

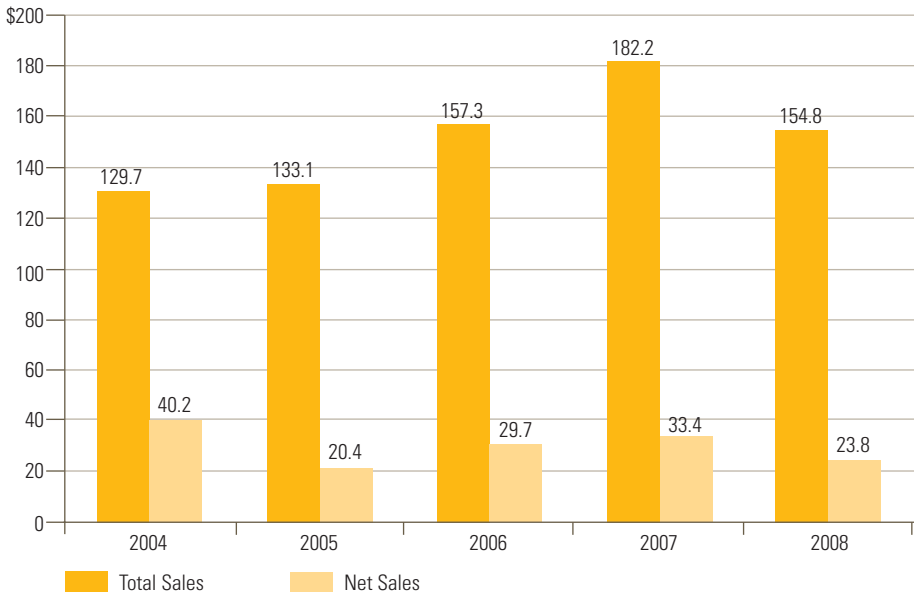
Variable Annuities—2008/2009 Update

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Variable annuity sales fell precipitously in 2008, mostly due to depressed activity in the second half of the year. Total annual sales were \$154.8 billion as compared with 2007 sales of \$182.2 billion, a decline of 15%. The bulk of retail sales in 2008 continued to be driven by living benefits, but losses and continued uncertainty kept many investors from investing in variable products.

Net sales in 2008 were \$23.8 billion, a 28.7% drop from 2007 net sales of \$33.4 billion. Net sales as a percentage of total sales also declined slightly, from 18.3% in 2007 to 15.4% in 2008. Withdrawal and surrender activity, as well as 1035 exchanges of existing contracts, are some of the factors that influence the extent to which increases in total sales drive increases in net sales. The greater the level of activity that either does not result in new dollars to the industry (exchanges) or drains dollars from the industry (withdrawals and surrenders), the lower net sales tends to be as a percentage of the total. In the second half of 2008, heavy losses resulted in lower dollar value exchanges, depressing sales to some extent, while overall lower levels of investment impacted both sales and net cash flow.

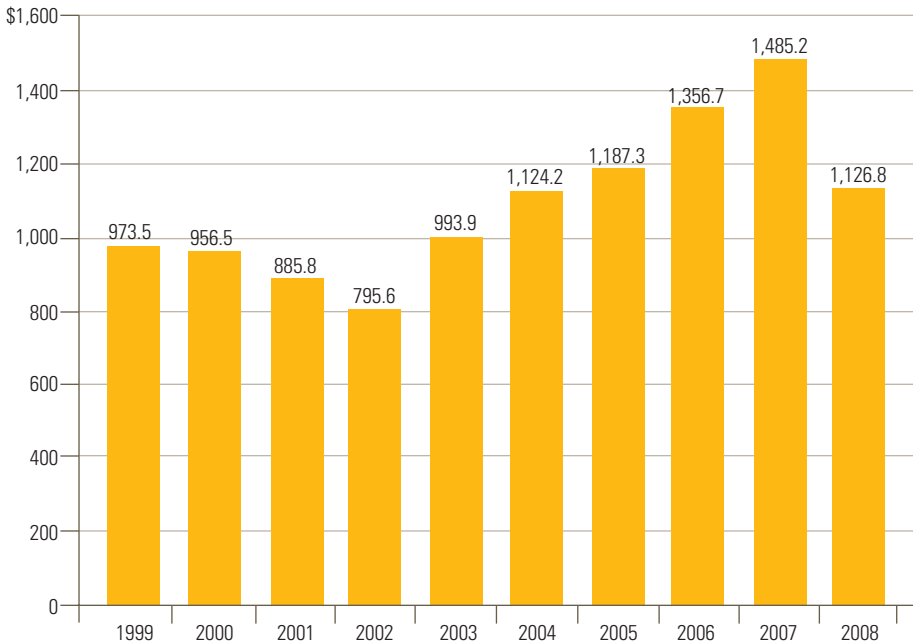
Figure 6-1 Variable Annuity Total Sales and Net Sales
(dollars in billions)



Source: Morningstar, Inc.

Total variable annuity net assets shrunk to \$1.1 trillion in 2008, ending 24.1% lower than the end of 2007. The drop was largely driven by the huge drop in domestic equities in the second half of 2008, as evidenced by the 37% negative change in the S&P 500 Total Return index.

Figure 6-2 Variable Annuity Net Assets
(dollars in billions)



Source: Morningstar, Inc.

Factors Impacting the Variable Annuity Industry

Baby Boomers

With 77 million baby boomers turning 63 this year, securing income continues to be in focus as a crucial element of planning for a potentially long retirement. The variable annuity can be an important component of an overall plan, providing a hedge against inflation through exposure to the growth potential of equity investment, and the security to remain invested in the market with the protection of guarantees offered by the many products in the case of a market downturn.

Living Benefits

The industry remained heavily focused on guaranteed living benefits in 2008, particularly guaranteed minimum withdrawal benefits (GMWBs) and guaranteed lifetime withdrawal benefits (GLWBs). The unexpectedly severe pullback in markets in 2008 caused many insurers to close out riskier living benefits and re-launch them under more restrictive terms and at higher cost. Ironically the same downturn that caused insurance companies to retool their products is increasing investor interest, causing sales to attenuate after reaching multi-year lows in the late fall of 2008. While the benefits are certainly less lucrative now, demographic forces and increased uncertainty and fear should continue to drive sales higher.

Regulation

Regulatory scrutiny (which will be discussed in more detail later in this chapter and in the chapter on *Regulation and Taxation of Annuities*) continued to have an impact on the industry. FINRA continues to increase its focus on the sales practices and market conduct of those who sell variable annuities. The industry condemns any improper sale of its products and feels that those who are involved in such transactions are not representative of the industry as a whole. The industry supports strong consumer protection legislation and regulation and enforcement against those who violate these laws.

Product Trends and Innovations

Guaranteed Minimum Withdrawal Benefits

The GMWB continued to grow in both popularity and complexity in 2008. The standard GMWB design guaranteeing that a certain percentage (typically 4-7%) of a benefit base (often premiums paid) can be withdrawn each year until the base is completely recovered, regardless of market performance, has evolved into a multi-faceted benefit offering benefit value step-ups, bonuses for postponing withdrawals, spousal continuation, and other features designed to address both longevity and inflation risks.

The GLWB offering withdrawals for life, first introduced in 2004, continued to drive sales in 2008. This benefit guarantees that a certain percentage of the benefit base (typically 4-5%) can be withdrawn each year for the life of the contract holder. In 2004, there were three companies offering this product. As of this writing, the majority of companies offering a GMWB have an option that guarantees payments for life. Companies have reported contract holder election of the GLWB rider at anywhere from 50-80%.

There are a number of reasons why GMWBs and particularly GLWBs are so popular. GLWBs provide a floor of protection for the contract owner, guaranteed income payments that the annuitant cannot outlive, flexibility (partial withdrawals, the ability to start and stop payments), and liquidity (cash surrender value available if needed). These products saw significant enhancements in 2008 with companies offering richer and more diverse benefits. Now, as mentioned above, a reversal of sorts is taking

place as companies pull back on these guarantees. Lower withdrawal rates, higher fees, fewer opportunities to “step up” the guaranteed value or earn enhancement credits, and more restrictions on investment are the primary modifications companies are making.

As more and more baby boomers approach retirement, the popularity of products that address the need for guaranteed income, such as GMWBs and GLWBs, will likely continue to grow. However, innovations that companies may have been planning, such as Consumer Price Index (CPI), indexed withdrawal guarantees and more aggressive value enhancements in exchange for delaying withdrawals will likely remain on hold pending the establishment of a clearer direction for the market and the broader economy.

Longevity Insurance Products

As a result of this growing need for income guarantees, longevity insurance products are offered by some companies and are on the drawing boards of others. The defining characteristic of these products is that they provide competitive guaranteed future income, generally starting at an advanced age such as 85, to those who are still living. The idea is that longevity is a risk that can be pooled and diversified much like life insurance. Those who die prior to age 85 “subsidize” the income stream paid to those who reach 85. With these products, a relatively small portion (e.g., 10%) of the retiree’s nest egg is invested in an annuity. The remaining 90% can be used to fund retirement prior to age 85 as the longevity insurance will provide an income stream to cover the years after 85. While the approach is conceptually interesting, anti-selection risk and delayed gratification may impede widespread availability and adoption.

Immediate Variable Annuities

Immediate variable annuity (IVA) sales for 2008 were virtually unchanged from 2007 and still represented less than 1% of total sales. The ceding of a pool of dollars to the insurance company in exchange for scheduled payments is a tough sell when investors are used to measuring wealth by the size of the portfolio rather than by the amount of income generated, an interesting dichotomy given that annual income, rather than net worth, is a more commonly used yardstick for measuring success during one’s working years. There is also the issue of advisor perception that annuitized assets are assets lost in terms of generating future fees or commissions, which decreases the likelihood that annuitization will be recommended. Finally, the continued success of variable annuities with guaranteed living benefits, particularly GMWBs, combined with the above perceptual issues makes it hard to envision significant investment in the development of new annuitization-based products. This is unfortunate; while GMWBs may be more flexible, fixed and variable immediate annuities can be an important part of an income plan, and the higher income payments achievable through the pooling of mortality risk are not achievable in any other investment product. Single Premium Immediate Annuities (SPIAs), which are fixed annuity payout products, will likely get a boost as retirees look to generate maximum income from depleted portfolios.

Sales Trends

Contracts

Due to continued consolidation in the industry, the number of companies offering variable annuities last year dropped again for the seventh consecutive year. The number of unique products offered, however, continued to grow with 1,491 available at the end of 2008—a three-fold increase over the past ten years.

Figure 6-3 Variable Annuity Contracts

(dollars in billions)

Year	# Unique Products Offered	# Cos. Selling Variable Annuities	# Contracts in Force (millions)	Average Individual Contract Value	Average # Funds Per Registered Contract
1999	359	66	-	-	-
2000	437	64	29.7	\$32,722	-
2001	523	60	28.2	\$32,071	33
2002	667	55	27.7	\$29,376	34
2003	818	50	28.0	\$35,860	38
2004	941	48	21.5	\$52,200	39
2005	1,008	45	21.8	\$55,800	44
2006	1,150	42	22.5	\$61,400	44
2007	1,376	40	22.8	\$66,500	52
2008	1,491	39	23.4	\$49,200	51

Source: Morningstar, Inc. and LIMRA International

Share Class

In 2008 X-share (Bonus) contracts were broken out separately, changing the market shares of the other classes. Traditional B-share contracts, with surrender charge periods of approximately seven years, continued to be the leading seller with 42% of the market in 2008. L-share contracts (which have shorter surrender charge periods, typically three to four years) rose slightly to 28% of total sales. A-share products (with up-front sales charges and no surrender charges) and C-share products (which have no up-front or surrender charges) accounted for 4% and 6%, respectively. Contracts with the new “X-share” designation accounted for 14% of total sales, and the remaining contracts classified as “Other” (generally contracts where the investor is required to choose from among multiple share class options) made up 6% of total sales.

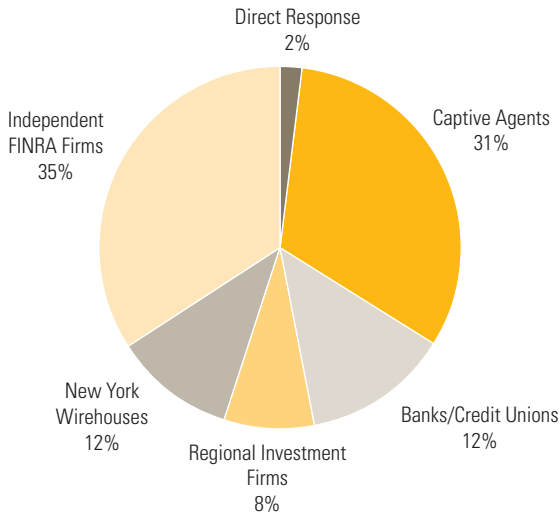
Distribution Channel

Sales by distribution channel remained essentially unchanged in 2008. The most popular channels continued to be captive agency and independent FINRA firms.

Figure 6-4

Variable Annuity Total Sales by Distribution Channel

(as of 12/31/08)



Source: Morningstar, Inc.

Recent Regulatory Developments

On January 8, 2009, the SEC adopted new Rule 151A in an effort to require the registration of all fixed indexed annuity contracts. The Rule reflects an interpretation by the SEC that the registration exemption for “annuity contracts” under the Securities Act of 1933 excludes fixed indexed annuity contracts. The effective date of the Rule is January 12, 2011, so the registration of fixed indexed annuity contracts would be required by that date. The Rule was challenged by American Equity Investment Life Insurance Company and other members of the fixed indexed annuity industry as well as state regulatory authorities on the grounds that the SEC’s interpretation was arbitrary, capricious, and unreasonable under the US Supreme Court’s standard of review for administrative rulemaking articulated in *Chevron*, and that the SEC failed in its obligation to consider the effect of the Rule on efficiency, competition, and capital formation. On July 21, 2009, the U.S. Court of Appeals for the D.C. Circuit held that the SEC’s interpretation was reasonable but remanded the matter to the SEC after concluding that the SEC’s consideration of the effect of Rule 151A on efficiency, competition, and capital formation was arbitrary and capricious.

At the same time it adopted Rule 151A, the SEC also adopted Rule 12h-7 under the Exchange Act, which provides an exemption from the reporting requirements of Section 15(d) of the Exchange Act for insurance companies that issue securities registered with the SEC and regulated as insurance under state insurance law.

Rule 12h-7 does not apply to equity securities issued by an insurance company, and is subject to certain conditions, including conditions intended to ensure the absence of any trading interest in the securities. The Rule became effective May 1, 2009.

On April 15, 2009, the SEC approved certain amendments to NASD Rule 2821 governing the suitability of purchases and exchanges of deferred variable annuity contracts. The amendments limit the Rule's application to recommended transactions, changes the triggering event that begins the principal review period from the date of the customer's signature on the application to the date when a firm's office of supervisory jurisdiction receives a complete and correct copy of an application, and clarifies certain matters through supplementary materials. The amendments are effective February 8, 2010.

(More information on these and other regulatory initiatives can be found in the chapter on *Regulation and Taxation of Annuities*.)

Summary

Despite the fact that the variable annuity industry saw significant sales declines in 2008 and net sales decreased even more, there are arguments for assuming brighter days ahead. The use of variable annuities for securing a portion of retirement income should significantly grow the pie in the next few years as baby boomers look for ways to maximize income from shrunken nest eggs while being mindful of future inflationary pressures. Many investors, in hindsight, would have preferred the certainty of a small loss (the fees of a variable annuity with a guaranteed living benefit) vs. the 40% loss they may have experienced late last year – particularly those investors in or nearing retirement who are unable, or less able, to offset these losses with earned income. The variable annuity industry is well positioned to capitalize on baby boomer demographics, the question is simply whether compelling benefits can be offered with manageable risk profiles; clearly the industry can accomplish this, and the message of “growth potential with guarantees” should resonate in this market and economic environment.

