

It's Still All About Guarantees

BY JEREMY ALEXANDER

BY HISTORICAL STANDARDS, second quarter 2009 was a good one for U.S. fixed annuity (FA) sales. At an estimated \$27.8 billion, it was the third-best quarter in the 6½-year history of the *Beacon Research Fixed Annuity Premium Study*.

Results were 10% ahead of a year ago, but 20% behind first quarter 2009.

Investors became somewhat less risk-averse in the second quarter, but there was continued demand for conservative investments like FAs.

This makes sense given the economy. The recession began to ebb during the quarter. Gross domestic product shrank at a 1% annual rate, a big improvement over the first quarter's 6.4% annualized decline. There were several signs of incipient recovery including a stock market rally. But rising unemployment fueled concern regarding future consumer spending and loan delinquencies, and dimmed the outlook for corporate earnings growth.

These concerns made the investing public cautious despite rising equities prices. Mutual fund money flowed out of money market funds and mainly into bond—not equity—funds. Variable annuity sales increased from the first quarter. It appears that guaranteed living benefits were driving much of the gain. In particular, the election rate for guaranteed lifetime withdrawal benefit riders report-

edly reached a record high, even though many issuers had raised fees and reduced benefits.

Demand for guarantees probably would have resulted in another record quarter for FAs, if not for the interest rate

environment and the new business capacity constraints of many carriers.

The spread of the average 5-year CD-type FA rate over the 5-year Treasury rate was 1.77% in April, 1.23% in May, and just 0.54% in June. Even if the FA rate advantage had been larger, credited rates were simply too low to be attractive for many potential buyers.

The threshold rate of 5% was more and more difficult to find as the quarter progressed, except on one-year renewal rate products.

Given all this, the second quarter was not favorable for FAs. Market value-adjusted (MVA) FAs were the only product type to post lower results (-2%) compared to second quarter 2008 and were 46% behind first quarter 2009. Book value (non-MVA fixed rate) results were not as grim. Sales were 9% ahead period-to-period, and 28% behind quarter-to-quarter.

From a historical perspective, these results look pretty good however. MVAs did better than in any quarter from 2003 through 2007. Book value sales were well above quarterly results from 2005 through 2007, and these annuities remained the dominant product type with 50% of second quarter's FA sales.

Indexed annuities had their best quarter since 2003. Sales climbed 20% from a year ago and 16% sequentially. The second quarter's rising stock market and fragile economy made it the perfect time for the upside potential/downside protection value proposition of IAs. Some purchases certainly were made for this reason.

But as was the case for variable annuities, it looks like guarantees were the main driver of indexed annuity sales. The vast majority of promotions for these products stressed downside protection and guar-

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■ MIXED BAG						
ESTIMATED U.S. FIXED ANNUITY SALES BY PRODUCT TYPE (IN BILLIONS)						
	Q2 '09	Q2 '08	% Change	Q2 '09	Q1 '09	% Change
Total	\$27.8	\$34.8	-20.0%	\$27.8	\$25.3	9.8%
Fixed Interest:						
Book Value (non-MVA)	\$13.9	\$19.2	-27.8%	\$13.9	\$12.7	9.1%
MVA	\$3.6	\$6.5	-45.6%	\$3.6	\$3.6	-2.0%
Indexed	\$8.2	\$7.1	16.1%	\$8.2	\$6.9	19.9%
Immediate	\$2.2	\$1.9	11.6%	\$2.2	\$2.1	2.1%

Source: Fixed Annuity Premium Study, Beacon Research, Evanston, IL

environment and the new business capacity constraints of many carriers.

The market's strong appetite for corporate bonds reduced their yields, and the yield curve of these bonds remained relatively flat. As a result, guaranteed minimum interest and credited rates in FAs declined over the second quarter. The average rate on a 5-year CD-type FA was 3.63% in April, 3.36% in May, and 3.25% in June.

A decline was inevitable, given interest rate conditions. But average credited rates probably slipped further and faster because some issuers were crediting lower than necessary in order to limit sales.

Demand for corporate bonds also narrowed the spread of their yields over Treasury rates. This gave FAs less and less advantage over the conservative alterna-



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and guaranteed lifetime income (with income account bonuses and guaranteed annual step-ups). In addition, IAs generally do well when bond yields and credited rates are low, and the second quarter was no exception.

Indexed annuity results would have been even stronger if many issuers had not been holding down sales to conserve capital. That's why the growth was not very broad-based. (Two insurers generated 77% of the quarter-to-quarter gain.) The IA share of sales climbed to 30%, reversing a five-quarter decline but still below 2007 levels.

Fixed income (immediate and delayed payout) annuities also had their best quarter since 2003. Results were up 2% from second quarter 2008 and 12% sequentially. Demand for guaranteed income drove these results as well. In addition, long-term corporate bond rates were higher, and this should have enabled issuers who wanted the business to increase payouts. But income annuities continued to have a small share (8%) of overall sales.

If FA sales for the next few quarters stay even with second quarter, that will be a real accomplishment.

Corporate bond yields and credit spreads have continued to slide since June 30. That means lower, less competitive, credited rates as well as reduced indexed annuity cap or participation rates. Carrier capacity generally has improved, but many pressures remain. In addition, it is reportedly becoming more difficult to find attractive, investment-grade, corporate bonds to back new business. But underlying demand for FAs appears strong and this should remain so for the foreseeable future.

The recession has made many investors realize they are far more risk-averse than they thought. They want guarantees to an extent not seen in decades. FAs have been providing these guarantees for many years.

There will be plenty of competition from VAs, new mutual funds and life insurance for this conservative-minded business. But as the interest rate environment normalizes and capital constraints ease, FAs are likely to capture a healthy share. ■
