The GMWB and why it's so popular

Two experts talk about where the Variable Annuity industry is headed

By Darla Mercado February 13, 2011 InvestmentNews

In the world of variable annuities, 2010 may have been the year of the guaranteed-minimum-withdrawal benefit. To discuss that and other developments in the variable annuity business, InvestmentNews spoke with Kevin Loffredi, vice president of Morningstar Inc.'s annuity solutions group, and John McCarthy, a product manager in the group. Morningstar recently acquired the annuity research business of Advanced Sales and Marketing Corp., where both executives worked on the company's annual Annuity Intelligence report. Their edited comments appear below.

InvestmentNews: Your just-published report covers some of the top VA trends of 2010. Can you share them?

Mr. McCarthy: First, the lifetime guaranteed-minimum-withdrawal benefit established itself as THE living benefit.

We also saw the pendulum swing back, somewhat, in terms of a little more generosity in step-ups and withdrawal percentages, as well as more consolidation among the big-three carriers; almost 40% of inflows are going to the big three.

And we saw more of a trend to the fee-only share class.

InvestmentNews: You said that the lifetime GMWB was the most popular product released in 2010. What makes this particular rider so popular among carriers and customers, especially when compared with benefits such as guaranteed-minimum-income benefits?

Mr. McCarthy: Some of the popularity is a function of sales. When carriers see money flowing into lifetime GMWBs from the start, they move away from what's not selling. Our flow data reports from last year show that something like 55% to 65% of the money went into lifetime GMWBs. If you take away the one big income benefit player — MetLife [Inc.] — the numbers are skewed even more to GMWBs.

Other considerations driving GMWB sales are costs and the fact that income benefits have been harder to reinsure and manage actuarially than lifetime GMWBs. The message is the same: Investors are looking for a replacement for the pension they had years ago, and they want a guaranteed paycheck. All of that makes the GMWB very attractive.

We can't tie this back to sales, but 95% of lifetime GMWBs are required-minimum-distribution-friendly, compared with 95% of income benefits, which aren't. The issue of putting money into qualified accounts that require minimum distributions becomes one less problem with a GMWB.

Mr. Loffredi: Actually, MetLife came out with an income benefit that is RMD-friendly. The RMD is tied to the step-up. If the RMD is $5,500 in a given year and the 5% step-up provided only $5,000, the benefit base would increase by the greater of the two to accommodate the RMD. Alternatively, the client could take the RMD from another IRA but still get the full $5,500 step-up amount.

Once the owner annuitizes, a hard-dollar steady stream is promised in the future. A lifetime GMWB, in contrast, promises to pay an annual amount, but if the policyholder takes out too much through excess withdrawals, the carrier can pay less.

InvestmentNews: What about fee-based VAs?

Mr. Loffredi: Fee-based products don't make much of a difference in terms of how they affect the insurance companies. Instead of paying a commission, it's coming out of advisory fees; it's a different share class situation. Insurers really do believe that if they build it, advisers will come.

But when you don't have many people in the space offering a lot of different options, you have a hard time attracting registered investment advisers into it. In general, RIAs are a difficult group to work with, especially in VAs. They don't necessarily understand or appreciate the insurance features that come with the product, and are more focused on investment selection and less on protection. And if they believe in protection, they may try to create it themselves. They believe their expertise is taken away when an investor buys a VA with a lifetime withdrawal benefit.

Mr. McCarthy: We should note that with fee-based VAs, the product features don't change; it's all about the compensation structure. They're getting to critical mass for an RIA to look at them.

InvestmentNews: Do you foresee a change in the VA sellers' leader boards in 2011, now that some carriers are ramping up benefits while other players are retreating?

Mr. Loffredi: It won't be overnight, but you'll start seeing a gradual shift when you get a more level playing field in terms of benefits being offered. It might be orchestrated by Prudential [Financial Inc.], which would be their way of saying, "We don't want any more of the pie." I've heard from other carriers that they want to limit their exposure and have taken deliberate steps to make sure too much does not flow in.

The second part of that is, who do we think might step up? I would look at who's paying the same types of rates, who's got large wholesaling forces, whose back-office service has a good reputation and who's a pain to work with. That all factors into it, so you can't just go by who's got the best benefit; that's not the only part of the equation.

Mr. McCarthy: One thing that comes into play is the stated rates on the amount protected under the GMWB that can be stepped up to a higher contract value after the contract is issued. Ohio National, for example, has an 8% simple step-up and the question is, how appealing will that be for those who like that nice teaser rate? A number of other companies offer compounding, which can give investors more, depending on anniversary dates. It will be interesting to see how that plays out.

InvestmentNews: What's ahead for 2011?

Mr. Loffredi: We're seeing a lot of innovation. For example, there are now ETFs in the VA instead of an ETF fund of funds, and Allianz has introduced a benefit tied to the 10-year Treasury. Axa released theirs in 2010, as well as a structured-investment-like contract in which you buy an index fund that limits downside. The client then adds a "buffer" which protects them against losses up to 30% in a given period.

These are all very interesting options; insurers are trying to attract different types of investors and reps to the VA marketplace, and everyone is trying to get a bigger piece of the pie. The carriers want a broader universe of reps and advisers to use the tools they offer. Especially as the carriers go after RIAs, we're going to see more of them trying to get advisers to use their tools.

Mr. McCarthy: There seems to be more product and marketing innovation now, which is a bit different from the mood a year or two ago when sales went down and people complained about complexity. Today, everyone's doing crazy, innovative stuff, and while we're not sure that the innovative stuff works, a necessary part of innovation is adding complexity. That means we're going to be in a period where simplicity is not on top. People are going to need time to wrap their minds around the new products. It will be interesting to see how much flow goes into them.

Mr. Loffredi: Simplicity is nice, but the evil is that it limits, and nobody wants limits.

InvestmentNews: Will we see a return to the benefit-rich days of the mid-2000s?

Mr. Loffredi: That all depends on interest rates. There's a direct correlation between what companies can offer and what interest rates are doing. Since we're not in a rich-interest-rate environment on government bonds, when companies run their actuarial calculations, everything is lower than what it could be.

Mr. McCarthy: It's tied to the equity markets, too. Markets went up in the last year and a half, and that's going to push benefits higher and make them more generous. But as Kevin mentioned, you can only go so far with low interest rates.

The take-aways for this year are the rise of the lifetime GMWB, the ratcheting-up of benefits, consolidation and innovation, which means more complexity and the growth of the fee-based area.

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