Regarding Risk – and How VA Insurers’ Methods Are Evolving to Manage It

This year has been one of rapid change, as variable annuity insurers of all sizes have sought to reduce their product-related risks in one form or another, and we’re sure that anyone looking at all the activity from the outside has to be wondering about the health of the industry. They might have questions like: why are so many insurers scaling back? Have they priced their products correctly? What about sales growth going forward?

An event that attempted to address such outstanding questions and concerns was the “2012 Variable Annuity & Life Insurance Summit: Managing Risk in Volatile Times,” hosted by S&P Dow Jones Indices last Tuesday in New York City. We were fortunate to participate in the summit, and in this commentary we’ll share with you some thoughts and impressions we took away from it.

Cause for Cautious Optimism?

Keynote speaker Bob Kerzner, president and CEO of LIMRA, was not shy about acknowledging the challenges that insurers face today, stating that there has not been a more difficult time to be an insurer than the present. Industry fundamentals are “out of whack,” he said, because there is no longer a healthy balance between insurers’ returns and the risks they are taking on; and the latter is a problem that won’t go away anytime soon.

Insurers are pulling back on product because they took on too much product risk. At the same time the low interest rate environment has sapped the investment returns of their general accounts, and has harmed client account values (and has been partly behind the uptick in VA benefit de-risking, but more on that later).

Those are just the current problems, but other potential ones loom on the horizon. Two issues Kerzner said to look out for are legislative and regulatory change. He said that “consumers will be hurt if regulators require us to hold too much capital,” and that pressure of that type was a contributing factors in the departures from the annuity industry of players like Sun Life Financial and John Hancock, whose Canadian parents face more stringent capital requirements than those of U.S. companies.

Of the VA business Kerzer retraced the progress of the industry after 2000, when insurers turned to guaranteed benefits to spur sales during difficult market conditions; this ushered in an arms race, which served to make such benefits very attractive, perhaps too much so. He cited LIMRA survey data that revealed that despite the general trend of product de-risking 86% of VA purchasers in 2Q12 elected a guaranteed living benefit if one was available on their contracts.

Kerzner believes that demographic trends are in annuity insurers’ favor (10,000 Baby Boomers turn age 65 every day) but they are not yet capitalizing on this opportunity. “We’ve blown it in the annuity space,” noting how, from 1996-2010, mutual funds captured far more of Americans’ financial assets than annuities.

One problem for annuity providers is that they have been marketing primarily to Americans ages 65 and older, but “that’s not where the money is,” Kerzner said, making his point via a bell curve graph that showed a high distribution of assets in slightly younger individuals. Thus insurers need to capture the imaginations of such investors, most of whom don’t adequately grasp the concept of longevity risk. Those who will be particularly vulnerable to this risk are individuals who have not saved adequately for retirement, and there are an alarming number of them.
Kerzner said that a total of 76% of pre-retirees surveyed said that getting a regular check in the mail during retirement will be important to them. So by the sounds of that, such people should be good candidates for achieving reliable income through traditional annuitization.

Whenever we get a chance we like to ask industry insiders their thoughts about the future of annuitization. At the summit we spoke with Lawrence P. Greenberg, president of Jefferson National Life, which has been steadily growing sales of its low-cost Monument Advisor VA contract to fee-based reps. Greenberg said that at present he doesn’t foresee many of his clients annuitizing; they are purchasing the VA primarily for accumulation purposes.

Other attendees expressed similar views. They don’t totally rule out getting more people to annuitize eventually, but it will take time. Something that bears mentioning is that there is the prospect of more annuitization occurring eventually as a matter of course, because with Guaranteed Lifetime Withdrawal Benefits (GLWBs), once the client’s actual account value is exhausted, the income stream switches to annuity payments.

Investors' Trepidations

From time to time we hear that investors in insurance stocks have reservations about how well VA carriers are managing their risks. Eric Berg, an equity analyst who is a managing director at RBC Capital Markets, relayed some of these concerns in his presentation at the summit. He said that VA benefit risk is one of several possible reasons for low price/book valuations of insurers these days (the others were regulatory issues, low interest rates and the weak economy causing reduction in demand). Regarding VA hedging, he said that “anxiety remains high” about it among investors.

And it’s possible that mispricing episodes that have occurred in other areas of the insurance business are in the back of investors’ minds. Berg related how Unum Group Corp. got out of the Long-Term Care insurance business early this year because it didn’t count on policyholders – in particular women with dementia – living longer than expected. It’s like Unum threw up its hands and said, “we have no idea what to charge,” for LTC policies, he said.

Anyone following the VA business for the past five years should see parallels between the experience of Unum and VA providers who have bowed out for product-related reasons. Berg pointed out how Hartford, once an industry giant, is now “dismembering.” Furthermore, other less drastic kinds of de-risking have arisen of late, such as the cutting off of additional premium to existing contracts and features. Investors are very interested as to why such steps are being taken.

Berg said he and his team recently interviewed Deep Patel, an actuary at Milliman who consults with leading VA insurers. Patel said that the current low interest rate environment is a big reason why providers have been cutting off additional money going into legacy VAs. This is because older contracts and riders were priced with an expectation that owners’ funds would grow at a certain rate of return; now that interest rates have fallen so low, account values aren’t growing as fast as companies first assumed. Insurers end up in a bind because the additional contributions have to be hedged at today’s hedging costs, which would not be fully covered by the rider charges assessed on vintage benefits.

In his presentation Berg cited other de-risking measures we have covered amply in these pages, such as two-tier GLWB withdrawal rate schemes, with higher rates going to owners who agree to invest in certain “protected” funds that seek to mitigate volatility (the whole topic of “vol-managed” funds was a common thread throughout the summit, but more on that later). Lincoln National’s arrangement with its GLWBs is an example of such a format. In fact, as we pointed out in our October 1 commentary Lincoln will be soon making fresh adjustments to rates on its Lincoln Lifetime Income Advantage 2.0 and Lincoln Lifetime Income Advantage 2.0 Protected Funds riders effective December 3; we figure they will be lowered, but the withdrawal levels have yet to be disclosed.
To us, Berg’s presentation underscored the importance of VA benefit issues in investors’ minds and that this fact is steadily causing insurers to provide more transparency about their risk management techniques.

**Hedging Effectiveness and “Vol” Funds**

Actuarial firm Milliman is currently the leading provider of hedging solutions to the VA industry, and we thought that the presentation of Ken Mungan, the firm’s risk management practice leader, was a fairly optimistic one. He said that the hedge practice began in 1998, and (not surprisingly) started to grow in leaps and bounds in 2000 after the market downturn.

He admitted that insurers’ hedging operations have undergone refinements over time and he showed how, using the Milliman Hedge Cost Index (which tracks the hypothetical cost of hedging the VA guarantees of a GMWB block) hedge costs have spiked considerably in certain periods, such as late 2008-early 2009, late in 2010, and in this year as well. This would help explain the emergence of numerous risk-managed funds into the variable space, which have been developed to assist insurers’ hedging. Mungan broke them out into three types: target volatility, capital protection and duration extension.

One risk factor that insurers were not hedging adequately early on, Mungan said, was volatility of fee income, that is, the chance that rider fees insurers collect will fluctuate as client VA account values go up and down. Mungan said that half of the cost of hedging is related to the pure benefit risk, while the other half has to do with fee volatility.

**Fund allocation makes a big difference in hedging costs, and Mungan said that vol-managed funds can assist in managing fee income risk:** “If you put the hedge inside the fund it stabilizes the fund and therefore the fee revenue,” he said. In one illustration he showed how the hedge savings for an insurer using a volatility-managed fund could be as much as 0.96%. That breaks down to 0.40% for the company having to purchase fewer hedges; 0.36% for having to hold less capital; and 0.20% in reduction to earnings volatility.

And Mungan maintains that vol-managed funds are working as advertised. He provided a comparison between standard variable funds and vol-managed ones under the same market conditions. In a down market scenario if the standard variable fund lost 27%, a vol-managed fund would be off by only 8%. In an up market, if the standard fund returned 34%, the vol-managed one would gain 25% (the difference due to the vol-management providing less exposure to equities on a relative basis).

Something that Mungan thinks will be worth monitoring in the future is how insurers manage the risks of earlier in-force benefits, the very ones now being closed to add-on premium. We predict that creative solutions will emerge to assist with these blocks, even (or perhaps especially) for insurers who have stopped actively selling VAs. These could take the shape of rider buyback programs (we’ve already seen a few), fund transfer schemes (to move investors into less risky sub-accounts) and innovative tweaks to pricing.

The summit featured a panel discussion about the proper investments insurers should use with their annuity and life products given the current concern over risk, and particular consideration was given to volatility-managed funds. To provide some perspective we published a Featured Research spreadsheet, which is being distributed with this report, with data on such portfolios that were in operation through the second quarter of this year. By Q2, assets in these portfolios surged by nearly 24% compared to the end of last year, to $67 billion. And new registrations of them keep on coming: through Q2 we’ve identified 24, well ahead of the pace from last year.
A noteworthy beneficiary of the increased interest in vol-managed funds is the **TOPS/ValMark Investment Alliance**. We have been monitoring the progress of its series of TOPS variable portfolios – the abbreviation standing for **The Optimized Portfolio System** – since they were first filed with the SEC. They commenced operations last April, and since then have rapidly grown their assets, and now appear on products written by Ohio National, New York Life, Jefferson National, Minnesota Life, Kansas City Life and Prudential.

Within the TOPS fund series are **three “Protected” versions** which are now being used by a number insurers as required sub-accounts for certain guaranteed benefits. Michael McClary, chief investment officer of the TOPS/ValMark Alliance said that the protected funds have gotten quick acceptance because they combine investment in a basket of underlying Exchange-Traded Funds (ETFs) with a hedging sub-strategy run by Milliman, and the hedge strategy is robust but flexible; it can be removed in favorable markets with low vols. The funds have gone beyond VAs to be included Variable Universal Life (VUL) policies, the reason being that the reduced volatility can thus reduce the risk of lapsing the policy.

Another thing we have noticed in recent years is the rapid growth of ETFs, especially funds of ETFs, in the variable space, and we have heard anecdotally that these funds dovetail well with insurer’s hedging efforts. **We had been under the impression that ETFs were probably reaching a plateau in terms of growth of assets in the variable space**, but panelist Raman Suri, head of iShares New Markets Distribution, BlackRock, said that he believed ETF penetration into variable market has only reached the “tip of the iceberg.”

For now it appears that most insurers are opting to embed risk management in underlying funds, but SunAmerica has taken another approach by linking the fees on its Income Plus and Income Builder GLWBs to movements in the Chicago Board Options Exchange (CBOE) Volatility Index. Panelist John Wiesner, risk management strategist at CBOE said that such fees have proven to be beneficial to both the insurer and the benefit owner.

Panelist Alan Grissom, vice president of the insurance channel for S&P Dow Jones Indices, said that the aforementioned approaches – tying rider fees to movements in the VIX and embedding vol management in underlying funds – have proven to reduce hedging costs for variable insurers. However he felt that the industry would be better off not pursuing any renewed product “re-risking” even if hedging costs stabilize and stock market and interest rate conditions improve dramatically.
A Model of Utility

Jim Benson, a director on the US Olympic Committee gave the concluding presentation at the summit and we found his remarks insightful. Benson served as an executive at numerous insurers over a long career, among them Equitable Life, MetLife Investors, and John Hancock Life Insurance Company (he was CEO at the latter).

He related how dramatic change in the industry began to take place in 1981, when 1) insurers moved beyond their legacy captive agencies into third-party distributors; 2) there was a rapid increase in the concept of financial planning (everyone was getting into it); 3) there was a shift away from life insurance to annuities such that the latter became a principal product type for many carriers; 4) mutual insurers went public, which was a form of culture shock. VAs really began to come onto the scene starting in 1985.

In the late 1990s, VA sales production really ramped up and guarantees began to be introduced in ever greater numbers, he said, but companies did not foresee the pricing and risk issues that would arise later. Benson was president at Equitable when it introduced the industry’s first-ever Guaranteed Minimum Income Benefit (GMIB), and in retrospect, Benson admitted of that rider “I don’t think we priced it right.”

That income benefit was offered with a tandem death benefit, was initially filed on August 31, 1995 and rolled out in 1996. As for the pricing, we located an Income Manager contract amendment from October 15, 1996 which listed a Combined GMDB/GMIB Benefit (Plan A) with two options at different fees: 0.45% for a 6% rollup to age 80 Benefit and GMIB and 0.30% for a 6% rollup to age 70 Benefit and GMIB.

To Benson, the VA benefit arms race was a period when companies were scrambling wildly to attract assets, and he was hopeful that they are becoming more mature about how they do business. For the future, he suggested that insurers would be better served if they emulated the business model of a utility, one that provides a reliable service, and that fosters a high level of trust.

Final Thoughts – And An Abrupt Change

To wrap up, we came away from the summit feeling that major challenges facing the insurance industry were summarized very well. As for the VA business in particular, those presenters that work most closely with insurers – such as Ken Mungan and the members of the panel – seemed to agree that risk management strategies have greatly improved in recent years, and that the business should weather this period of relative uncertainty.

That said, it sounds like members of the investment community remain skeptical as to whether insurers have “got it right.” With all the pulling back we’ve seen this year it’s not hard to see why investors would feel this way. One summit attendee said he detected a slight tone of pessimism that ran through the event. Another raised the question as to why, if the VA industry is really healthy, insurers would be seeking to reduce their sales.

In fact on the very day of the summit, Jackson National announced a series of VA de-risking measures that would go effective that Friday, October 12. The insurer closed its stand-alone bonus contract, Perspective Rewards, its C-share Perspective Advisors II, the Retirement Latitudes contract and the joint-life options on its LifeGuard Freedom 6 Net and LifeGuard Freedom Flex GLWBs. It also removed optional credit enhancements on all contracts of the Perspective series.

The product closures were made with the shortest notice to financial advisors we have ever seen in recent memory (we recall sudden closings from Transamerica and Allmerica, circa 2002, which
were also very quick). In fact an article in a trade publication said advisors were very unhappy about the scant lead time. Usually insurers will allow sales to go through for applications that had been in the works prior to a closure deadline (say, in a given window period of weeks or months), but we saw no such indication in Jackson’s broker-dealer announcement letter or related SEC filings.

Quite a few of our industry contacts were expecting that Jackson might need to scale back, because its riders remained relatively robust, its flagship GLWB riders don’t impose sub-account restrictions, and the company had not been quite as active in terms of de-risking as rivals like Prudential and MetLife. Jackson might not have decided on this recent set of moves impulsively, it could have planned to pull the plug suddenly as a way to avoid fire sales into the products as they left the shelf – we’ve seen plenty of that in recent years.

So for now, we don’t see any letup in the stream of product closures that have been occurring – and that have been disconcerting to investors and industry observers. And we think that it will take time to determine the full effectiveness of current VA product pricing and risk management strategies. Policyholder behavior remains one of the biggest unknowns (and, truth be told, we know of a number of past cases where groups of contract holders have sought to “game” insurers by exploiting product loopholes).

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"Slap’ to reps as Jackson National cuts VA features on short notice," in October 10 issue of Investment News.