annuities offered guaranteed benefits such as guaranteed minimum death benefits, guaranteed minimum income benefits, and guaranteed minimum withdrawal benefits. The riders attracted attention and by 2004 the income benefits rider was being added by 59% of VA purchasers, with a great deal of interest also being seen in withdrawal benefit riders[12]. I have heard speculation that these riders are the sole reason VA sales have rebounded.

Index annuities used new crediting methods to attempt to differentiate themselves from one another. From three basic methods at product inception there came to be over 40 variations by 1999.

The number of available methods decreased during the bear market, but within the past year or so the number of methods has once again jumped higher. Are the new methods increasing sales? With the exception of the now somewhat dated monthly-cap-forward-not-back method no other new method appears to have lit a fire under sales. Carriers have also played with offering different indices, trailing commissions, and even a rider to help pay taxes on accumulated interest upon death, but none of these truly excited the marketplace.

The newest index annuity innovations, borrowed from the VA world, are riders that guarantee a better death benefit, greater certainty of income, or provide a few other benefits. Although I believe we will see swarms of these riders as they are adopted by other carriers it will be interesting to see what ultimate effect they have on sales. VA riders are all designed to lower the risk of owning an investment while index annuities already offer strong guaranteed death and income benefits.

On the subject of riders, it is interesting to hear concerns in some quarters that VA carriers may not be charging enough to cover the costs of these benefits. By contrast, a couple of regulators have shared they are concerned index annuity carriers may be charging too much for their riders.

Regulation, Litigation & Bad Press

That variable annuities are regulated by both security and insurance regulators is an issue that was resolved many years ago. Regulator attention increased as VA sales increased. As regulator attention increased trial lawyers began looking around for new revenue sources and both parties excited the media to examine the variable annuity world. The three parties initially seemed to focus on the appropriateness of VAs in qualified plans, then looked at high fees and then bad 1035 exchanges. I am optimistic that better supervision is decreasing all of these issues.

By contrast, the question on whether an index annuity is okay in an IRA is seldom raised – hopefully because the overriding reason people buy index annuities is for yield and not tax-deferral[13]. The fee question does not usually persist after it is explained that a participation rate is not a fee. And of the fifteen lawsuits mentioning index annuities I have read not one is saying the index annuity concept is bad, but usually is based on allegedly bad agent behavior. Although I am concerned about index annuity exchanges the outside world does not seem hung up on it. The media is perhaps the biggest problem because they keep trying to fit index annuities into their preconceived variable annuity box.

Assets in VAs climbed to $1.2 trillion in 2005[18]

However, index annuities have one unique regulatory issue – they are caught in a turf war between the NASD and state insurance departments. Industry growth has a cloud hanging over it because the SEC has not clearly defined which camp an index annuity must join.

Advantage Compendium estimates there are $108 billion of in-force index annuity policies

The Message

The SEC says the message of variable annuities is as follows, "Although variable annuities are typically invested in mutual funds, variable annuities differ from mutual funds in several important ways:

First, variable annuities let you receive **periodic payments** for the rest of your life (or the life of your spouse or any other person you designate). This feature offers protection against the possibility that, after you retire, you will outlive your assets.

Second, variable annuities have a **death benefit.** If you die before the insurer has started making payments to you, your beneficiary is guaranteed to receive a specified amount – typically at least the amount of your purchase payments. Your beneficiary will get a benefit from this feature if, at the time of your death, your account value is less than the guaranteed amount.

Currently only 3 out of 1000 variable annuities are surrendered due to death or disability[19]

Third, variable annuities are **tax-deferred**. That means you pay no taxes on the income and investment gains from your annuity until you withdraw your money. You may also transfer your money from one investment option to another within a variable annuity without paying tax at the time of the transfer. When you take your money out of a variable annuity, however, you will be taxed on the earnings at ordinary income tax rates rather than lower capital gains rates. In general, the benefits of tax deferral will outweigh the costs of a variable annuity only if you hold it as a long-term investment to meet retirement and other long-range goals. [from http://www.sec.gov/investor/pubs/varannty.htm]

In 1993 the number of new VA products filedincreased 50% over 1992[20]. From 2005 to 2006 the number of available index annuities nearly doubled to over 250.

Here is how index annuity carriers defined their product ten years ago:
"You enjoy the safety and security that a traditional fixed annuity guarantees, combined with the potential of interest earnings linked to the S&P 500 Index"[15]. "You will only share in the increases in the index. Your index annuity value will never decline due to decreases in the index and previous increases once earned are locked in and guaranteed"[16]. Excess interest is determined annually and is based on your contract's participation rates, which are a percentage of the performance of the S&P 500"[17].

The messages of both variable and index annuities have stayed amazingly on target over the years. The GMIB, GMWB and GMDB riders all relate to the VA core message of income and death benefits, and are designed to enhance one or the other. Index annuities are still predominantly marketed as a traditional fixed annuity with higher interest potential due to an index link.

Summary

A question for both products is are there enough consumers to continue past growth rates? The low percentage of new money entering the VA arena would indicate that the market for VA benefits is saturated. To illustrate, in 2005 similar amounts of outside fresh money came into the variable annuity and index annuity segments, but total variable annuity sales were five times those of index annuities.

Index annuities, as with other fixed annuities, may well be an interest rate play that enjoys strong sales when CD rates are weak and poor sales when CD rates are strong. It is possible that all fixed annuity sales have a saturation point of $100 to $150 billion in annual sales and index annuity sales will plateau at around the $50 to $80 billion mark.

VA & FIA Similarities	Regulatory Attention As Sales Grew
A Prolonged Period Of Rapid Growth	New Sales Are Increasingly From Existing Annuity Exchanges
A Constant Stream of Meaningful (and sometimes meaningless) Product Innovations	Uncertainty Over Where Future Growth Will Come From
	The Original Consumer Message Has Stayed The Same

Although demographics strongly support a growing need for all types of annuities the security industry has done a much better job of communicating their alternate retirement story to the public. Whether variable and index annuities track a parallel future course is unknown.

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