What is Driving the Rush for the Variable Annuity Exit?

The variable annuity industry in the U.S. is highly concentrated. Ten *insurance companies* generate roughly 80 percent of industry revenue, and the top 20 companies generate over 90 percent of total sales.

A meaningful signal is sent when five of the top 20 variable annuity companies announce that they are either exiting the business entirely or paring-back existing product lines.

This is exactly what has taken place over the past several months with the following companies dialing down their variable annuity exposure or pulling-out entirely:

- Sun Life
- The Hartford
- Jackson National
- ING
- MetLife

Equity market *volatility* and low interest rates are the common themes running through the most or all of the retrenching decisions. There are a few way in which high volatility and low interest rates can hurt the companies that provide *variable annuities*:

- Poor equity market performance and low interest rates affect the value of *guaranteed living benefits* which are liabilities for the *insurance* company. Poor stock market performance and low rates both increase the amount of the insurance company liability.
- Higher volatility results in higher *hedging* costs.
- Stock market performance affects the value of *separate account assets* which, in turn, affects fee *income* related to those assets under management.
- Many return on equity (ROE) models consider *capital* market volatility or "beta" as a proxy for risk. In this context, "extreme" capital market conditions create higher hurdle rates and result in lower return on equity.

MetLife's recent investor conference call sheds some light on the return on equity issue. During the call, MetLife categorizes its product lines based by level of ROE. There are three ROE categories: 1) greater than 15 percent; 2) 10 - 15 percent, and; 3) less than 10 percent.

Retail annuities (including variable annuities) are in the less than 10 percent ROE bucket. Included in this less than 10 percent bucket are other capital intensive business lines that require "margin improvement."

SEC Cautions Against Purchasing Variable Annuities

The SEC recently issued warnings to investors considering purchasing variable annuities. The SEC has prepared a brochure, available at the website www.sec.gov, which discusses the benefits, risks and costs of variable annuities. Investors should read it carefully.

As most investors may know, a variable annuity is a contract between the investor and an insurance company. The insurance company agrees to make periodic payments to the investor beginning immediately or at some future date. Variable annuities are "variable' (as opposed to fixed) because the amount of payments that the insurer will pay the investor depends upon the return that the selected investments generate. As their investments, investors can choose from among a wide range, including mutual funds.

No doubt, investors considering the purchase of a variable annuity will hear the benefits of the product. They principally are: tax deferral, periodic payments for life, guaranteed death benefits and the offering of a wide range of investment options. But what about the risks and costs of variable annuities?

The SEC brochure highlights several risks and costs. First, the SEC cautions that, for most investors, it is prudent to make the maximum allowable contributions to IRAs and 401(k) plans before investing penny one in variable annuities. That is because IRAs and 401(k) plans offer the same kind of tax deferral without the risks and costs of variable annuities.

Second, the SEC warns that a variable annuity offers investors no additional tax advantage when bought through a 401(k) plan, IRA or other tax advantaged retirement plan. Thus, investors should not consider purchasing variable annuities in a tax advantaged retirement plan unless they are attracted to the other features of the variable annuity. These features include receipt of lifetime income payments, death benefit protection or long-term care insurance, all within the variable annuity. Of course, these features may or may not be important to investors.

Third, the SEC cautions that investors are paying extra costs to have these and other features in place. The SEC urges investors to understand the charges. Also, the SEC recommends that investors consider whether they can buy the benefit more cheaply as a separate product. An example cited is the purchase of a long-term care insurance policy, independent of any variable annuity purchase.

Fourth, regarding costs generally, the SEC reminds investors that there are several costs associated with variable annuities, and that these costs will reduce the value of the investment. There are five basic types of costs charged:

1. Surrender charge;
2. Mortality and expense charge;
3. Administrative fees
4. Underlying mutual fund expenses; and
5. Fees and charges for other features (for features such as long term care insurance).

Fifth, the SEC cautions against making tax-free "1035" exchanges. The tax laws allow investors to exchange an existing variable annuity for another variable annuity without paying tax, either on the income or the investment gains.

http://instor.financialcounsel.com/Articles/Investment/ARTINV0000045-SECCautions.asp