2018 IRI Annual Key Findings

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OVERVIEW

U.S. Annuity Markets 2017: Guaranteed Retirement Income in a Fiduciary World

Survey conducted in partnership with Insured Retirement Institute (IRI)

January 2018. The following are key findings from ***The Cerulli Report—U.S. Annuity Markets 2017: Guaranteed Retirement Income in a Fiduciary World***. These findings were created exclusively for the Insured Retirement Institute (IRI) as part of a survey partnership in 2017. Your insight and time are greatly appreciated and we look forward to your continuing support.

Executive Summary

A majority of surveyed insurers (40%) say the cost of variable annuity (VA) benefit hedging is their main obstacle, followed by building and distributing fee-based VAs. **(Exhibit 1)**

Greater than two-thirds (64%) of surveyed insurers believe there will be greater availability of guaranteed living benefits over the next few years, although most believe it will occur in fixed-indexed annuities (FIAs), not VAs. **(Exhibit 2)**

Overall, 84% of insurers believe the availability of optional guarantees associated with fee-based annuities will increase over the same time period. **(Exhibit 2)**

Nearly 67% of surveyed insurers said guaranteed living benefit (GLB) risk management operations would not be unduly harmed if interest rates stay at historic lows. **(Exhibit 4)**

Greater than two-thirds (70%) of surveyed insurers believe the Department of Labor (DOL) Conflict of Interest Rule will be positive for fee-based platforms and independent registered investment advisors (RIAs). **(Exhibit 6)**

Greater than three-quarters (81%) of insurers believe the diminishing guarantees provided by VAs are the driving factor behind the recent success of FIAs. **(Exhibit 8)**

Less than one-quarter of insurers believe the recent success of FIAs is due to more consumer-friendly marketing (24%), increasing product supply and distribution support (19%), and/or improved advisor training (14%). **(Exhibit 8)**

All insurers believe that positioning products to better meet advisors' needs is the best strategy to increase VA sales, followed by constructing products for fee-based platforms. **(Exhibit 10)**

Exchange-traded funds (ETFs) are viewed as the funds with the highest chance of earning opportunities in the VA space, followed by passively managed funds. **(Exhibit 11)**

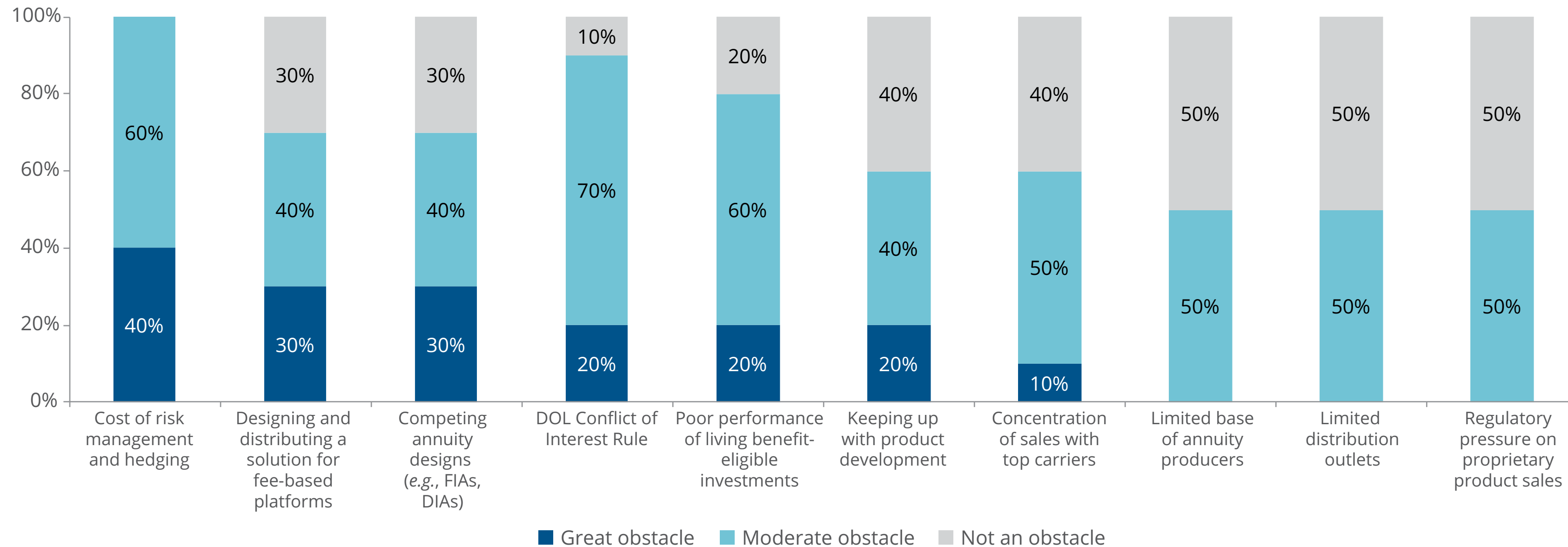
Most surveyed insurers (66%) believe the most important attribute of an investment-only VA (IOVA) is a low M&E charge; a wide variety of subaccount options is also crucial, with passively managed funds much in favor. **(Exhibit 12)**

Exhibit 1

Insurer Perspective: Greatest Obstacle in Variable Annuity Business, 2017

Sources: Cerulli Associates, in partnership with IRI

Analyst Note: No survey respondents indicated a limited base of annuity producers, limited distribution outlets, or regulatory pressure on proprietary product sales as being the greatest obstacles in their VA business.



- A majority of surveyed insurers (40%) say the cost of variable annuity (VA) benefit hedging is their main obstacle, followed by building and distributing fee-based VAs.
- Although proprietary sales are expected to be negatively impacted by the Department of Labor (DOL) Conflict of Interest Rule, no companies rank it among the greatest obstacle.

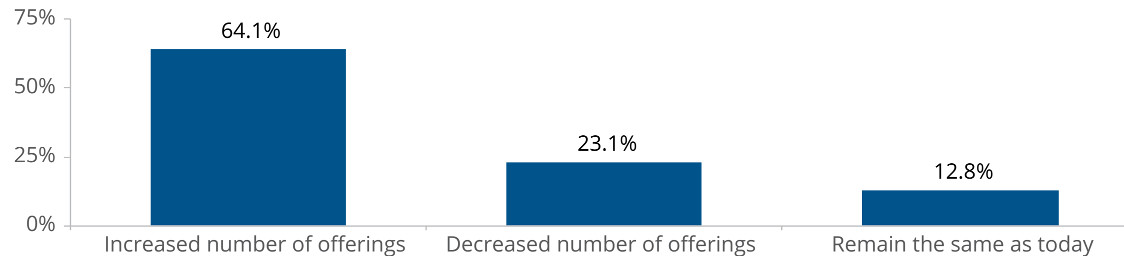
Key Implication: Benefit hedging is a major issue for VA insurers as it is costly and complex. However, it is necessary due to the lack of reinsurance capacity to back up these guarantees. There have been multiple instances since the 2008 financial crisis where insurers have admitted pricing their riders too low to cover hedging costs, and/or failed to hedge specific market risks adequately. Some insurers admit to not covering volatility at all, which became extremely problematic when the CBOE-VIX spiked. On a related note, 80% of respondents believe that lackluster performance of living benefit-approved investments is an obstacle. This is especially noteworthy because such funds are integral to nearly every insurer's risk management efforts.

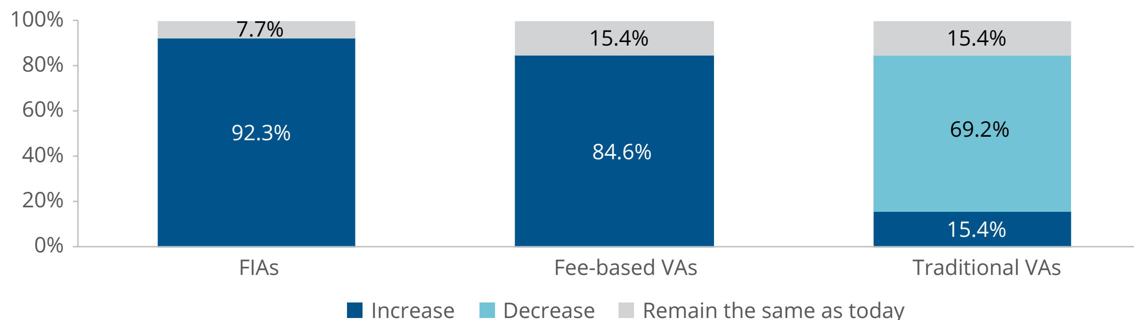
Exhibit 2

Anticipated Availability of Living Benefits in the Next Three Years, 2017

Sources: Cerulli Associates, in partnership with IRI

Analyst Note: No insurers indicated that the supply of FIA and fee-based VA guaranteed living benefits would decrease over the next three years.





- Greater than two-thirds (64%) of surveyed insurers believe there will be greater availability of guaranteed living benefits over the next few years, although most believe it will occur in fixed-indexed annuities (FIAs), not VAs.
- Overall, 84% of insurers believe the availability of optional guarantees associated with fee-based annuities will increase over the same time period.

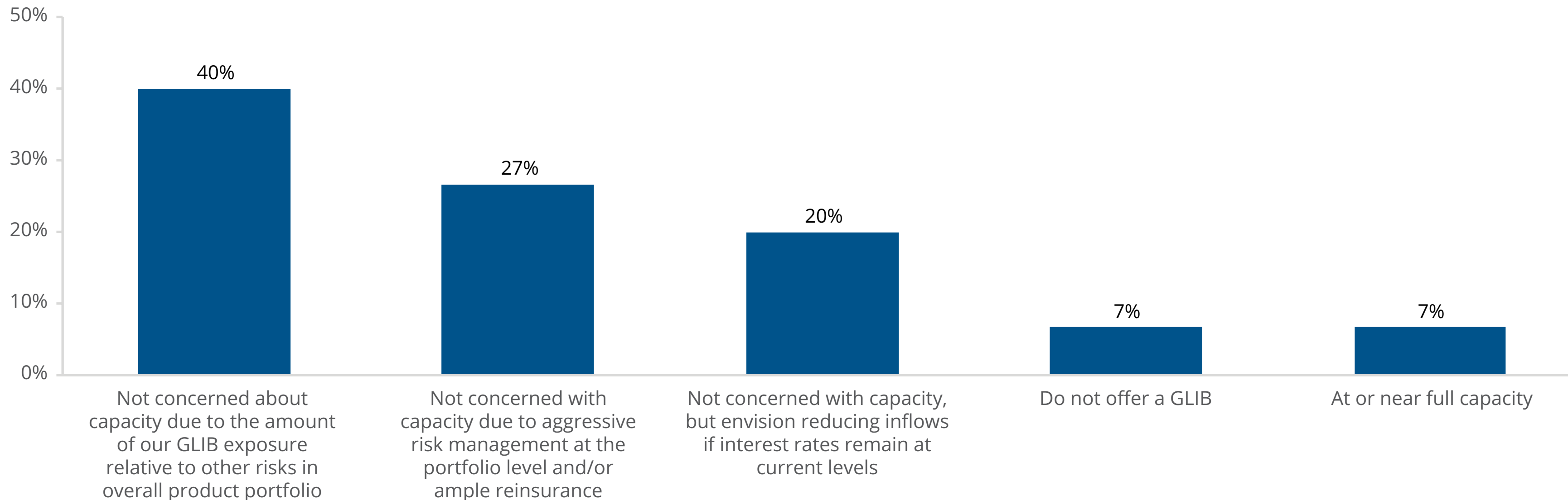
Key Implication: Cerulli finds it interesting that a large portion of insurers believe the prevalence of guaranteed living benefits (GLBs) will grow over the next three years. The general trend around the VA space has been toward derisking, which has made benefits less attractive than in the past. This has been a contributing factor to lower industry sales, but most insurers believe they now have adequate risk modeling. If true, signs of insurers gaining comfort in reintroducing compelling, yet sustainable, options may be materializing. Still, as illustrated here, this product development is more likely to benefit FIAs than it is VAs.

Exhibit 3

Insurers' Capacity for Guaranteed Lifetime Income Benefits, 2017

Sources: Cerulli Associates, in partnership with IRI

Analyst Note: Insurers were asked, "Which statement most closely represents your capacity for guaranteed lifetime income benefit risk?"



- Although not a majority, 40% of surveyed insurers think they have room to take on more GLB capacity.
- More than one-quarter of insurers (27%) believe the reason they have more capacity is that they have the correct portfolio risk management systems in place.

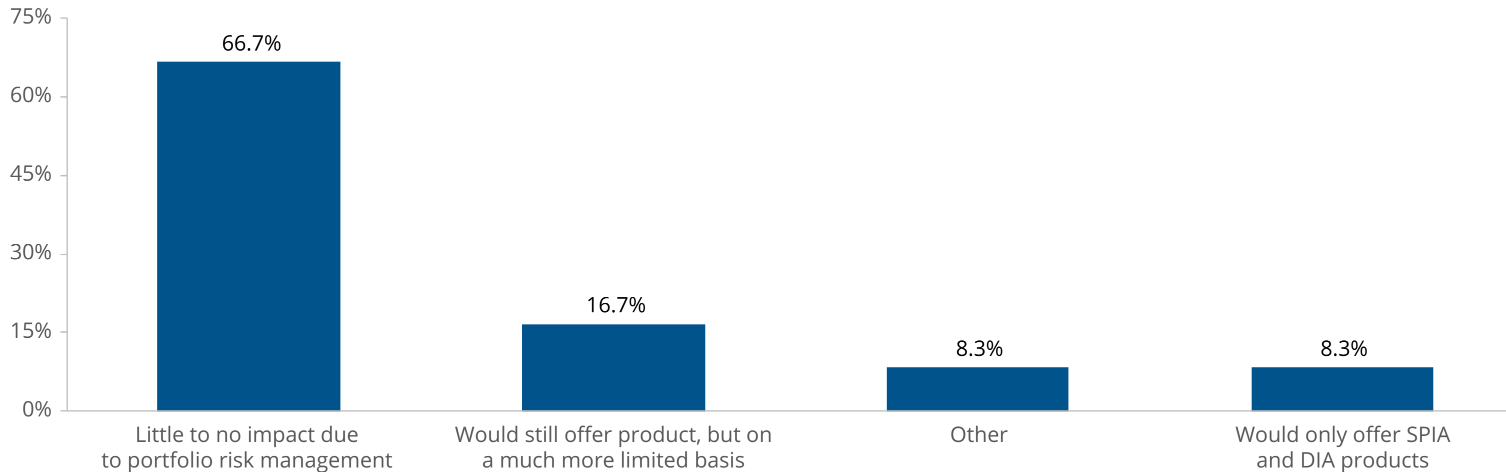
Key Implication: A considerable number of insurers surveyed, albeit not most, believe they have room to take on more GLB business. One reason given by 40% of respondents was that they don't consider GLB risk to be as big of an issue as other products in their portfolio. That could be because they are relative newcomers to offering such benefits, and have not accumulated large books of net amount at risk (NAR) that they need to service. Another group indicates they have the correct risk management techniques that will allow them to take on more benefits. That's understandable because such programs have evolved greatly since their infancy, with many added sources of assistance. Cerulli can confirm a few companies that make up the 7% that say they are at or near capacity are those that participated in the benefits "arms race" of 2002–2007 and are now scaling back.

Exhibit 4

Potential Impact of Interest Rates on Guaranteed Lifetime Income Benefits, 2017

Sources: Cerulli Associates, in partnership with IRI

Analyst Note: Insurers were asked, "Imagine that interest rates remain at current levels through the end of 2020: What is the most likely impact on your guaranteed lifetime income annuity business (not including investment-only VAs)?" Other responses included, "We would introduce a FIA with a GLWB" and "We would reduce the benefit guarantees or value proposition."



- Nearly 67% of surveyed insurers said GLB risk management operations would not be unduly harmed if interest rates stay at historic lows.
- About 17% of insurers would scale back their benefit sales in a persistent low-interest-rate environment.

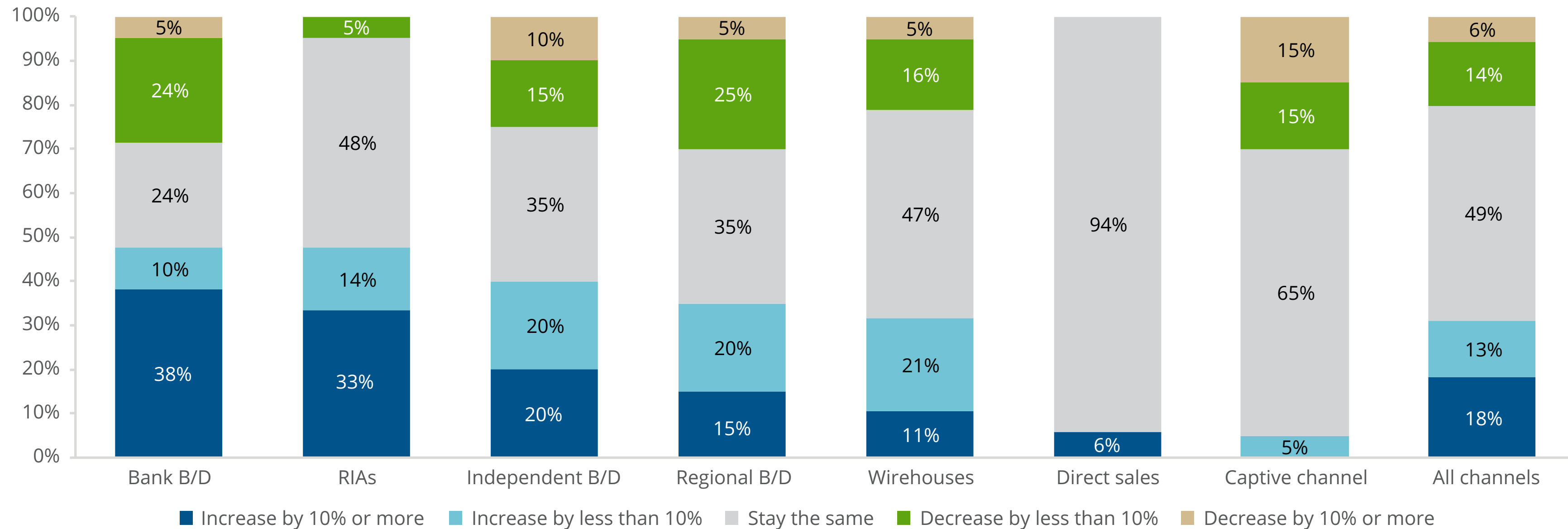
Key Implication: On the face of it, interest rates should be a major consideration for insurers with income guarantees, as companies will need strong yields from their general account fixed-income portfolios to support future payments. Based on this survey, it appears that issuers have rate hedging under control. Perhaps the emergence of risk-levered guaranteed living withdrawal benefits (GLWBs) has helped: in some designs, the withdrawal rate decreases after the VA's account value falls to $0. Naturally, this can reduce the amount the insurer must pay out over the remainder of the client's life.

Exhibit 5

Expectations of VA Sales Over the Next Three Years by Channel, 2017

Sources: Cerulli Associates, in partnership with IRI

Analyst Note: Insurers were asked, "How do you expect your firm's annual sales of VAs in the following channels to change during the next three years?"



- Surveyed insurers believe bank broker/dealers (B/Ds) and registered investment advisors (RIAs) will be the most likely to increase VA sales over the next three years, while wirehouse production is expected to grow slightly, at best.

Key Implication: Bank VA sales are expected to increase 10% or more over the next three years; however, a good portion of respondents predict a decrease at least to some degree. This could be because there is already sufficient use of the product in banks. As for RIAs, 33% of insurers believe they will experience sales growth of 10% or more, and yet nearly half (48%) say sales would remain the same. This speaks to the unpredictability as it relates to guaranteed income products in the channel. This is in spite of explosive headcount and asset growth and insurers genuinely attempting to meet all of their "desired" annuity features.

Exhibit 6

Insurers' Perceived Sales Impact of DOL Conflict of Interest Rule by Channel, 2017

Sources: Cerulli Associates, in partnership with IRI

Sales Impact	Positive	Neutral	Negative
Fee-based platforms	70%	30%	0%
Independent RIAs	70%	30%	0%
Strategic partnerships with direct-to-consumer providers (*e.g.,* Fidelity, Schwab)	30%	70%	0%
Commission sales through nonaffiliated broker/dealers	20%	40%	40%
BGA/IMO	10%	50%	40%
Proprietary advisorforce	0%	40%	60%

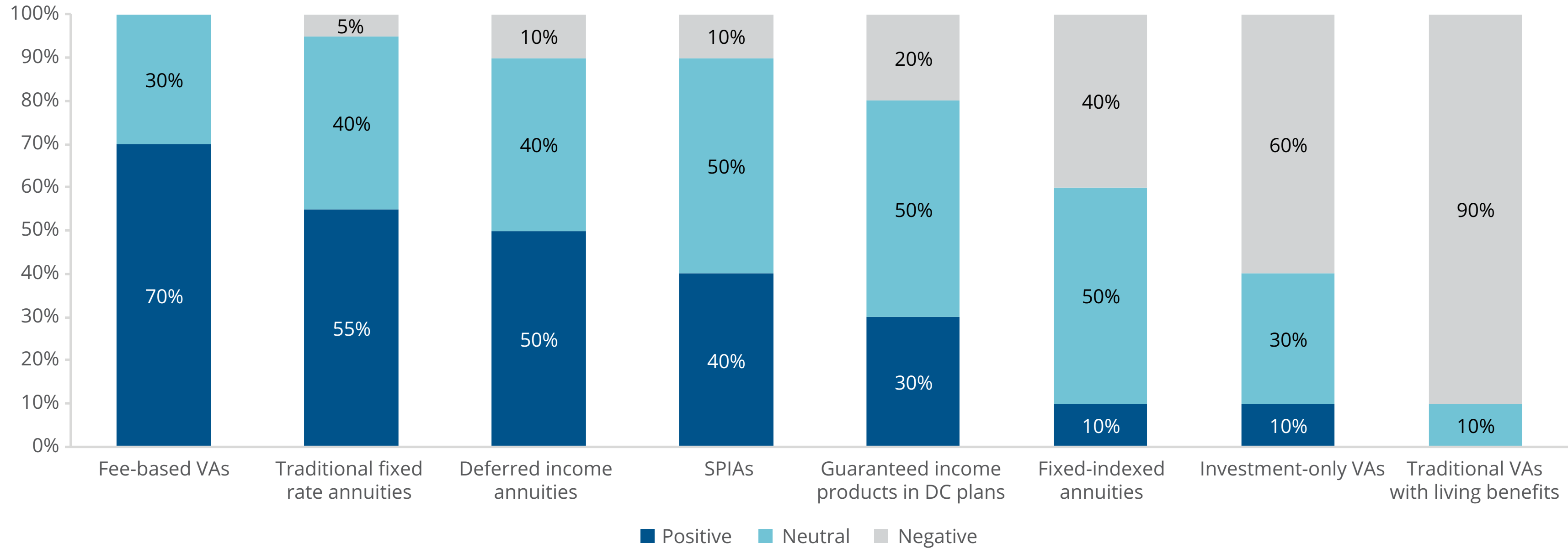
- Greater than two-thirds (70%) of surveyed insurers believe the DOL fiduciary rule will be positive for fee-based platforms and independent RIAs.

Key Implication: Insurers generally agree that success among fee-based platforms will be helped by the DOL fiduciary rule; in fact, 25 out of 45 new VA registrations in 2016 were I-share contracts. However, addressing RIAs will continue to bring challenges. Other Cerulli data points illustrate that 82% of independent RIAs did not sell an annuity in 2016, but making the effort is worth it. Of the 16% of RIAs that sold up to five VA contracts in 2016, the average sale was $254,132. On average, this is two to three times the amount of any other channel.

Exhibit 7

Insurers: Anticipated Sales Impact of the DOL Conflict of Interest Rule by Annuity Product, 2017

Sources: Cerulli Associates, in partnership with IRI



- As expected, 70% of surveyed insurers believe fee-based VAs will be the main beneficiaries of the DOL Rule, followed by traditional fixed annuities and DIAs.

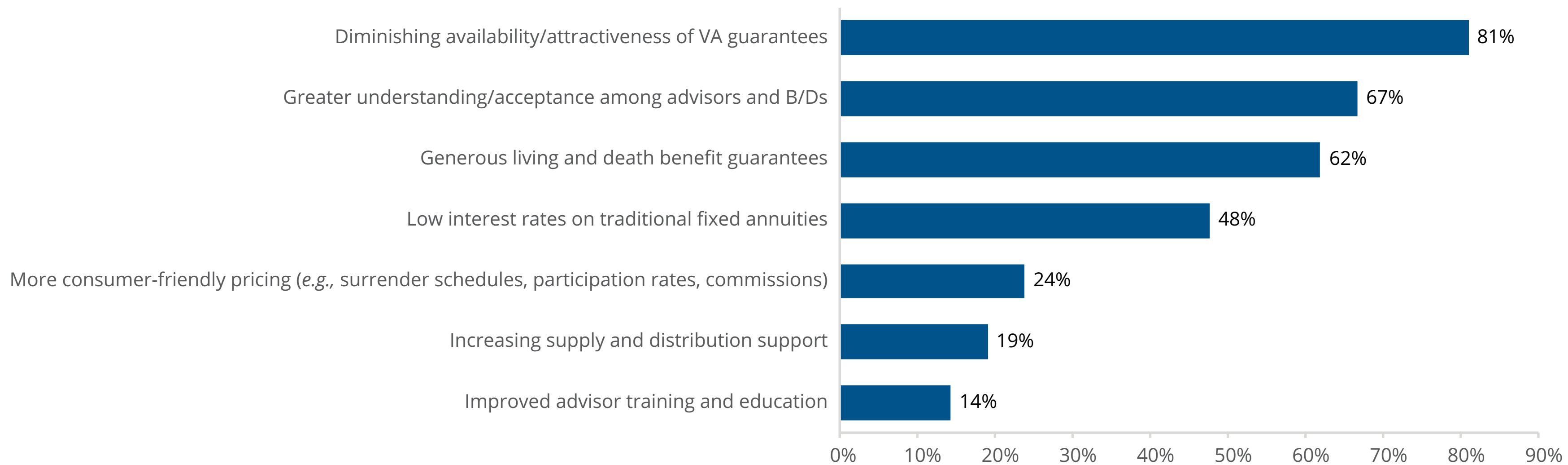
Key Implication: The consensus is that use of fee-based VAs will certainly grow due to the DOL Rule, whatever final version is implemented. After that, the most likely beneficiaries of the rule are those with two attributes: 1) principal protection, which is inherent to traditional fixed annuities and FIAs; and 2) a strong guaranteed income story, such as DIAs and SPIAs. Cerulli expects high activity around the designing of I-share VAs, but more traditional VA share classes will likely be harmed by the rule. This will be more due to their compensation structure and fees than lifetime income features. Other products will arise that will offer the same kind of attractive guarantees that have been staples in traditional VAs.

Exhibit 8

Insurers: Factors Driving Growth of Fixed-Indexed Annuity Sales, 2017

Sources: Cerulli Associates, in partnership with IRI

Analyst Note: Unsolicited consumer demand and consumer-focused marketing materials were offered as options, but were not selected in 2016 or 2017. Other responses included "advisor compensation" and "fear of interest rates rising and/or a market correction."



- Greater than three-quarters (81%) of insurers believe the diminishing guarantees provided by VAs is the driving factor behind the recent success of FIAs.
- Less than one-quarter of insurers believe the recent successes of FIAs is due to more consumer-friendly marketing (24%), increasing product supply and distribution support (19%), and/or improved advisor training (14%).

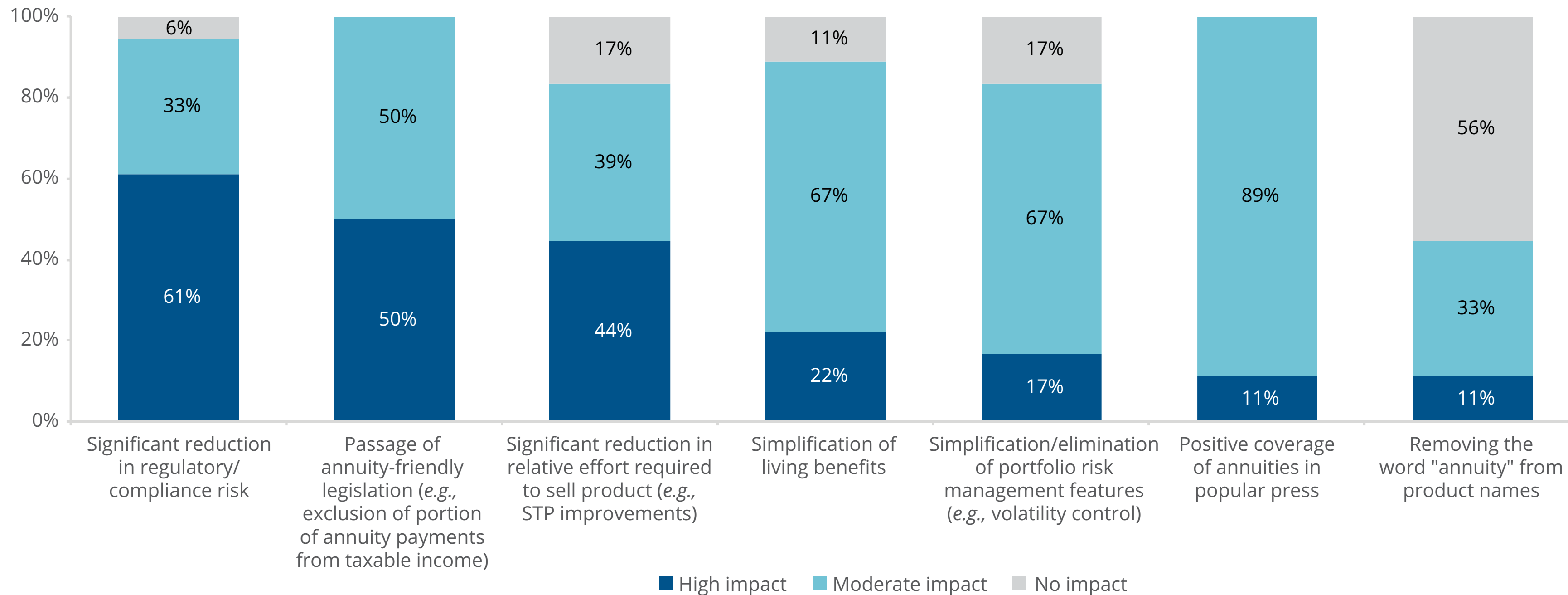
Key Implication: Even many FIA providers' survey responses reflected a belief that the recent sales successes of FIAs is due to increasingly unattractive VA guarantees and an overall limited supply. Cerulli is encouraged by the improvements made in the FIA marketplace, including improved transparency and product simplification, although B/Ds' and advisors' acceptance of FIAs is also likely a result of unattractive VAs. Many advisors are simply forced to look at new solutions for their pre-retiree and retiree clientele. As a result, Cerulli is relatively optimistic on the outlook of FIAs, although VAs are likely to gain unrivaled marketshare if insurers regain confidence in their ability to offer and hedge more appealing VA income riders.

Exhibit 9

Insurers: Advisors' Willingness to Use Annuities with Retirement Income Clients, 2017

Sources: Cerulli Associates, in partnership with IRI

Analyst Note: Insurers were asked, "Please indicate the level of impact you believe the following would have on a financial advisor's willingness to use annuities with their retirement income clients."



- Across all annuity designs, insurers believe the top-three methods to increase advisors' willingness to use annuities are to reduce compliance risks, annuity friendly legislature, and reduce the efforts needed to sell the products, respectively.

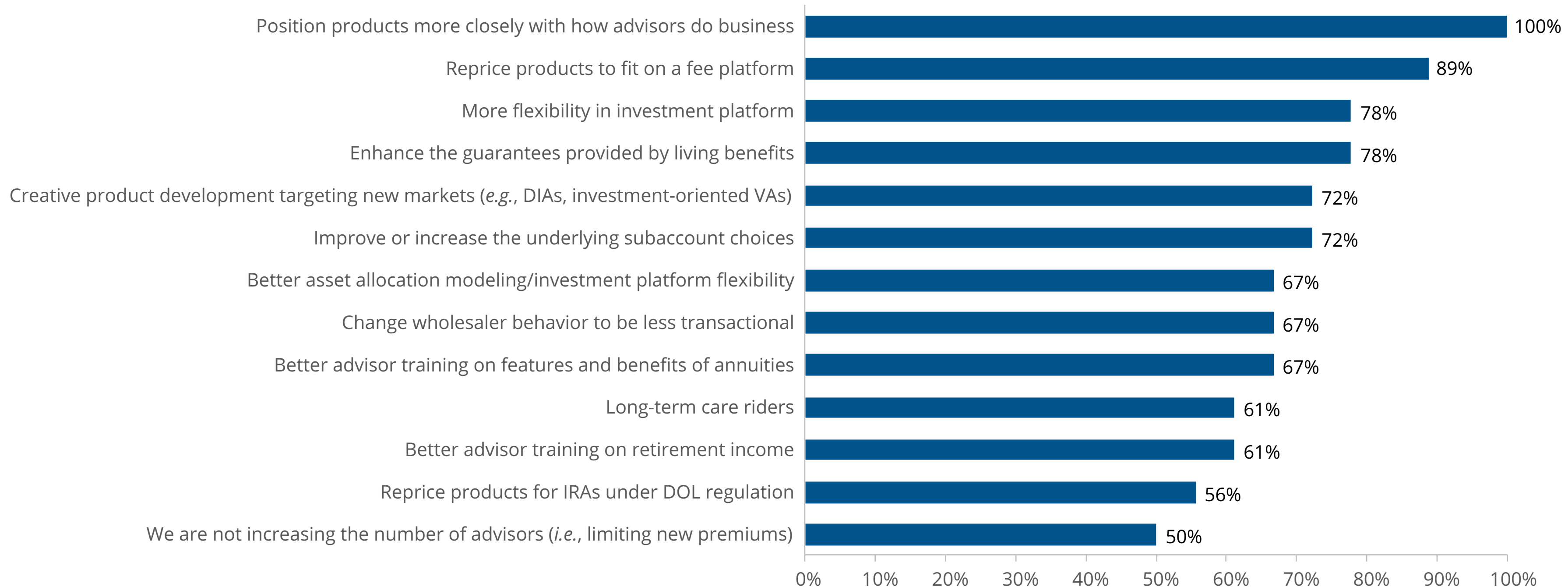
Key Implication: This feedback from insurers should not be surprising and depicts the challenges that the industry faces if the DOL Conflict of Interest Rule is fully implemented. Not only is the rule not "annuity friendly," but it will significantly add to the challenges that advisors already face when positioning annuities to clients, particularly compliance concerns. As Exhibit 10 demonstrates, insurers should focus on increasing the value proposition of their solutions, while keeping costs reasonable. Just as important is ensuring that distribution teams are better prepared to position their products with how advisors conduct their practices and processes.

Exhibit 10

Insurers: Methods for Increasing the Number of Advisors Who Sell Variable Annuities, 2017

Sources: Cerulli Associates, in partnership with IRI

Analyst Note: Insurers were asked "What strategies are most promising for broadening the number of advisors who sell variable annuities?"



- All insurers believe that positioning products to better meet advisors' needs is the best strategy to increase VA sales, followed by constructing products for fee-based platforms.
- Investment platform flexibility is another feature that is believed to be key in driving future sales.

Key Implication: While not a new concept, for VAs specifically, insurers understand they could do a better at aligning their product and distribution strategies with how advisors conduct their practices. Unfortunately, much of the industry is still in more of a transaction-based mode rather than consultative-based. On the other hand, half of insurers said they are not looking to increase the number of advisors they work with. Many of these companies have derisked their offerings and have tempered sales goals. While 61% of respondents say long-term care features would help sales, so far there have been few VA offerings on that front, none of which have garnered significant sales.

Exhibit 11

Most Attractive VA Subaccount Options for Future Sales Potential, 2017

Sources: Cerulli Associates, in partnership with IRI

Analyst Note: Insurers were asked to rate the sales potential of the following investment styles within their VA subaccount platforms over the next three years.

Investments	High Potential	Some Potential	No Potential
Exchange-traded funds	68%	16%	16%
Passive investments	58%	42%	0%
Creating own living benefit strategies	37%	37%	26%
Alternative strategies	26%	63%	11%
Target-risk funds	21%	74%	5%
Traditional domestic fixed income	21%	58%	21%
Managed volatility	21%	58%	21%
External firm acting as consultant and asset allocator for living benefit options	17%	50%	33%
Traditional domestic equity	16%	74%	11%
Target-date funds	16%	58%	26%
Global equities	5%	89%	5%
Global fixed income	5%	89%	5%

- Exchange-traded funds (ETFs) are viewed as the funds with the highest chance of earning opportunities in the VA space, followed by passively managed funds.
- Target-risk funds are perceived to have "some potential" in terms of future sales potential.

Key Implication: Cerulli sees a great opportunity for ETF providers to achieve wider success in the VA space as the funds can dovetail well with insurers' benefit hedging programs. Passive investments that track a benchmark index can also work well in this regard. It is interesting to see respondents say that funds that replicate living benefit strategies have potential, as there is historical evidence that they earn minimal flows (*i.e.,* return-of-premium funds that imitate VA accumulation benefits).

Exhibit 12

Most Important Features in an Investment-Only VA, 2017

Sources: Cerulli Associates, in partnership with IRI

Features	Very Important	Important	Not Important
Lower mortality & expense (M&E) charge	66.7%	33.3%	0.0%
Extensive subaccount lineup	50.0%	50.0%	0.0%
Tax inefficient investments (*e.g.,* high yield)	25.0%	25.0%	50.0%
Passive investments	16.7%	83.3%	0.0%
Unique investment managers and/or unique investment strategies	16.7%	66.7%	16.7%
Priced to fit on a fee-based platform	16.7%	66.7%	16.7%
Basic death benefit	8.3%	75.0%	16.7%
Upfront commission for advisor	0.0%	75.0%	25.0%
Pre-packaged models of investments	0.0%	66.7%	33.3%
Basic living benefit	0.0%	8.3%	91.7%

- Most surveyed insurers (66%) believe the most important attribute of an investment-only VA (IOVA) is a low M&E charge; a wide variety of subaccount options is also crucial, with passively managed funds much in favor.
- If a basic guarantee is to be offered on an IOVA, 83% of insurers believe it should be a basic death benefit.

Key Implication: The results of this survey back up Cerulli's contention that IOVAs are for somewhat cost-conscious investors who want to maximize their potential for tax-deferred growth and potential access to "unique" investments. That is why low costs and investment diversity are important. And yet some companies think a little protection is in order: 75% of respondents say that a basic death benefit (*e.g.,* return of premium) would be an important feature.

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