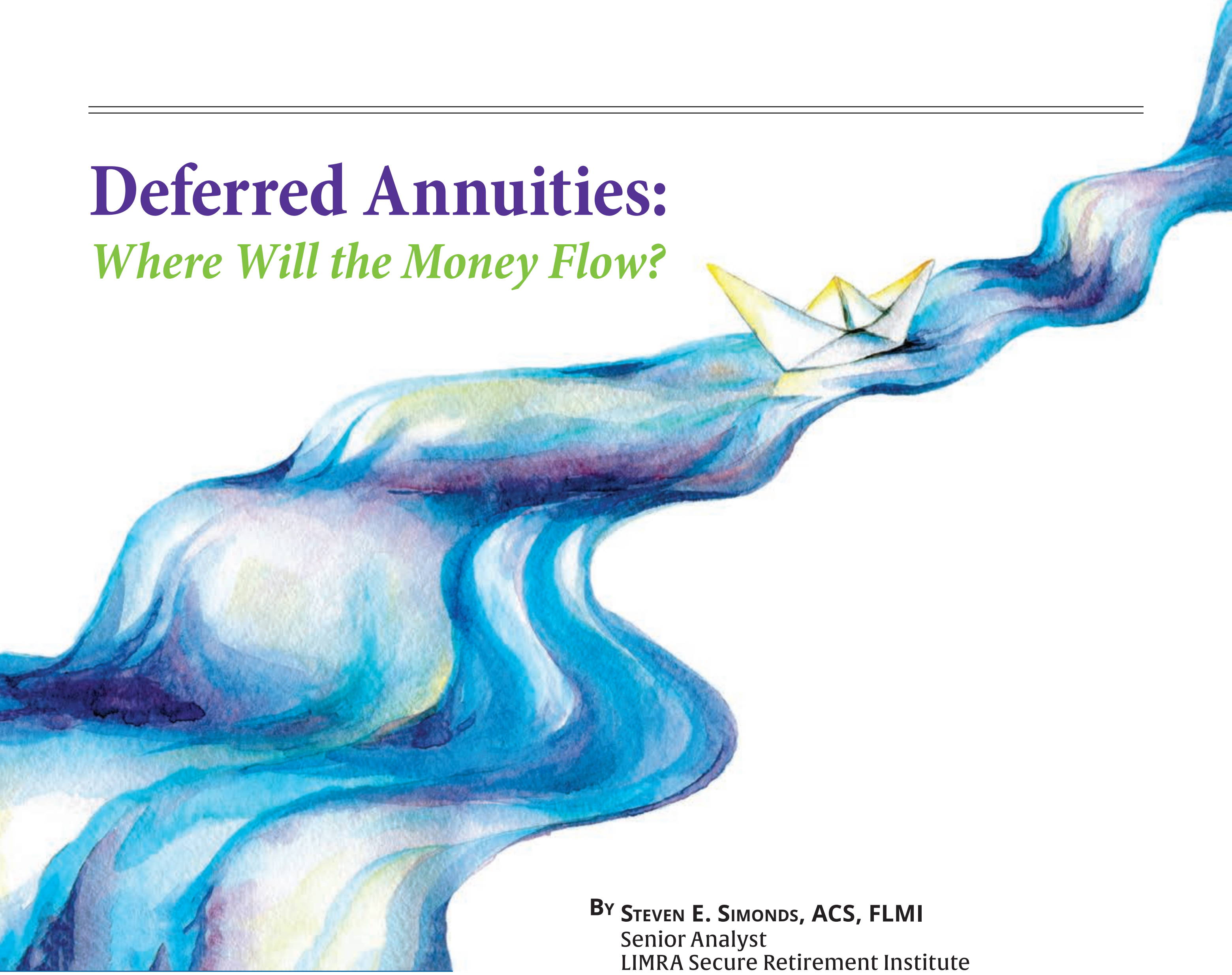
Deferred Annuities:

Where Will the Money Flow?



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Hundreds of billions of dollars are invested into deferred annuity solutions each year. With these inflows, deferred annuity in-force assets have grown to over $3 trillion to date. To gain insight into this market, LIMRA Secure Retirement Institute has explored the flow of money within it and the impact to the different distribution channels for deferred annuities.

Total Deferred Annuities

Presence of a surrender charge has long been the primary predictor of future movement of annuity assets. This concept makes sense; without a direct cost or penalty to leave an annuity, the balance of the cost-benefit calculation shifts toward movement.

However, two trends have tempered that logic: a prolonged period of low interest rates and the rise of guaranteed living benefit (GLB) riders on variable and indexed annuities.

Over the next five years, the following trends are expected to occur in this space:

- Overall deferred individual annuity assets will not grow substantially.
- Assets will continue to shift to the fixed annuity market.
- More money will leave the deferred individual annuity market than will enter it.
- Cumulatively, more than $1 trillion will leave deferred annuity products over this time frame.

Variable Annuities

More than 40 percent of variable annuity (VA) assets are protected by a GLB rider, making those funds less likely to move, even when surrender charges expire. The shock-lapse of these contracts has been muted over the past few years, considering that benefits offered in the market are not as favorable as seven years ago, and a majority of VA assets with a GLB rider are "in the money." Partly because of this, annual full surrenders of VAs are likely to decrease from $98.5 billion in 2019 to approximately $87 billion by 2023.

Taking a closer look at assets by distribution channel, GLB elections are higher in the broker-dealer and career agent channels. These VA GLB assets are likely to remain "sticky." With a total of $460 billion in VA surrenders forecasted through 2023, and only an estimated 20 to 25 percent of that leaving VA contracts with GLB riders, the difference will likely come disproportionately from the already smaller holdings in the bank, direct, and independent agent channels.

As nearly half the career channel VAs are still subject to a surrender charge, and given the strong influence of GLB riders, movement in this channel is expected to be moderate. However, the pool of available assets is huge (estimated to exceed $380 billion).

Banks are the only distribution channel with a majority of VA assets (just over 50 percent) still subject to a surrender charge. As such, advisors working through banks have had less access than broker-dealers to products with GLB riders. These factors should lead to increased surrender activity among the $84 billion in bank channel VAs without a charge in the medium to long term.

Distributors should carefully assess their in-force VA business to determine the risk of the assets leaving the products—and possibly even the firm. Our net flow forecast shows VA outflows continuing to exceed inflows. Advisors, on the other hand, should provide continued support and review of their clients' portfolios to determine whether annuity solutions are still beneficial for their changing needs as they near or enter retirement. The need for guaranteed lifetime income should be part of these reviews, as this could help reiterate the value of the product purchased or provide an opportunity to adapt to changing needs.

Indexed Annuities

In terms of annuity product development, indexed annuities are still relatively young—but they seem to have hit the annuity "sweet spot" by offering upside potential and downside protection. Sales growth is expected over the next five years, with LIMRA Secure Retirement Institute forecasting sales to exceed $85 billion annually by 2023. As such, indexed annuity assets are on track to double about every decade—driven more by the influx of new sales than investment earnings. In fact, indexed annuities are the only deferred annuity product type for which asset growth is expected over the next five years.

Independent agents still dominate this space, holding approximately two thirds of the $476 billion of in-force indexed annuities. That proportion will decrease as sales in other channels—particularly in banks and broker-dealers—continue to accelerate. The overwhelming majority of the $100 billion in indexed annuity surrenders forecasted for the next five years presumably will come from older contracts sold through independent agents (as those contracts age out of surrender charges). The increase in the asset base of products with GLWB protections will slow the rise in surrenders expected due to maturing contracts and shorter surrender charge periods on more recent issues.

This presents both an opportunity and a threat for distribution channels. Depending on the demographic characteristics of those contract owners, these assets could be poised for reinvestment into newer indexed products with improved features. The increased potential upside available through registered index-linked annuities (RILAs) might offer an alternative option, but these products are not generally available through independent agents. As the in-force indexed annuity business matures, more contracts will have exited their surrender charge schedule. Independent agents should closely monitor their books of business, as indexed annuities are now more readily available through other distribution channels than when customers initially purchased the contract. Other distribution channels likely will have an opportunity to capture surrendering indexed annuity assets.

Fixed-Rate Deferred Annuities

Fixed-rate deferred annuities' product design lends them to a potentially significant amount of money in motion. As most of these product designs involve a set rate for a set term, once that term comes due, owners are likely to shop for the next best rate.

Our U.S. Individual Annuity Persistency study shows that surrender activity is volatile in the full-service national broker-dealer and bank channels, and these seem to be the most sensitive to interest rate swings. Assets no longer subject to charge in the full-service national broker-dealer channel have declined steadily, with annualized surrender rates often two or three times higher than those of other channels.

With high rate sensitivity, ready access to competitive fixed-interest products, and close to $90 billion held without surrender charges, the bank channel in particular is primed to shed annuity assets.

The career channel, on the other hand, has shown to be the least affected by fluctuations in interest rates. Further, it is likely that this channel is relatively weighted with the block of older contracts having higher minimum guarantee rates, making them even less likely to move.

Fixed-rate deferred annuity assets held through independent agents have declined slowly, despite the growth of indexed annuities. Around $40 billion without charges is expected to be available each year.

As fixed-rate deferred sales in 2019 are likely to hit their highest levels since the financial crisis, it will be important to watch the surrender activity of these assets in three and five years. Distributors and advisors should plan proactive outreach to clients as these contracts exit surrender charges.

Final Thoughts

With over $1 trillion expected to exit deferred annuity contracts over the next five years, manufacturers, asset managers, and distributors will face both opportunities and challenges. Again, the key question is, where will this money be going? A portion will be flowing back into individual annuities, but not at the pace seen in the past. Regardless, the retirement industry should maintain focus on annuities' unique value proposition—helping Americans transition from accumulating and protecting retirement assets to distributing lifetime income to maximize their retirement security.

As Senior Analyst in the LIMRA Secure Retirement Institute, **Steven Simonds, ACS, FLMI** is responsible for annuity benchmarking surveys such as the LIMRA Secure Retirement Institute's quarterly U.S. Individual Annuities Persistency study. Simonds joined LIMRA's Retirement Research department in 2013.

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