State of the Insured Retirement Industry

2014 Review and 2015 Outlook

IRI

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About the Insured Retirement Institute:

The Insured Retirement Institute (IRI) is the leading association for the retirement income industry. IRI proudly leads a national consumer coalition of more than 30 organizations, and is the only association that represents the entire supply chain of insured retirement strategies. IRI members are the major insurers, asset managers, broker-dealers/distributors, and 150,000 financial professionals. As a not-for-profit organization, IRI provides an objective forum for communication and education, and advocates for the sustainable retirement solutions Americans need to help achieve a secure and dignified retirement. Learn more at www.irionline.org.

OVERVIEW

The State of the Insured Retirement Industry report is the third of an annual series of reports covering significant trends and developments in the industry. As 2015 approaches, persistently low interest rates are a formidable headwind, but demographics and growing consumer awareness of the need to create an effective retirement plan that includes the use of guaranteed retirement income products and solutions continue to create a favorable market environment for annuities.

THE DEMAND SIDE

- The percentage of Boomers who are confident they will have enough money to live comfortably throughout their retirement years has dropped from 37% in 2011 to 33% in 2014.
- The percentage of not-yet-retired Boomers who are planning to retire at age 70 or later has increased each year, rising from 17% in 2011 to 28% in 2014.
- In 2014, 55% of Boomers said they calculated a retirement savings goal, compared to 50% in 2013. Of those who have determined a savings goal, 76% said this calculation factors in estimated costs for health care expenses.
- Consumer need remains high, particularly among those in or nearing retirement. IRI research shows that Boomers who own insured retirement products have higher confidence in their overall retirement expectations, with nine out of 10 believing they are doing a good job preparing financially for retirement.
- Eight out of 10 investors say that they are better prepared for retirement as a result of working with a financial professional.
- According to an IRI survey of financial advisors, three quarters of financial advisors report that their clients are receptive to annuities. Clients' attraction to annuities is accounted for by product features including guaranteed income in retirement (90%) and principle protection (84%).
- Implication: as Boomers increasingly work to calculate savings goals and contemplate their expected expenses and longevity, they are becoming less confident in their ability to achieve a successful retirement. But when those investing for retirement work with financial professionals and/or incorporate annuities into their retirement strategies, they report being better prepared and more confident. This market dynamic should drive annuity sales higher.

THE SUPPLY SIDE

- Issuers of insured retirement income products remain financially strong; balance sheet fundamentals are sound, and post-financial crisis efforts to manage risk and better balance overall books of business are yielding positive results.
- Persistently low interest rates in 2014 were a significant headwind for all types of annuities on both the sales and product development fronts; that sales increased at all is a testament to the increasing need for income guarantees driven by demographics.
- Product development efforts were largely focused on refinement and risk management, though the latter half of the year saw interesting developments emerging around Deferred Income Annuities in light of Treasury's Qualifying Longevity Annuity Conract (QLAC) rule.
- Fixed annuity sales were up 25.6% as of the third quarter year-to-date in 2014 vs. the prior year-to-date period.
- Variable annuity (VA) sales have remained relatively flat, slipping about 2.5% on a third quarter year-to-date comparison basis.
- Variable annuity net assets reached a new all-time high during 2014, exceeding $1.90 trillion at the end of the third quarter.
- Industry-wide annuity sales were on track to increase 3% to 5% in 2014, reaching or exceeding $225 billion, the highest level since 2011.

Rising interest rates during most of 2013 had a positive impact on the insured retirement income industry. Among some of the benefits, costs decreased for hedging living benefits, reserve requirements for living benefits decreased, and immediate and deferred income annuities offered higher payout rates – meaning consumers received more retirement income. That sales continued to rise, albeit moderately, in 2014 as rates followed a downward path is a strong indication of the product demand that is being driven by consumer need for guaranteed retirement income products.

KEY OBSERVATIONS

Despite some macroeconomic challenges, the insured retirement industry is financially sound and in a strong position to expand its share of the retirement market as continually evolving demographics lead to increased consumer demand.

Key trends coming out of 2014 into 2015:

- Modestly increasing sales, shifts in sales by product type:

  Industry-wide sales rose 4.3% in 2013, and as of third quarter 2014 appeared on track for another modest increase. While 2013 and 2014 have not been significant growth years for the industry as a whole, sales began to shift away from variable annuities and toward fixed products, with fixed indexed annuities and immediate and deferred income annuities showing especially strong growth.

- Buyer demographics ripe for annuities:

  2014 IRI research revealed a Baby Boomer generation in great need of income planning services and guaranteed retirement income solutions. Only 35% of Boomers are confident in their efforts to prepare financially for retirement, compared to 44% feeling confident in 2011. Large numbers of Boomers have not calculated retirement savings goals, and/or have retirement savings that may be insufficient to maintain sustainable income in retirement using systematic withdrawal strategies. However, those who work with financial advisors are twice as likely to say they are confident in their preparations for retirement, and those who own annuities are more confident as well. Pre-retirees need guidance and solutions, and are better prepared and more confident when these are applied.

"The Treasury Department adopted the new QLAC rule to improve the accessibility and usability of deferred income annuities in qualified retirement plans."

- **External challenges:**

  Falling interest rates were the backdrop of a lackluster year in product development on the variable side, though there were a few cautious moves toward more generous lifetime income benefits in variable products, driven in part by the continued expansion of the use of risk controls, such as volatility managed funds and dynamic rebalancing, in the portfolio allocations underlying such benefits. With 10 Year Treasury Rates persisting below 3% any material enrichment of VA lifetime income guarantees was challenging, and absent new and/or improved offerings sales declined moderately.

- **Product innovation:**

  2014 witnessed continued development in deferred income annuities and investment-only variable annuities, as demographics fueled growth of the former and tax increases and tax expectations helped drive sales of the latter. The "uncapped" fixed indexed annuity began to proliferate in 2014, as product structures emerged that use strategies other than participation rates, caps and spreads to guarantee principal in the fixed indexed product while providing some measure of upside potential. Near the end of 2014 companies began announcing Deferred Income Annuity products modified or designed for use in conjunction with the new QLAC Treasury rule.

- **Public policy:**

  The Treasury Department adopted the new QLAC rule to improve the accessibility and usability of deferred income annuities in qualified retirement plans. The VA Summary Prospectus garnered strong support from the SEC Chair and Commissioners. Variable Annuities have been excluded from the Financial Industry Regulatory Authority's (FINRA) Comprehensive Automated Risk Data System (CARDS) proposal. The National Association of Insurance Commissioners (NAIC) made substantial progress on bringing clarity to applying existing law to Contingent Deferred Annuities (CDAs). Additionally, NAIC model regulation was adopted by three states and progress toward adoption was made in five others.

IRI continues to monitor two key legislative and regulatory issues with the most potential to negatively impact the industry:

- **Tax Reform:**

  The tax-deferred treatment of retirement savings products, including annuities, has been identified by the Congressional Joint Tax Committee as one of the five largest tax expenditures. As a result, tax deferral is always on the table for possible review.

- **"Fiduciary" Definition Changes:**

  A revised Department of Labor fiduciary rule was originally expected last year, but has been pushed back to January 2015 at the earliest. The rule would change the circumstances under which a provider of investment advice is considered a fiduciary under ERISA.

What to look out for in 2015:

- **Financial Strength:**

  Life insurance companies will operate on solid financial ground in 2015 despite a challenging interest rate environment, with years of rationalizing product, i.e. risk, exposure and improving hedging strategies continuing to pay dividends.

- **Continued trending of sales toward fixed and income annuities:**

  As the bull market, and Boomer investors, continue to age and Boomers are confronted with retirement realities, expect a continued shift of annuity purchases toward principal protected and income producing products. A significant uptick in interest rates above the critical 3% level could drive a resurgence of product development and marketing efforts on the variable side, but in the interim demographics favor continued migration toward guarantees of both principal and income. Fixed indexed annuities are likely to continue to be a bright spot in a persistently low interest rate environment as both a retirement savings accumulation vehicle offering both a principal guarantee and growth potential, and as an attractive alternative to certificates of deposit (CDs).

- **Continued product innovation:**

  Despite persistently low interest rates, demand for retirement accumulation and income solutions will continue and issuers will be challenged to find innovative ways to meet that demand. Expect product development to continue, especially in the following areas:

  - **Deferred Income Annuities –** with QLAC paving the way for more efficient use in qualified plans, expect product innovations geared toward making the products more palatable to the consumer, such as enhanced flexibility in payment start/stop dates.
  - **Investment-Only VA –** expect new product and portfolio introductions as sales continue to increase, boosted by a rising tax environment and longer track records for outcome oriented strategies such as alternatives based portfolios, rising interest rate strategies, and inflation defense.
  - **Fixed Indexed Annuities (FIA) –** as distribution continues to broaden, expect further innovations in structure, following on the introduction of "uncapped" strategies in 2014. Blended indexes, volatility controlled indexes, and other risk management enhancements will likely continue to develop as a means to increase the versatility of the product in terms of its "fit" in the investor's portfolio.
  - **Variable Annuities with Lifetime Income Benefits –** as challenging as the environment is for these products, even with persistently low interest rates expect some development supported by the continued evolution and refinement of risk management techniques.

- **Volatility Managed Funds:**

  Volatility Managed Funds, which use an options overlay strategy to reduce volatility in returns, have proliferated in the past few years as some variable annuity issuers have required their use when guaranteed income benefits are elected to reduce the risk that the account value will be insufficient to support the benefit liability, which would require higher reserves. To date this has been the primary use of these funds, and it remains to be seen whether they will come into significant use as a stand-alone fund investment designed to improve outcomes by reducing volatility.

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- **National Association of Registered Agents and Brokers Reform Act (NARAB II):**

  NARAB II would establish a one-stop, national licensing clearinghouse for financial professionals holding state insurance licenses in multiple states. IRI's research shows that its passage would remove a barrier that is impeding broker-dealers' ability and financial advisors' willingness to sell lifetime income products. NARAB II passed both the House and Senate in different forms in 2014, and is under consideration for inclusion in the reauthorization bill for the Terrorism Risk Insurance Program during the lame duck session. Passage this year would put advisors on the path towards a simple, streamlined licensing process as it would remove onerous multi-state licensing requirements that IRI research has shown impede the ability and willingness of broker/dealers and financial professionals to sell lifetime income products.

2014 A Year in Review

SALES STABLE, BUT SHIFTING

As of this writing, industry-wide annuity sales are on track for a 3% to 5% increase for the year. With sales dropping in three of the five years post the 2008 financial crisis levels at the same time as legions of Boomer generation retirees and pre-retirees wrestle with solving the retirement income puzzle, the potential exists for sales to increase dramatically in coming years. Historically an extended bull market has resulted in significant increases in VA sales, but those sales may be suffering from a "wait and see" attitude, with savvy investors and advisors waiting for interest rates to normalize and benefits to increase before committing. Fixed Indexed Annuities, conversely, may have gotten a boost from the combination of the aging of the bull and persistent low interest rates; as neither the downside risk of equities nor the low interest rates of CDs are attractive, the fixed indexed annuity as a product with some growth potential in addition to behaving as a fixed income, CD-like product without interest rate risk drew considerable interest. Sales jumped 13% in the full year 2013 and appear on track to close out 2014 with an even larger increase in sales, eclipsing traditional fixed products. While the product itself is certainly broadening its appeal, it should be noted that a significant boost to sales resulted from the product, historically solely available through insurance agents, beginning to be offered through several major broker/dealers and is finding its place as a rather unique arrow in the advisor's quiver.

Here is an overview based on sales data analysis through the third quarter 2014:

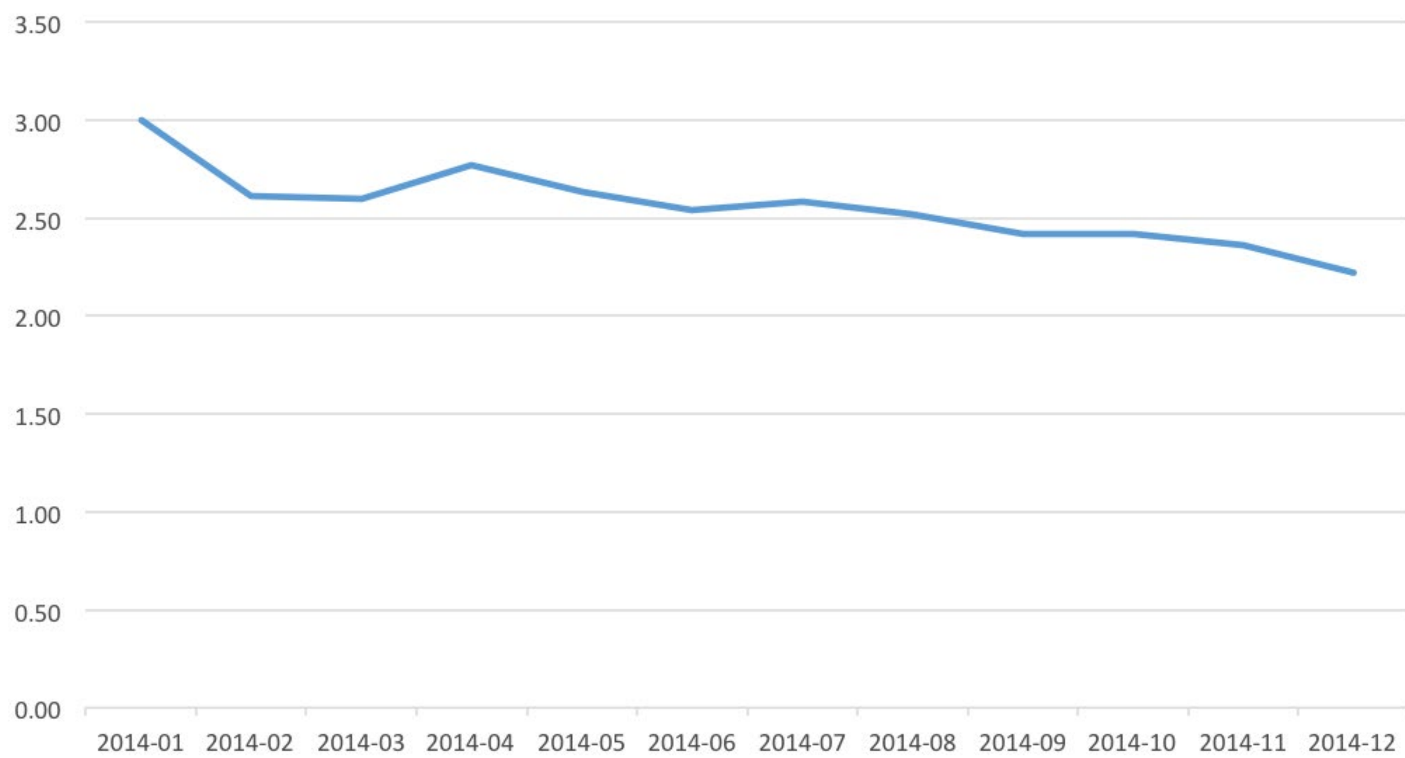
- 2014 third quarter year-to-date annuity sales of $172.8 billion were up 7% over 2013 third quarter year-to-date sales of $161.6 billion.
- 2014 total annuity sales are expected to end up 3-5% above 2013 levels.
- Variable annuity sales are down about 2.5%, following a drop of about 1.5% in 2013 vs. 2012.
- Fixed annuity sales increased 26% in the third quarter year-to-date period vs. the prior third quarter year-to-date, and will likely show an overall increase of 15% to 20% for the year. As interest rates dropped over the course of 2014, the increase was primarily driven by fixed indexed annuities, which rose 33% in the year-to-date comparison, according to date from Beacon Research, Inc.
- Deferred income annuities sales have more than doubled to $2.2 billion in 2013 and will likely exceed that level in 2014.

Assets under management (AUM) in variable annuities reached almost $2 trillion in the second quarter of 2014 before pulling back to $1.9 trillion as of the end of the third quarter. Strong equity market performance in the fourth quarter, barring a significant correction prior to the end of the year, should boost VA assets near or over the $2 trillion mark as of year-end. According to historic data from Morningstar, Inc., as of the end of the third quarter of 2014 VA assets were 179% higher than their post-crisis low point of $1.07 trillion in the first quarter of 2009, and 2% higher vs. the end of 2013. Total AUM (all types of annuities), is expected to reach $2.7 to $2.9 trillion by the end of 2014.

INTEREST RATES DECREASED

Interest rate levels directly impact both the costs and benefits of annuities. The 10-year treasury constant maturity rate, used as reference in pricing debt securities at issuance, was generally expected to continue a slow ascent in 2014 but actually dropped. Coming into 2014 at about 3%, the CMT Rate had dropped to about 2.2% as of this writing, following a fairly consistent downward trajectory since the start of the year.

10 YEAR TREASURY CONSTANT MATURITY RATE



Persistently low interest rates have a negative impact on the annuity industry, for example:

- Payout amounts decrease on immediate and deferred income annuities, exacerbating payout pressure from the inherent anti-selection bias in the product (only the healthiest tend to buy income annuities) and increasing lifespans.
- Crediting rates on fixed deferred annuities fall.
- Fixed indexed annuity caps and participation rates decrease; lower interest rates require more of each premium dollar to be set aside to support the guarantee, leaving less to purchase the index options that provide the growth component.
- Lower interest rates drive increased hedging costs and higher reserve requirements, making it more difficult to structure a lifetime income guarantee on a variable annuity with a compelling withdrawal rate while also keeping fees reasonable and allowing enough risk in the portfolio to provide upside potential.

Despite Headwinds, a Financially Strong Industry

The life and annuity industry will enter 2015 on firm financial footing despite persistently low interest rates, with that strength underpinned by several fundamental positive factors:

- Strong equity market support for legacy VA business and fee based income – US equity market levels should continue to support legacy VA blocks by holding account values close to liabilities, reducing reserve requirements otherwise forced upward by low interest rates. AUM-driven fee business will also continue to improve due to higher account values in fee-based and investment only VA products.
- Continually evolving VA product designs that shift more risk to the policy holder, for example requiring investment in volatility managed funds when lifetime income benefits are elected.
- Monetary tightening expected in 2015 should propel interest rates closer to historic norms, though the increases may take an extended period of time to have an effect given the longer durations of insurance company assets. Rising rates should be viewed as having more of a late 2015, into 2016 impact on product design and/or sales.
- Improvements in job creation and incremental wealth should improve the overall sales picture for the insurance industry, helping to boost revenue and earnings growth.
- Most insurance carriers hold ratings of "A" or higher, with favorable outlooks, from the major independent financial ratings agencies.

In December 2014, Moody's Investor Service produced a report detailing the results of liquidity stress tests intended to gauge the ability of U.S. Life Insurance companies to weather a financial storm in comparison to how they were positioned in 2008. Moody's found that the industry as a whole has strong operating company liquidity, with liquidity resources on average of 2.6 times its needs as compared to approximately double its needs in 2008, even given stress testing scenarios that include policy surrenders at 1.5 times the rate encountered in 2008. While the report noted that the liquidity resources of the top three companies were below the industry average and that the resources of the industry would be considerably stressed in a scenario where interest rates rise sharply and rapidly, it concluded that liquidity buffers would dissipate but remain sufficient and that cash reserves would be enough to honor policyholder claims and manage other balance sheet pressures.

PRODUCT DEVELOPMENT

Most of the product development in 2014 took the form of enhancements to existing products. Many new annuity products have been developed in the industry during the past few years. These new products are tailored to meet consumers' needs by providing limited downside protection, higher payout rates than traditional benefits, and increased flexibility of income start dates, to name a few. A brief description of the benefits, and growth trajectories where available, of these products follows.

- "Uncapped" Fixed Indexed Annuities
  - Same basic structure as other FIA products: a portion of the premium is invested in the general account at a fixed rate of return, the remainder is used to purchase options on one or more market indexes.
  - Rather than using a participation rate or spread to manage risk, either a "bucket" approach or a volatility managed index is used.
    - **Bucket approach:** only a portion of the premium is credited with interest based on the change in the index value, the rest is credited with a fixed interest rate. The portion that receives the index-based credit receives 100% of the increase in the index.
    - **Volatility Managed index:** the interested credited is 100% of the increase in the index, but the index itself is risk managed through a volatility overlay.

Deferred Income Annuities (DIAs)

- DIAs provide guaranteed annual income payments two to 40 years in the future, though most provide income between five to 15 years from issue.
- While guaranteed payout amounts are higher than living benefits offered on variable and fixed indexed annuities, there is no account value for the client to access.
- DIA sales totaled $2.2 billion in 2013.
- 2014 sales will exceed 2013 levels.
- The number of companies offering DIAs has doubled since the start of 2012.
- In late 2014 companies began promoting DIAs modified specifically for use in qualified plans in conjunction with Treasury's new QLAC rule.

Investment Only Variable Annuities (IOVAs)

- Compared to traditional variable annuities, IOVAs differ in three significant ways:
  - No guaranteed living or death benefits.
  - Lower costs, generally.
  - Multiple investment options offered, including alternative asset classes.
- Sales of IOVA products increased during 2014 as more companies entered the market. Nine companies currently offer 19 version of IOVA products, sales of which were just under $5 billion for the third quarter 2014 year-to-date period, about 4½% of total variable annuity sales and an increase of 60% over the prior year-to-date period. Sales are expected to continue to increase as more investors seek to protect their portfolios from the impact of higher expected tax rates.

Structured Variable Annuities

- Sometimes referred to as collared VAs or indexed-linked VAs.
- Structured variable annuities provide limited upside growth potential with limited downside protection.
- The account value growth is linked to various equity-based indexes.
- There are currently four companies offering this product type; sales have increased moderately to approximately $1.3 billion as of the third quarter year-to-date in 2014, up about 8% from $1.1 billion in the prior year-to-date period.

Variable Annuity Living Benefits Designed for Immediate Income

- Compared to other living benefits, the payout rates on these riders are higher than traditional living benefits.
- Clients with these living benefits may be more inclined to start income within the first year or two as a result of the more lucrative payouts. In these cases, the account value continues to fluctuate based on market performance.
- Generally these annuities have more restrictive investment choices that enable the company to offer higher payout rates.
- Several companies currently offer these living benefits with higher payout rates.

VOLATILITY FUNDS

The annuity industry first introduced volatility managed funds, or "Vol Funds," in 2011. Vol Funds typically allocate a percentage of the portfolio to the purchase of options, with the percentage at any given time varying based on market volatility, the goal being to mute the effect of significant movements in equities markets and maintain a more stable account value.

Vol Funds were initially used by variable annuity providers to help mitigate the risk of offering living benefits as stable account values lower the risk of offering such benefits. Nearly all of the top variable annuity living benefit writers require the use of Vol Funds, or other account-value risk mitigators, with their living benefits.

Some companies are offering Vol Funds for use outside their living benefits to offer some potential downside account-value protection to clients. It is expected that additional companies will add Vol Funds to their fund lineup as a way to offer clients more diverse options.

As 2014 draws to a close, data from Morningstar, Inc. puts vol fund assets at approximately $360 billion, a 25% increase over year-end 2013 vol fund assets of about $289 billion.

OUTCOME-ORIENTED PORTFOLIOS

Increasingly, variable annuity issuers are positioning portfolio strategies within VAs that are designed to address specific risks. This is especially prevalent in investment only VA products, as such strategies are often tax inefficient. For example, a portfolio with a significant allocation to alternative investments such as commodities is designed to address diversification risk. Other strategies may include portfolios designed to deliver positive real returns in an inflationary environment, or hedge against rising interest rates. Such strategies may consist of a passive core combined with a tactical overlay; that is, the bulk of the portfolio passively tracks one or more broad market indexes while a smaller percentage is actively managed based on the manager's identification of investment opportunities that complement the investment thesis of the strategy. It is difficult to measure the accumulated assets of such strategies as they are not yet identified by data aggregators as a specific fund type, but as a rough proxy there have been over 140 allocation funds created specifically for use within variable product separate accounts since the beginning of 2013 that collectively have over $15 billion in assets under management, and the majority of these are some type of outcome oriented strategy.

MANAGING IN-FORCE BUSINESS

There were over $1.9 trillion in variable annuity net assets as of September 30, 2014, according to Morningstar, Inc. Of this, an estimated $800 billion is included in variable annuities with living benefits. Most were sold in a higher interest rate environment.

Companies are exploring ways to manage their in-force risks more efficiently. Since 2011, four companies have offered living benefit buyback programs, where select clients are offered an incentive to surrender a contract or to remove a guarantee. These buyback programs are strictly optional, and clients have no obligation to accept these offers.

While most annuities are purchased with a single payment, some clients continue to fund a contract over many years. Because of the low interest rate environment, some companies have suspended additional payments into in-force contracts with living benefits to better manage the risk to the company.

PUBLIC POLICY CHANGES

The insured retirement industry faced numerous legislative and regulatory issues in 2014. Updates on the highest priority issues are included below, together with an overview of IRI's efforts to advance and advocate for its members' positions on these issues.

Federal Level

Tax reform

House Ways and Means Committee Chairman Dave Camp (R-Mich.) released a tax reform discussion draft bill in February. While tax deferral for retirement savings products, including annuities, were protected in Chairman Camp's draft, other provisions harmful to retirement savings were in the package. These include freezing for a decade the inflation adjustments for the limits on annual contributions to retirement plans and individual retirement accounts and requiring employee contributions to a 401(k) or similar plan above $8,750 be made on a Roth basis, adding complexity and possibly increasing administrative costs. The Camp draft raises $51 billion from industries across the board, but the new taxes disproportionately affect the life insurance industry. Of the total, $29 billion comes from new taxes on the insurance industry, which is a 26 percent increase in its taxes. For consumers who depend on life insurance products like annuities for financial security in retirement, this increase would significantly impact them since costs would go up and the availability of products would likely be negatively affected.

Chairman Camp's draft was never considered by the House of Representatives and he is retiring. Rep. Paul Ryan (R-Wis.) is the incoming Ways and Means Chairman and is expected to continue efforts to reform the tax code. Tax deferral for retirement savings products, including annuities, has been identified by the Congressional Joint Tax Committee as one of the five largest tax expenditures. As a result, reducing or eliminating tax deferral for retirement savings is always on the table for possible review when lawmakers search for new revenue sources and offsets. IRI believes that Congress should encourage retirement savings for American workers through the preservation of the current tax treatment of retirement accounts, and continues to share this view with congressional offices.

Increasing Access to Lifetime Income

The Treasury Department adopted a new rule that will make deferred annuity options more accessible to participants in qualified retirement plans, including individual retirement accounts. Under the new rule, the value of longevity annuities that meet the conditions specified in the rule (known as "qualifying longevity annuity contracts" or QLACs) will be excluded from the account balance used to determine required minimum distributions. Previously, the use of longevity annuity contracts, in which income streams commence at an advanced age such as age 80 or 85, were typically impeded in qualified retirement plans by required minimum distribution rules that apply beginning at age 70.5.

Treasury announced the adoption of this new rule at the IRI 2014 Government, Legal and Regulatory Conference in recognition of IRI's considerable contributions throughout the rulemaking process that helped to shape the final rule, which included an increase in the maximum permitted investment, the inclusion of "return of premium" death benefits, premium overpayment protection, and more flexibility in issuing longevity annuities.

In addition, Treasury and the Labor Department issued new guidance that will enable employers to offer target date investment options that include certain types of deferred annuities within defined contribution plans. Specifically, the guidance applies to plans that offer a series of target date investment options, each of which is available only to participants whose normal retirement age will fall within a limited number of years around the specified target date, where unallocated deferred annuities are offered as fixed income investments only in those options available to participants over age 55.

Definition of "Fiduciary"

The Department of Labor (DOL) continued its work on a revised version of a proposal that would modify the circumstances under which a person is considered a "fiduciary" under the Employee Retirement Income Security Act of 1974 (ERISA) when providing investment advice to an employee benefit plan or a plan's participants. The revised proposal had been scheduled for issuance in August 2014, but has now been pushed back to at least January 2015. The original version, released in October 2010, was withdrawn in 2011 amid extensive objections from across the financial services industry and members of Congress on both sides of the aisle.

The insured retirement industry was concerned that the original proposal would have led to increased costs and complexity, limited consumer choice regarding retirement plans and individual retirement accounts (IRAs), and deprived middle-income Americans of the opportunity to affordably access services to make educated decisions related to their own retirement security.

IRI, together with a large coalition of financial services and retirement trade associations, has held hundreds of Capitol Hill meetings on this issue. In addition, IRI contributed to the growing body of research supporting the industry's position with a research report issued in March 2014 that overwhelmingly showed investors are satisfied with their relationship with their advisor.

In December, a delegation of IRI member company senior executives and subject matter experts met with senior officials from the White House and the Department of Labor to discuss the Department's plans to issue a new fiduciary definition rule proposal. We shared ideas about how to craft a rule to avoid the unintended consequences of millions of Americans losing access to help with saving for retirement and access to a workplace retirement plan. The Administration emphasized that it is fully committed to ensuring Americans have access to lifetime income so they can enjoy a dignified retirement after a lifetime of work.

Variable Annuity Summary Prospectus

In a series of meetings with IRI Board members in late 2014, SEC Chair Mary Jo White and Commissioners Luis Aguilar, Daniel Gallagher, Kara Stein and Michael Piwowar each expressed strong support for IRI's proposal to create a summary prospectus for variable annuities. The proposal was originally submitted to the SEC in 2008 and has had the support of former Chairman Mary Schapiro as well as Director Norm Champ of the Division of Investment Management and several of his predecessors.

National Insurance Licensing Legislation

The National Association of Registered Agents and Brokers Reform Act (NARAB II) legislation was reintroduced in both chambers of Congress last year. The legislation passed both chambers in different forms this year, and at the time of this writing is currently being considered by lawmakers for inclusion in a bill to reauthorize the Terrorism Risk Insurance Program during the lame duck session. IRI continues to be a leading advocate on Capitol Hill for NARAB II passage this year.

If this bill becomes law, it would establish a one-stop, national licensing clearinghouse for financial professionals with state insurance licenses in multiple states. Financial professionals who have passed background checks in their home state could apply for NARAB membership, enabling them to sell guaranteed lifetime income products in other states without the burden of having to deal with multiple state insurance departments. Previous research by IRI shows that its passage would remove a barrier that is impeding broker-dealers' ability and financial advisors' willingness to sell lifetime income products.

FINRA CARDS Proposal

The Financial Industry Regulatory Authority issued a proposal in 2014 to create a new automated data collection system, known as the Comprehensive Automated Risk Data System, or CARDS. Under this system, which was originally outlined in a December 2013 concept release, broker-dealer firms would be required to provide FINRA with certain account information, account activity, and security identification information. In response to feedback from IRI and other stakeholders on the concept release, FINRA decided to exclude variable annuities from the initial implementation of CARDS, and will not require the submission of any personally identifiable information.

State Level

Contingent Deferred Annuities

The National Association of Insurance Commissioners made significant progress in 2014 with respect to its efforts to determine whether and how to revise existing model laws and regulations to clarify how they apply to contingent deferred annuities. Most notably, with substantial input from an industry coalition co-led by IRI, the NAIC has finalized revisions to four models – Annuity Disclosure, Suitability in Annuity Transactions, Advertisements of Life Insurance and Annuities, and Life Insurance and Annuities Replacement – and concluded that no changes were needed to the Producer Licensing Model Act or the Life and Health Insurance Guaranty Association Model Act. In addition, IRI and the industry coalition worked closely with the NAIC to develop a draft guidance document to help states determine how to apply their existing annuity laws and rules to CDAs or, if necessary, how to amend their existing annuity laws and rules to clarify how they apply to CDAs.

Suitability Regulations

New Hampshire and Wyoming adopted the current version of the NAIC Suitability in Annuity Transactions Model Regulation in 2014. The current version of the Model has now been adopted in 32 states, prior versions of the Model remain in effect in 17 states, while one state has suitability regulations not based on the Model and another has no suitability regulations. IRI played an active leadership role in the development of the current version of the Model, and worked with the states listed above to ensure uniform adoption.

Annuity Disclosure Regulation and Buyer's Guides

In 2014, three states – Alabama, Colorado, and Ohio – adopted the current NAIC Annuity Disclosure Model Regulation, which extends the buyer's guide delivery requirement to variable annuities and establishes standards for the use of annuity illustrations. In addition, five states – Georgia, Idaho, New Jersey, Oklahoma, and Utah – took other steps to either require or permit use of the new Buyer's Guide for Deferred Annuities adopted by the NAIC in August 2013. IRI played an active leadership role in the development of the current version of the Model and the new Buyer's Guide, and worked with the states listed above to ensure uniform adoption of the Model and a smooth and orderly transition to the new Buyer's Guides.

Market Conduct Reform

In mid-2014, the NAIC created a new working group to consider establishing accreditation standards for market conduct examinations. At the NAIC's Fall National Meeting, the Working Group issued a discussion draft of Potential Objectives, Guiding Principles and Goals, as well as a Proposed Timeline for the Working Group to complete its work.

2015 Outlook

PUBLIC POLICY

Federal Level

Increasing Access to Lifetime Income

The Department of Labor is expected to move forward with its lifetime income illustrations proposal and its efforts to revise the selection and monitoring of annuity provider safe harbor, while the Department of Treasury will look to finalize its pending partial annuitization proposal. Both recognize the importance of lifetime income as part of a financially secure retirement, and they will continue their efforts to reduce barriers that prevent Americans from accessing lifetime income products within their retirement plans, i.e., 401(k) and 403(b) plans, and to create incentives for plan sponsors to offer these products.

Other Retirement Legislation

Retiring Senator Tom Harkin (D-Iowa), Chairman of the Senate Committee on Health, Education, Labor and Pensions, introduced his USA Retirement proposal to address the retirement income crisis through a privately-run hybrid pension plan called USA Retirement Funds this year. Of interest in Chairman Harkin's bill was a proposal to provide a guaranteed lifetime income benefit that employees would be able to take with them when changing jobs. However, his legislation did not receive consideration in the Senate. Additional retirement legislation, such as incoming Finance Committee Chairman Orrin Hatch's (R-Utah) SAFE Retirement Act of 2013,. is likely to be reintroduced. Sen. Hatch has indicated in interviews that it is one of his top priorities moving forward. The SAFE Retirement Act includes provisions to eliminate outdated barriers to the use of Multiple Employer Plans (MEPs) and the 10 percent auto-escalation upper limit in auto-enrollment 401(k) plans. It further expands the ability of employers to offer annuities to 401(k) participants and creates a Starter 401(k) wage deferral-only safe harbor plan for small businesses. In addition, the Senate Finance Committee held a hearing on retirement savings in September, and all indications are that the committee will continue to examine retirement savings proposals in the new Congress.

State Level

Suitability and Disclosure Regulations

Proposals to adopt the current NAIC Suitability in Annuity Transactions Model Regulation are currently pending in Georgia and Maine, and proposals to adopt the current NAIC Annuity Disclosure Model Regulation are currently pending in Maine and West Virginia. IRI expects that several other states will issue proposals to adopt the current versions of these Models.

Market Conduct Reform

The proposed timeline issued by the NAIC Market Regulation Accreditation Working Group in late 2014 calls for extensive work to be conducted in 2015 towards the establishment of accreditation standards for market conduct examinations, with final standards to be in place by mid-2016. As it begins this process, the Working Group is focused on establishing "standards for the qualifications and competencies of state insurance market regulation professionals" and developing "a training program for market regulation and additional resources…in support of market regulation activities" in order to promote consistency, collaboration and coordination across the states.

ANNUITY SALES IN 2015

The most significant hurdle facing annuity sales in the coming year will be the direction of interest rates. Persistently low interest rates create a challenging environment for issuers that must increase reserves against income payment and guarantee liabilities, face higher hedging costs against guarantees in variable products, and lower spreads, caps and participation rates on fixed indexed annuities. Additionally, low interest rates may be having an effect, particularly on income annuity sales, similar to the macroeconomic impact of a deflationary environment, i.e. deferring the purchase decision in anticipation of a lower price in the future – higher interest rates mean a lower purchase payment per dollar of income.

Projecting future annuity sales is a difficult exercise given the various economic, financial, legislative, and regulatory factors that influence the annuity market. However, in IRI's view, if interest rates are permitted to gradually ascend to a level reaching or exceeding 3% in 2015, given the wealth controlled by retirees and near retirees wrestling with the problem of generating guaranteed, sustainable lifetime retirement income, income-oriented annuity sales should see a significant boost. And even in a continued environment of low interest rates 2015 should see modest gains in sales driven by demographics and a growing preference among consumers for guaranteed income and the exchange of upside potential for downside protection. The strongest growth areas will likely continue to be fixed indexed products as an alternative to high risk equities and low return CDs and deferred income annuities as a financial planning solution that provides an "income backstop" such that financial advisors can employ other solutions, such as systematic withdrawals and dividend strategies, over a finite time period.

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IRI forecasts that the demand for annuities will remain strong given the following factors: investor desire for guaranteed income, an aging population, increased longevity, increased interest rates, and market volatility. Additionally the supply of annuities has increasing as companies are developing new products and features to attract a wider range of clients. Specifically, the industry has seen an increase in the number of companies offering:

- DIAs
- Growth-oriented VAs
- Structured VAs
- Living benefits with higher payout rates

As additional companies enter these markets, along with sustained demand, it is reasonable to expect sales to increase in 2014. However, a drop in equity markets and/or a return to lower interest rates could be hindrances to sales growth.

Long-Term Outlook

The long-term outlook for the annuity industry is promising. Annuity products are changing to meet consumer demand as Americans become more aware of their retirement income needs. Research conducted by IRI in 2014 found that only one-third (33%) of Boomers believe they will have enough money to live comfortably throughout their retirement years, down from 37% when the study was first conducted in 2011. This is a statistic that bears reflecting upon: despite multiple years of stock market gains post the 2008 financial crisis, those closest to or in retirement feel less confident rather than more confident. This implies that large numbers of Boomers may have exited risk assets after the financial crisis and could not tolerate the risk of re-investing in those assets given their proximity to retirement, and/or fears about health care costs and longevity are causing them to re-evaluate the ability of their nest eggs to generate sufficient income. In both cases the opportunity for insurance companies is clear: as the only legal entities that can ensure retirement income for a person's lifetime, insurance companies alone can provide consumers with the core products they need to create and maintain sustainable income producing portfolios.

"... insurance companies alone can provide consumers with the core products they need to create and maintain sustainable income producing portfolios."

Consumer demand for guaranteed lifetime income remains strong for a number of reasons:

- **Demographics:**

  Pew Research Center estimates, beginning January 1, 2011, 10,000 Baby Boomers begin to turn 65 every single day, and will continue to do so for the next 16 years.

- **Consumer needs:**

  IRI research shows that "guaranteed income each month" and "will not lose principal" are among the most important traits of a retirement product.

- **Increased longevity:**

  As people live longer, guaranteed lifetime income becomes a key component to managing longevity risk. According to the Society of Actuaries, by age 65, U.S. males in average health have a 40% chance of living to age 85 and females have more than a 50% chance. The survivor of a 65-year-old couple is more than 70% likely to reach age 85. Working longer is a proposed option for managing longevity, yet IRI research shows half of retirees reported they retired earlier than planned.

- **Decline of traditional pension plans:**

  In 1985, there were 114,000 private-sector defined benefit pension plans, but by 2014, there were less than 24,000 of these plans remaining, according to the Pension Benefit Guaranty Corp. The Bureau of Labor Statistics' National Compensation Survey reports that only about 19% of private-sector, non-union workers have access to a traditional pension.

- **Large dollar amounts in qualified plans:**
  The total assets in qualified retirement plans, as of the second quarter 2014, were $24.0 trillion, up almost 15% from the same period in 2013. The following table details this amount by the different types of retirement plans.

- **Concerns over Social Security and other governmental programs:**
  The 2014 Social Security Trustees Report projects the combined Old Age and Survivors Insurance and Disability Insurance Trust Fund will be exhausted in 2033. The 2014 Medicare Trustees Report projects the Hospital Insurance Trust Fund (Part A) will be exhausted in 2030, 4 years later than was shown in last year's report.

ASSETS IN TAX QUALIFIED RETIREMENT PLANS

SECOND QUARTER 2014

Private Trusted Defined Benefit Plans	$3.2 trillion
Private Trusted Defined Contribution Plans	$6.6 trillion
Individual Retirement Accounts (IRAs)	$7.2 trillion
State and Local Government Plans	$3.7 trillion
Federal Government Retirement Plans for Federal Employees	$1.5 trillion
Annuities	$1.8 trillion
Total	**$24.0 trillion**

Sources: Investment Company Institute with data derived from Federal Reserve Board, Department of Labor, National Association of Government Defined Contribution Administrators, American Council of Life Insurers, Internal Revenue Service Statistics of Income Division.

SUMMARY

As America ages and begins focusing on retirement, and with 10,000 Baby Boomers turning age 65 each day, the demand for guaranteed lifetime income has never been higher. This generational cohort desperately needs income solutions, and they are more confident and better prepared for retirement when they employ them – especially when doing so with the help and guidance of financial advisors. To meet this demand, annuity providers continue to explore new innovations to diversify their risks and to offer clients more retirement income options. Life insurance companies – via annuities and other guarantees – are the only companies legally allowed to pool risk and offer guaranteed lifetime income. These companies are financially strong, and through stress testing have been shown to be better positioned now than in 2008 to weather financial storms.

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Some of these product innovations include deferred income annuities, growth-oriented variable annuities, and structured variable annuities. More companies are expected to begin offering some of these products and different variations of them are likely to be launched as the industry evolves.

On the public policy front, many issues with ramifications for the insured retirement industry continue to progress at the state and federal levels. While no tax reform legislation advanced in 2014, tax incentives for retirement savings can always be put on the table when lawmakers search for new revenue sources and offsets. The QLAC rules released by Treasury in June 2014 were an important step forward in improving the legal framework within which deferred income annuities can be used. On the regulatory front, while proposals from the SEC and the Department of Labor on the definition of a fiduciary have stalled, these efforts are still active and such a proposal, if adopted, could have sweeping implications for the industry and investors alike.

Macroeconomic factors, such as interest rates, continue to impact the industry in terms of product development and dampening sales. However, on a year-to-date over year-to-date basis, fixed annuity sales as of the third quarter of 2014 realized significant increases, underscoring the extent to which demographic trends are driving sales activity even in a persistently low interest rate environment. Variable annuity sales have flattened and will likely continue in a tight range until interest rates increase enough to support the development and sales of more generous lifetime income benefits, though sales are seeing a boost from investment only VA products. It will likely take a sustained period of interest rates above 3% before a meaningful trend toward the development of more generous income benefits on variable products takes root.

RESEARCH SOURCES

Supporting data for this report were derived from publicly available research from the 2014 Social Security Trustees Report; 2014 Medicare Trustees Report; American Council of Life Insurers; Beacon Research; the Bureau of Labor Statistics; the Department of Labor; the Federal Reserve Board; Internal Revenue Service Statistics of Income Division; Investment Company Institute; Merrill Lynch; Moody's; Morningstar, Inc.; the National Association of Government Defined Contribution Administrators; Pension Benefit Guaranty Corporation; St. Louis Federal Reserve Board, Federal Reserve Economic Data (FRED); Society of Actuaries.

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