

Indexed Annuity Products

Southeastern Actuaries Conference
Actuaries Club of the Southwest
New Orleans

Noel Abkemeier, F.S.A.
November 17, 2006



A MILLIMAN GLOBAL FIRM

Milliman

Consultants and Actuaries

page 1

Topics to Discuss

- **Introduction**
- **Current Product Designs and Compensation**
- **Market Conduct Issues**
- **NASD and SEC Activities**
- **Hedging Approaches**
- **Possible Future Direction**



page 2

Index Annuity Mantras

- **An Index Annuity is a fixed annuity with a nontraditional method of crediting interest.**
- **All Index Annuity benefit formulae are created equal.**
- **The highest returning design for a purchaser will be known only in arrears.**
- **An Index Annuity is not a VA with Living Benefits (VAGLB).**



page 3

Indexed Annuities in the Annuity Spectrum

- **Similarities to fixed annuities**
 - **Cumulative floor guarantee like fixed-rate annuity**
 - **Annual guarantee like a fixed rate annuity**
 - **Selling agent not required to be registered**
 - **Product not registered**
- **Similarity to variable annuity**
 - **Interest reflects index changes**



page 4

Indexed Annuities and VA with GLB Address Different Risk Profiles

- **Indexed annuity provides upside potential for fixed annuity purchasers**
- **VA with GLB provides comfort for equity investors who want to protect against a bad result**



Indexed Annuity vs. VA with GMAB

Indexed Annuity

- Expected return of 4-5%
- Aided by high long-term interest rates
- Floor protection is generally annual
- One index generally used
- Benefit profile may vary
 - Quick (cap)
 - Full (PR or spread)
- Average buyer 60-70

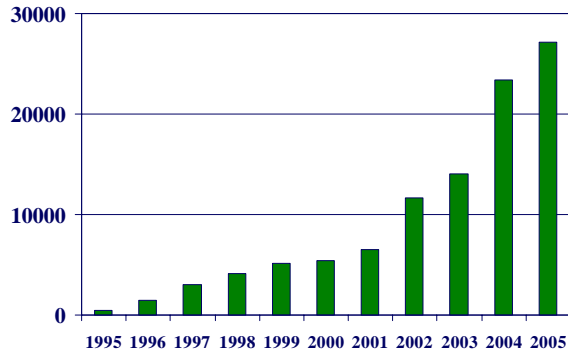
Variable Annuity

- Expected return of 8-11%
- Neutral to long-term rates
- Floor protection is long-term
- Many investments used
- Benefits are pass-through
- Average buyer 50-60



Indexed Annuity Sales Have Skyrocketed

Indexed Annuity Sales in Millions

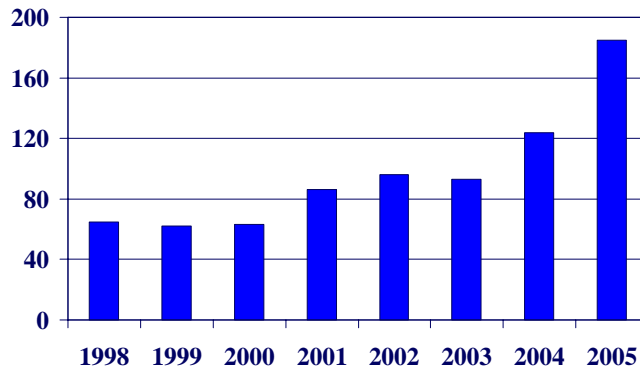


Source: Advantage Compendium

page 7

Indexed Life Premium Is Growing Strongly

Annualized Index Life Premium (in millions)



Source: Advantage Compendium

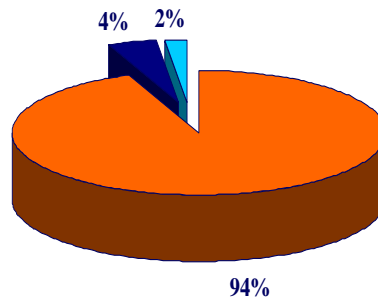
page 8

Indexed Annuity & Life Profile

- 55 companies from 45 groups comprise the indexed annuity industry
- Top six companies represent 69% of premium; top eleven are 87%
- 21 companies from 14 groups comprise the indexed life industry
- Top five companies represent 76% of premium

page 9

Indexed Annuity Sales by Distribution - 2005



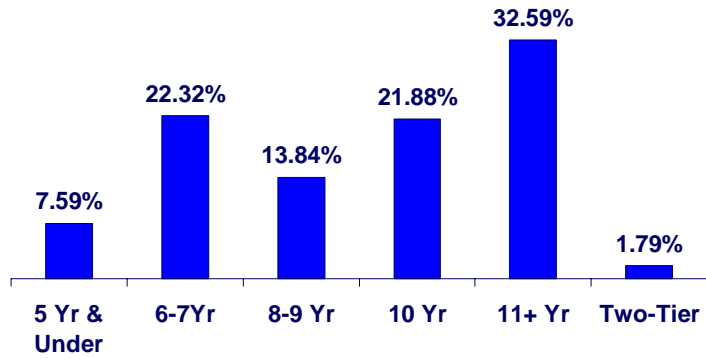
Agents Banks B/Ds

Source: Advantage Compendium

page 10

Indexed Annuity Products Have a Range of Surrender Charge Periods

Products By Surrender Charge Period

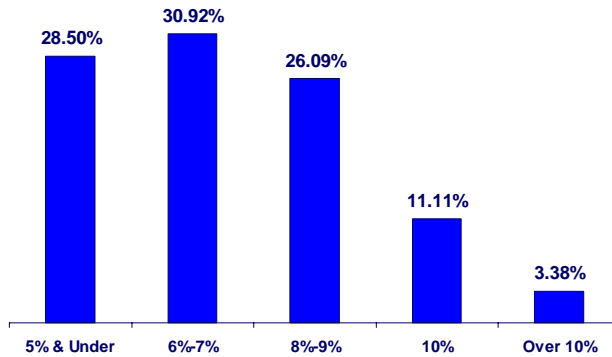


Source: Advantage Compendium, AnnuitySpecs

page 11

Indexed Annuity Commissions Cover a Broad Range

Products By Agent Commission Level



Source: Advantage Compendium, AnnuitySpecs

page 12

What's in a Name?

- **Almost all insurers now use the name “Fixed Indexed Annuity” (FIA)**
 - **Helps keep the agent from misdescribing as an equity product**
 - **But still “formerly known as...”**
- **Iowa is prohibiting the use of the name “equity indexed annuity”**
- **Some states require the use of “equity indexed annuity”**



Indexed Annuity Current Trends

- **“Clean and Simple” is the theme**
- **Shorter and lower surrender charges**
- **Reducing commissions**
- **More index benefit choices in a product**
- **Two-tier structures in retreat**
- **LTC and GLWB riders being added**



Leading Products Look Like...

- **Annual ratchet**
- **Surrender charges for 10 years or less**
- **Cap on averaged or unaveraged basis; or “sum of monthly capped”**
- **Several index benefit choices**
- **Strong floor guarantee**
- **Premium bonus of 5+%**
- **S&P 500 dominates**



Other Designs in the Market...

- **Multi-year point-to-point**
- **“All or nothing” / binary**
- **Unfloored indexed benefit + required fixed allocation**
- **Guarantee at SNFLIDA minimum (strong majority)**



Compensation Is Reducing

- **Historically high**
 - Independent agent channel is most expensive
 - Novelty line
 - Was 2-3% higher than fixed-rate
- **Other distribution is softening compensation**
 - Banks
 - Broker-Dealers



Market Conduct Is a Concern

- **Currently relatively few complaints**
- **Potential risks**
 - Characterization as having equity functionality
 - Unsuitable sale because of risk of 0%
 - Sales to seniors
 - Criticism (justified or not)
 - Long SC (despite no SC at death)
 - Inadequate product understanding



External Pressures Are Growing

- **NASD Notice to Members**
- **SEC data requests**
- **NAIC direction**



NASD NTM 05-50 Is Major Factor

- **Primary “suggestions”**
 - **Create “approved product list”**
 - **Bring sales “inside B-D”**
- **Much implementation January 2006**



"05-50" Impact on Insurers

- **Allianz market share shrank from 35% to 25%**
 - **Complex products**
 - **Two-tier structure**
 - **Strong surrender charges**
- **American Equity Investment share shrank from 11% to 8%**
 - **B+ rating (subsequently upgraded) inadequate for B-Ds**



page 21

Effects of "05-50"

- **Focus on simpler products**
- **More "10 & 10" products (SC < 10% and ≤ 10 years)**
- **More commissions ≤ 7%**
- **Retreat from two-tier structures**
- **More attention to NASD standards**
 - **Suitability**
 - **Marketing material**
 - **Agent training**



page 22

NASD Impact May Extend Beyond Indexed Annuities

- **“All annuities are alike”**
- **May see homogenization of fixed-rate, indexed, and variable presentations**
 - **Suitability**
 - **Marketing material**
 - **Agent training**
 - **Focus on simpler products**
- **Will NAIC pick up the theme?**



page 23

SEC Direction Is Unknown

- **“Requested” information from leading insurers in July 2005:**
 - **Products with guarantees below 90% of premium**
 - **Best-selling products**
 - **Sales materials**
 - **Identification of leading distributors**
 - **Legal arguments why not registered product**
- **Recently followed up with data requests to some insurers that use MVAs**
- **Will we hear something from the SEC?**



page 24

Why is SEC Studying Indexed Annuities?

- **Lobbying by Financial Planning Association**
- **Change in guarantee structure**
 - **Was 90% accumulated at 3%**
 - **Some moved to 70% at 3%**
 - **MVAs introduced**
 - **SNFLIDA revised**
 - **Rate CMT-indexed and 1% to 3%**
 - **1% extra allowance for indexed**
 - **Rate can be “redetermined”**
 - **Premium percentage to 87.5%**



The NAIC Is Slowly Moving Forward

- **IA and MN Insurance Departments are pushing for change**
 - **Suitability (Senior Protection in Annuity Transactions to all ages)**
 - **Marketing material standards**
 - **Disclosure material**
 - **Agent training (with insurer responsibility)**



Hedging May Become New Battleground

- **Initially cohort-matched OTC**
- **Next, aggregation and OTC/exchange-traded**
- **Moving to dynamic hedging**
 - **Comfort with VA hedging**
 - **Some natural offsets with put-based**
 - **15-20% savings (but watch capital)**
 - **But reduced predictability**



page 27

Indexed Annuity Industry Direction

- **Now 40% of fixed annuities => here to stay**
- **Third leg with fixed-rate and VA?**
- **Flat sales with adjustment to NASD NTM 05-50**
- **“Clean and simple” will continue**
- **Proper selling will be a focus**
- **Expect continued “non-security” status**
- **But some indexed annuities will be registered**



page 28

Indexed Annuity Product Direction

- **10-year/10% surrender charge limits will arrive via some route**
- **Compensation will approach that on fixed-rate annuities**
- **Premium bonuses will moderate**
- **Ancillary benefits (LTC, GLWB, and others) will be common features**
- **Immediate indexed annuities will be more available**

page 29

**Will an indexed annuity be in
your future?**

page 30