Income Annuities: Helping Our Industry Get Back To Its Roots
Is the Annuity Market at a Crossroads?

By Garth A. Bernard, FSA, MAAA
Vice President, Retirement Solutions, Retirement Strategies Group, MetLife.

The life insurance industry faces the distinct possibility that the annuity market has reached a transition point that describes a mature market along the traditional "S-Curve" of business life cycles. There is strong evidence that supports this view. In recent years there have been several acquisitions within the industry, creating fewer but bigger, more formidable competitors in the space. This type of consolidation — typical of a mature market — is expected to continue. There has also been an alarming and consistent downward trend in net flows into variable annuities over the past decade as indicated by the periodic survey results from MorningStar and NAVA. Despite the recent modest but welcome upswing in net flows and record variable annuity sales, this overall trend suggests that the growth in the variable annuity market has been slowing in terms of *new consumers* of the products. In other words, most buyers of new variable annuities are those who have already purchased one and are merely exchanging their previous purchase to "trade up" for new features and benefits.

Certainly, other reasons may be offered to explain these trends. However, if the hypothesis of a transition point is correct, then regardless of the reason for these trends, the following question can be posed: What development(s) will serve as the catalyst for the next cycle of strong organic growth in the annuity industry and the life insurance business as a whole?

It is easy to conclude that innovation in the annuity product arena could serve as the catalyst for future growth, since innovation was one of the key catalysts for past growth. The emergence of lifetime withdrawal guarantees on variable annuities, the enthusiasm with which the feature has been received, and the growing awareness among baby boomers of the need to secure retirement income that cannot be outlived, would prompt many observers to nominate this single revolutionary feature as the catalyst. The other key catalyst for past growth was the increased breadth of distribution that annuity manufacturers were able to secure, especially among investment advisors within mutual fund companies, banks, wirehouses, and independent broker-dealers.

The questions are whether the lifetime withdrawal guarantee feature or some other innovation will bring new customers rather than cause current variable annuity holders to trade up, and whether these innovations will attract producers who do not currently sell annuities. If observers are right on both these counts, we will experience unparalleled growth in the next phase. But if they are wrong, the annuity industry faces the prosprowth ti serve asrchaslna cou(Swf oau)-2 experienti

Furthermore, it is not clear that innovation is attracting enough new distribution among investment advisors to fuel substantial growth in net flows. Perhaps the fundamental challenge the industry faces is that it may have positioned annuities as an investment with value-added features. In other words, the industry may have established the value proposition of its historical growth engine within the framework of investments.

Viewing annuities through the investment lens can lead to a muddled value proposition. There is considerable evidence of potential confusion with the value proposition of annuities among many advisors and industry observers. The basic confusion is the perception that annuities are simply more expensive and complex investments, either without recognition that the extra fees pay for very valuable guarantees, or with a perception that those guarantees are unnecessary or not worth the fees charged for them. Interestingly, it is those very guarantees — risk management features — that are the foundation of the value proposition insurers bring to the table. The value proposition is thus potentially lost or diluted when viewed through the investment lens.

The continual struggle to establish the value proposition of insurance features of annuities from within the investment framework may ultimately prove to be a futile proposition. The reason may be quite simple: Investments are not the core value proposition of the insurance industry. Investments are only supplemental to the primary risk management value proposition that the industry offers. In other words, the industry is unlikely to win if its audience, including plan sponsors, intermediaries, advisors, and consumers, perceives the value proposition to be that annuities are simply better investments than pure investment vehicles because they contain certain guarantees.

An Alternative Approach
I would suggest an alternative approach for reasserting the value proposition: The industry should get back to its roots. The core value proposition of the insurance industry is risk management. Certainly, there are risk management vehicles in the investment space. Insurers, however, stake a unique claim to risk management solutions that cover critical risks that can derail retirement plans but that cannot be invested against. These include the risks associated with longevity, uncertain long-term care and health events, and untimely death. These risks must be insured against. No pure investment alternatives exist that can efficiently cover these risks.

The considerable success insurers have enjoyed in the investment space may potentially have led the industry to stray from its core. By reasserting the core proposition of risk management outside the investment space, the industry can establish a well understood proposition. By positioning the industry's core value proposition adjacent yet complementary to the investments, the insurance industry can continue to capitalize on opportunities in that space by establishing partnerships with providers whose core proposition resides within that space. Insurers can then provide the advice, tools, and support to deliver solutions that integrate investments and insurance through these partnerships. Such distribution partnerships have clearly already been in place for many years, but the key difference in this proposition is that the role and value of the insurance elements and the distinction from the investment elements in the solutions would be clearly understood and appreciated by a much wider audience of advisors and industry observers.

A Possibly Surprising and Shocking Catalyst
What may be the catalyst for the next powerful phase of growth in the insurance business? The answer may have been staring right at us all along — income annuities.

Consider the possibility that this product may be the most underappreciated of any in the insurance arsenal. Its relegation to the bottom of the insurance heap may well have been a self-fulfilling prophecy to date. The industry, with a few notable exceptions, has failed to broadly educate and innovate in the arena of these products. Also, historically, annuities were primarily viewed as asset accumulation vehicles rather than income replacement products. So it should come as no surprise that income annuities today make up an insignificant share of the sales of insurance products in general and annuities in particular.

Consider too that history is replete with examples of hidden treasures unrecognized for decades or even squandered. We've all read the stories of rare stamps used to post ordinary mail, valuable art by the masters discovered in basements or sold for pennies at flea markets, and millions of dollars of unclaimed lottery prizes sitting in state coffers today. Is it possible that the insurance industry is likewise sitting on a hidden jewel?

Of all of the products manufactured by the insurers, in the context of the current retirement market opportunity, there is none other that underscores the value proposition as well as income annuities. There are two key reasons I offer to support this view: One is the inherent value of the income annuity; the other is that an income annuity can significantly enhance the holistic retirement solutions that consumers and their advisors seek.

The Inherent Value of Income Annuities
It is well known that income annuities can protect against the risk of longevity by providing guaranteed lifelong income. It is also well established that the income stream may be substantially higher than the level of income produced with alternative financial vehicles. There is, nonetheless, a subtle and possibly underappreciated difference in the insurance element provided by income annuities that is not seen in other insurance vehicles.

To understand this subtle difference, we must return to the basic concept of insurance. Those who are insured against a particular event participate in an "insurance pool" by paying into the pool. Participants who experienced the insured event are paid out of the pool. Those who don't experience the insured event receive nothing from the pool (dividends may be paid, but these are a share of profits remaining in the pool). The insurance benefit payable is typically substantially higher than a participant could generate him- or herself. The insurer bears the burden that the pool is insufficient to pay all the participants who experience the covered event.

With income annuities, the insurance concept is identical — with one subtle but critical difference: It is not only those who experience the covered event (in this case living too long) who receive the benefits from the insurance pool. *All* participants in the pool receive insurance benefits that are paid starting right away! Those benefits may be significantly higher than participants could reliably sustain on their own through other financial instruments. Certainly, those who live the longest receive the most benefits from the pool, but the subtle point here is that income annuities pay leveraged benefits to everyone in the pool starting immediately.

There is an emerging innovation in income annuities called "longevity insurance," which in its purest form pays only those who live beyond a certain date (typically average life expectancy), but this is the most leveraged form of income annuity. Even in this form, income annuities still pay a higher portion of participants in the pool than do other forms of insurance.

How Income Annuities Enhance Holistic Retirement Solutions

Income annuities — including immediate fixed annuities, immediate variable annuities, and longevity insurance — can play an indispensable role in the creation of effective total retirement solutions because they can deliver a higher and more reliable stream of inflation-adjusted income than pure investment vehicles, and the income is guaranteed to last a lifetime.

In simple terms, because income annuities are so efficient in generating income and protecting against longevity risk, the inclusion of an income annuity in a retirement portfolio can raise the income generated by the portfolio and stretch the retirement assets of investors in the distribution phase of their financial lifecycle.

Due to this unique financial attribute, income annuities can be combined with other less efficient but popular approaches — such as deferred annuities with living benefits, systematic withdrawal programs, dividend-paying stocks portfolios, bond ladders, CDs, and so on — to create retirement income solutions that are significantly more efficient than these popular solutions on their own.

Further and perhaps most crucially, since income annuities as *part* of a portfolio can have such powerful leverage on the retirement income component of the solution, they can facilitate the *broader* retirement solution since assets and resources could be freed up to allow the advisor to address other catastrophic risks, such as long-term care, critical illness, medical events, and untimely death that might otherwise derail the best-laid retirement income plans.

Conclusion

This is a clarion call for the insurance industry to return to its roots. Insurers are in the business of risk management. A clearly articulated industry value proposition could be best reasserted outside but adjacent and complementary to the investment space. The industry can deliver unique solutions by seamlessly integrating insurance and investment components, but must do this where the insurance element is clearly understood and valued.

In this regard, income annuities may be the illusive catalyst that could fuel unparalleled future growth in the insurance business by facilitating more effective solutions than are possible in their absence. In addition, by drawing in new distributors and new customers, income annuities may serve as a stepping stone to the core range of valuable risk management components offered by insurers including deferred annuities, long-term care insurance, health insurance, and life insurance.

Garth A. Bernard, FSA, MAAA, is Vice President, Retirement Strategies Hroup, at MetLife. In this capacity, Bernard is responsible for coordinating MetLife's suite of retirement-related products across the company's business units and related distribution channels.

Prior to his current position, he was Vice president of Annuity Product Management at MetLife. Bernard has more than 20 years of experience in the financial services industry and has held management positions at Keyport Life, Reliastar Northern Life, Providian Capital Management, and Transamerica Life Companies. He is a frequent industry conference and workshop speaker and has served on numerous industry committees. Bernard holds a Master's degree in Mathematics from the University of Waterloo, Canada. He can be reached at 212-578-1106 (email, gbernard@metlife.com).

Reprinted with permission from *LIMRA's MarketFacts Quarterly (Winter 2007)*