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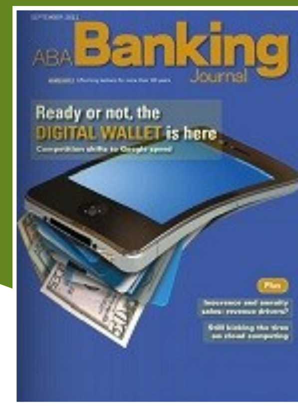

THE LONG AND SHORT OF Annuities

Strong sales performance through the first quarter generated welcome fee income. Will that pace continue? What impact will new FINRA regs have?

By Michael D. White

Annuity fee income jumped sharply in the first quarter—welcome news to an industry with an operating revenue problem. With no significant change in banks' net interest income expected soon, and service charges on deposit accounts pinched, the saleof annuities can give a boost to earnings. Annuities are subject to market forces, of course, but they have solid long-term potential.

A significant turnaround

Annuity fee income took off in second half 2010. Then, in first-quarter 2011, annuity commissions registered their high-water mark, reaching a record $748.2 million, up 28.4% from first quarter 2010, according to the *Michael White-ABIA Bank Annuity Fee Income Report*, compiled by Michael White Associates and sponsored by the American Bankers Insurance Association. To get there, 40.1% of reporting bank holding companies participated in annuity sales; also, 12% of banks contributed $204.2 million, or 27.2% of the total.

Among the top 50 BHCs in annuity concentration (i.e., annuity fee income as a percent of noninterest income), the median ratio was 7.3% in first quarter 2011. Among the top 50 small banks, the median was 16.6%.

Overcoming broker bias

These results were achieved despite the fact that some Series 7 securities brokers dislike annuities. They typically believe annuity guarantees are too expensive and that mutual funds, laddered bonds, and other securities are better buys. Community banks (those under $4 billion in assets) tend to orientate more toward financial planning and sales of packaged products like annuities. These different attitudes and approaches to delivering financial services are reflected in the fact that, in first quarter 2011, annuities represented 13.1% of investment program income among big banks, versus 25% at community banks.

An important factor in successfully distributing annuities among big-bank brokers has been a resurgence in the deployment of field wholesalers. These wholesalers, usually employed by insurers, are critical in delivering to financial advisors needed product training; sales ideas; and professional sales, marketing, and service support. Community banks receive similar assistance through their use of third-party marketers.

Near-term environment

Fixed annuities thrive when decent rate spreads exist between 5-year certificates of deposits and the average effective yield of fixed annuities guaranteed for 5 years. Historically, those spreads were about 150 basis points, but in recent months they have been compressed to low double-digit figures leading to a decline in fixed annuity sales. Current low spreads will likely continue, as interest rates remain depressed. Many people don't want to get locked in to low rates only to see rates rise, but they remain wary of variable annuities. Concerns about low interest rates and inflation, however, could give impetus to sales of certain indexed annuities, which have come to life now that the Dodd-Frank Act has declared that they are not investments.

Earlier this year, variable annuity sales experienced a recovery attributed to the improved performance of U.S. equities. That helped offset a decline in fixed annuity sales. However, the steep declines and volatility in the stock market in July and August have harmed investor confidence, so variable sales could slow as well. Still, variable annuity sales could be stimulated, considering that Morningstar reported in mid-August that second-quarter development of guaranteed benefits for variable annuities tripled over those of first quarter, and that average living benefit expenses continued to fall.

Long-term environment

If annuity sales do slow, it will not be for long, because the long-term environment is favorable. Baby-boomer demographics underscore a huge need for annuities, especially given the faded economic prospects of recent years, steep declines in consumers' personal and pension assets, and retreat to guarantees and safety.

In June, the Government Accountability Office (GAO) published "Retirement Income: Ensuring Income throughout Retirement Requires Difficult Choices." That report recognized the risk of retirees outliving their financial resources, particularly given the shift from defined benefit (DB) to defined contribution (DC) pension plans. That shift, concluded the GAO, requires retirees to make difficult retirement decisions and manage their assets so they have enough to live on during retirement. "Most retirees who left jobs with a DB pension received or deferred lifetime benefits, but only 6% of those with a DC plan chose or purchased an annuity at retirement," said the report.

To help retirees, GAO proposed greater access to annuities in DC plans to guarantee income during retirement, as well as promotion of financial literacy. Otherwise, "even those retirees who have adequate savings may be at risk of not having sufficient retirement income."

Regs coming down the pike

The Financial Industry Regulatory Authority (FINRA) recently revised some rules that become effective on July 9, 2012, and could impact annuity programs. Rule 2090 requires "reasonable diligence" be used in knowing "essential facts" about each customer at the beginning of the broker-customer relationship. Rule 2111 mandates that firms or affiliated brokers have a reasonable basis for believing that recommended securities transactions or investment strategies are suitable for each customer.

Further, the Life Insurance and Annuities Committee of the National Association of Insurance Commissioners (NAIC) endorsed a proposal to add standards for fixed annuity illustrations to the NAIC's Annuity Disclosure Model Regulation. NAIC was to consider the proposal at its meeting in Philadelphia in late August. The proposal requires that any annuity illustration 1. be clearly labeled as an illustration, 2. be accompanied by a disclosure statement and a buyer's guide for annuities, 3. list any relevant costs or fees, and 4. describe any riders or other optional features and declare whether they are included in the illustration.

Indexed annuity illustrations with non-guaranteed values must show the performance for the most recent ten years, the worst and best ten-year periods in the past 20 years, and must warn that the index will likely not repeat historical performance.

For other annuities with non-guaranteed components, the only "current" interest rate that may be shown is that which a carrier is currently offering. Also, a warning must explain that the annuity's current nonguaranteed elements will change and "be higher or lower than those in this illustration but will not be less than the minimum guarantees." ■

Bank Annuity Leaders, First Quarter 2011

ANNUITY FEE INCOME (IN THOUSANDS $000)

Bank holding companies over $10 billion in assets		
1	$186,000	Wells Fargo & Co., CA
2	$108,000	Morgan Stanley, NY
3	$84,000	JPMorgan Chase & Co., NY
Bank holding companies $1 billion to $10 billion in assets		
1	$5,022	Stifel Financial Corp., MO
2	$2,015	Hancock Holding Co., MS
3	$1,486	Nat'l Penn Bancshares, PA
Bank holding companies $500 million to $1 billion in assets		
1	$222	Northeast Bancorp, ME
2	$211	First Volunteer Corp., TN
3	$182	Van Diest Investment Co., IA
Bank holding companies under $500 million in assets		
1	$252	Jacksonville Savings Bank, IL
2	$165	Essex Savings Bank, CT
3	$150	Savers Co-operative Bank, MA

SOURCE: Michael White-ABIA Bank Annuity Fee Income Report

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