

HYBRID ANNUITIES

A GROWTH STORY

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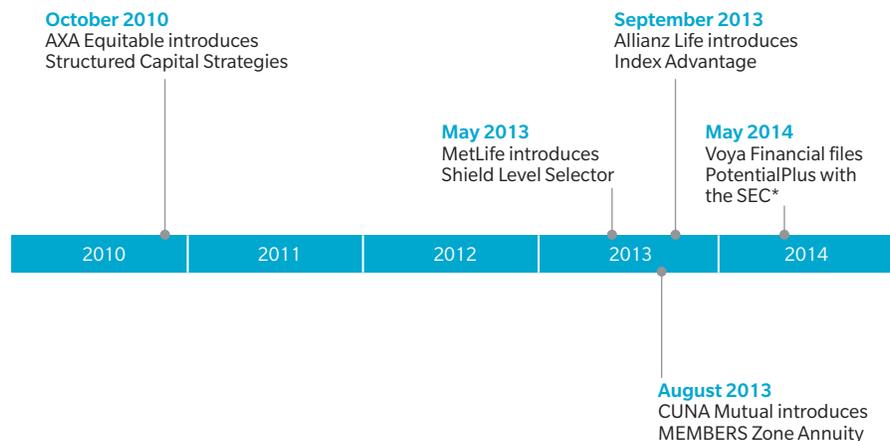
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More and more insurers are designing and offering “hybrid annuities” (also referred to as: structured annuities, structured-note annuities, structured variable annuities, structured indexed annuities, indexed variable annuities, and variable annuity/fixed indexed annuity hybrids). These products provide consumers with higher index-linked upside potential – relative to traditional fixed indexed annuities (FIA) – in exchange for sharing some downside return risk.

As shown in Exhibit 1, this innovation was first introduced in late 2010. By the end of 2013, the current market leader had garnered more than \$3 BN in cumulative sales. Other entrants are starting to gain significant traction. For instance, in the fourth quarter of 2013, a second carrier reported sales between \$200 MM and \$300 MM, while another reported \$90 MM.

Exhibit 1: Hybrid annuity launches and filings (as of mid-2014)



*Since the publication of this article, the Voya PotentialPlus product has been launched.

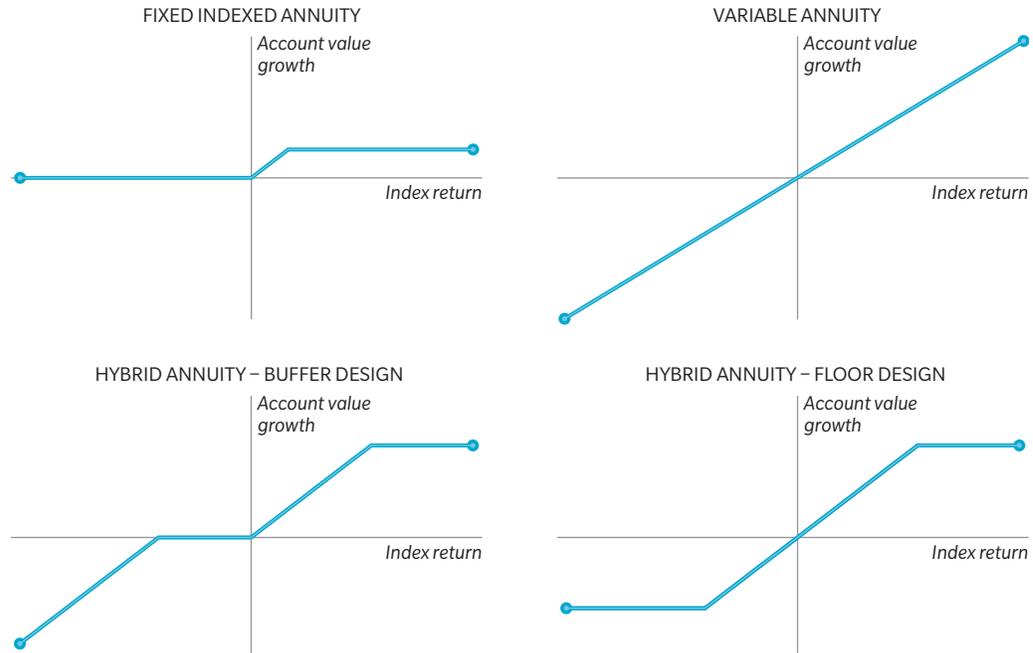
In this article we aim to address the following questions:

- What is the consumer appeal of hybrid annuities?
- What are key design and pricing considerations?
- What is the future outlook for these products?

WHAT IS THE CONSUMER APPEAL?

Generally speaking, hybrid annuities fill the risk spectrum between FIAs and accumulation variable annuities (VAs) invested in an indexed fund. Hybrid annuity crediting structures include “buffer” designs and “floor” designs. The consumer risk profile of FIA with annual cap, VA and these two types of hybrid designs is displayed in Exhibit 2.

Exhibit 2: Index-linked account value growth profile (before fees)



As shown in Exhibit 2, hybrid contracts can produce negative returns if index performance is negative. For buffer designs, this will be the case when the drop in the index exceeds the buffer. Once the buffer is breached, losses are uncapped. On floor designs, negative returns immediately lead to losses, but losses are limited to the floor.

Not unlike FIAs and VAs, hybrid annuities typically offer a choice of investment options. Policyholders may generally allocate funds to desired indices, crediting methods, crediting terms and protection levels. Unlike VAs, assets are not invested directly in unitized funds held in the separate account; rather, hybrid annuity policyholders participate indirectly in the performance of the underlying index, and assets supporting the contract are held in a non-unitized separate account.

WHAT ARE KEY DESIGN AND PRICING CONSIDERATIONS?

Hybrid annuities are currently registered with a prospectus filed with the Securities and Exchange Commission (SEC). Prospectus language differs by design with respect to whether the contracts represent a “variable and index-linked deferred annuity”, “deferred variable annuity” or “deferred annuity”. Some common characteristics of currently available products are:

- Lack guaranteed living benefits
- Link to an index (typically an equity index)
- Preserve the tax deferral, death benefits, and withdrawal provisions of traditional annuities

Hybrid annuities can be broadly categorized as “FIA like” and “VA like” designs, with the characteristics described in Exhibit 3.

Exhibit 3: Overview of hybrid annuity designs

“FIA LIKE” DESIGN	“VA LIKE” DESIGN
<ul style="list-style-type: none">• No M&E fee• Policyholders can allocate to one or more segments/accounts• Each segment/account credits a return based on the underlying index, term, buffer or floor	<ul style="list-style-type: none">• M&E fee• Policyholders can allocate between variable options and structured investment/index options<ul style="list-style-type: none">– Variable options behave like a traditional VA– Structured investment/index options behave similarly to “FIA like” products• Investment expense (applies to variable options only)

When designing and pricing a hybrid annuity, actuaries need to consider a range of pricing, risk management and regulatory matters:

- **Policyholder behavior:** Although the lack of guaranteed living benefits simplifies the pricing, hybrid annuity design brings additional considerations related to interest-sensitive and index-sensitive dynamic lapses.
- **Impact of hedging:** How can the synergies with existing FIA and VA designs be leveraged to reduce costs or increase competitiveness?
- **Complexity:** Certain hybrid annuity designs offer a wide range of crediting methodologies with varying terms. How will this complexity impact the modeling, administration, management of non-guaranteed elements, and general risk management of the business?
- **Reserving:** Hybrid annuities do not have well-established US Statutory or US GAAP accounting frameworks; modeling and implementation of reserving methodologies can be complex.
- **Regulatory concerns:** Regulatory concerns surrounding hybrid annuities are generally related to the filing of these products as VA contracts and possible conflicts with both the Variable Annuity Model Regulation and the Standard Nonforfeiture Law for Individual Deferred Annuities.

WHAT IS THE OUTLOOK FOR HYBRID ANNUITIES?

Although banks have offered structured notes for some time, hybrid annuities are relatively new and sales continue to gain momentum, presenting opportunities for new entrants. We believe that the following factors will contribute to existing carriers expanding their offerings and new carriers entering this market:

- **Consumer appeal:** Hybrid annuities help fill the risk spectrum between FIAs and VAs and offer considerable flexibility to consumers.
- **Access to new distribution:** Existing FIA carriers, in particular, may use hybrid annuities to expand sales with registered advisors and gain traction in new channels.
- **Balancing product profile:** Many VA carriers have significantly reduced their appetite for living benefit guarantees or have reached maximum capacity. Hybrid annuities offer existing VA carriers a new opportunity to attract assets without offering living benefits.
- **Offsetting VA guarantee risks:** Hybrid annuities can be designed in such a way as to help insurers offset risks from existing VA books and provide capital benefits.
- **Sustainable design in a low rate environment:** Hybrid annuities are less exposed to interest rate risk than FIAs or VAs with living benefit guarantees.

COMPARISON OF KEY VA, FIA AND HYBRID ANNUITY DESIGN ELEMENTS

FIXED INDEXED ANNUITY

- No downside risk¹
- Participate indirectly in the performance of the underlying index
- Choice of index, crediting method and term
- Guaranteed minimum crediting rate
- Fixed account is available
- Guaranteed non-forfeiture value

VARIABLE ANNUITY

- Unlimited downside risk
- Invest directly in separate accounts/funds
- Fixed account is often, but not always available
- No guaranteed minimum crediting rate outside of the fixed account

HYBRID ANNUITY

- Downside risk with some protection via buffer or floor
- Participate indirectly in the performance of the underlying index
- Choice of index, crediting method, term and protection level
- No guaranteed minimum crediting rate
- Fixed account is not usually available (only one carrier offers a fixed account in the investment options)

¹ Ignores surrender charges and other account-based charges.

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