Insured Retirement Institute

STATE OF THE INSURED RETIREMENT INDUSTRY

2015 Review and 2016 Outlook

December 2015

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**.

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2015 Review and 2016 Outlook

OVERVIEW

The *State of the Insured Retirement Industry* is the fourth in an annual series of reports covering significant trends and developments in the retirement industry. As 2016 approaches, several macroeconomic factors are in play. Interest rates remain below historic norms and equity market volatility is increasing. The DOL's forthcoming fiduciary rule looms large, potentially requiring new product designs and disrupting current distribution models. These issues will produce headwinds in 2016. On the other hand, demographics remain favorable as the population continues to age and consumers continue to become more cognizant of the extent to which they are responsible for generating their own income in retirement. This is a positive demand factor that should continue to create favorable business conditions and spur continued innovation in product design, helping to offset some of headwinds.

The outlook for any market is ultimately a function of the extent to which demand and supply are stable, or are expected to grow, contract, or shift. In the retirement income industry, there are many forces that impact both the demand for, and supply of, retirement income products.

The Demand Side

- Large cohorts of Americans are nearing or entering retirement, and focusing on their retirement needs.
- Only 27 percent of Baby Boomers are confident their savings will last throughout retirement, leaving a large pool of consumers who can benefit from lifetime income strategies.
- Increasing life expectancies are leading to longer retirements and driving both the need for, and awareness of, sources of lifetime retirement income beyond Social Security.
- The prevalence of 401(k) plans as the major retirement savings vehicle in the United States is leading to greater self-reliance and personal responsibility with regard to generating income in retirement, driving opportunities to provide lifetime income solutions to plan participants.
- Steady overall sales of annuities reflect strong demand despite the headwind of persistently low interest rates.

The Supply Side

- Financially stable annuity providers with strong liquidity and sound balance sheets continue to supply lifetime income solutions to the marketplace.
- Ongoing product innovation is creating a wide array of consumer choice in lifetime income strategies, as annuity providers diversify and expand their offerings to better manage risk and tailor their products to meet various consumer needs.

- Though in its infancy, the number of Qualifying Longevity Annuity Contracts (QLACs) greatly expanded during 2015, reflecting the opportunity created by the Treasury department via its QLAC rule to enable consumers to more seamlessly direct retirement assets into lifetime income solutions.
- Investment-Oriented Variable Annuities (IOVAs), while still a small portion of the overall VA market, have grown over 90% in sales in the past five years, reflecting growing interest in the tax deferral and outcome oriented investment strategies offered in these products.
- Interest rates continue to remain near historic lows, but there is growing consensus that rates will begin to rise steadily in 2016, allowing annuity issuers to further increase capacity and offer more attractive benefits.

Key Observations

As noted above, many demographic trends favor increased adoption of annuities in retirement planning, but challenges on both the supply side and demand side of the industry are producing headwinds to expanding the use of annuities by both consumers and financial professionals. Important trends, some new in 2015 and some ongoing, will shape the industry in the years to come:

- **Emerging and Continuing Trends in 2015:**
    - **Fixed Indexed Annuities (FIA) and Investment-Oriented Variable Annuities (IOVA) are growing rapidly.** FIAs are posting strong sales as both a fixed income substitute – meaning a bond-like return without interest rate risk – and on the attractiveness of optional guaranteed lifetime income benefits.
    - **Qualifying Longevity Annuity Contract (QLAC) offerings are expanding.** As of this writing, 11 companies are now offering a QLAC product. Only one company had introduced a QLAC by the end of 2014.
    - **Overall annuity sales are consistent.** Sales are relatively flat year over year, with pent up demand likely building in anticipation of rising interest rates in 2016.
    - **Sales continued to shift among product types.** Fixed Indexed Annuities, Deferred Income Annuities, and Investment-Oriented Variable Annuities continue to grow in overall market share.
    - **Buyer demographics continue to favor expanded used of annuities**. According to 2010 U.S. Census data, there are over 74 million Americans age 55 and over, and over 38 million age 65 and over. With only one in four Baby Boomers (27%) confident in their preparations for retirement, and GenXers and Millennials struggling to save, the table is set for annuities to help all generations realize a more dignified retirement.
    - **The Department of Labor proposes its fiduciary rule.** Based on its initial proposal, the rule will significantly restrict consumers' access to guaranteed lifetime income solutions currently available in IRA accounts.
    - **Providers continue to innovate their product offerings.** Insurers continue to diversify their product lines, as part of their risk management strategy.
- **Major Trends in 2016:**
    - **Lifetime income options in defined contribution plans.** Several insurers are now offering a Deferred Income Annuity for the defined contribution plan market, and at least one insurer launched an institutional QLAC. Look for insurers to continue to innovate by placing lifetime income options in workplace plans, where the bulk of investable retirement assets reside.

- **Growth of FIAs and IOVAs.** Expect insurers to continue to focus on FIA and IOVA product development as they continue to diversify product lines and position products to meet varying consumer needs. 2016 should see the introduction of new products to support the continued growth in sales of FIAs and IOVAs.
- **Continued use of volatility managed funds.** Volatility picked up in the third quarter of 2015, providing an opportunity for insurance companies to see how volatility managed funds performed. Feedback on the efficacy of these strategies has been mixed, so 2016 may bring refinements. But the use of these strategies in VA products that offer guaranteed income is unlikely to abate.
- **Rising interest rates?** Minutes from the October meeting of the Federal Reserve indicated that most Fed officials believed conditions for a rate hike would be met before the December policy meeting. Rising prices for services will square off against the disinflationary effect of falling commodities prices to frame the outlook for continued rate increases in 2016.

2015: A YEAR IN REVIEW

Flat Sales, Shifting Product Landscape

Sales of variable annuities with guaranteed lifetime income benefits still represent the lion's share of annuity sales, though other types of annuities, most notably FIA and IOVA products, continue to grow market share. This is a trend that has been developing for several years (see table).

	Q2 2011 YTD		Q2 2012 YTD		Q2 2013 YTD		Q2 2014 YTD		Q2 2015 YTD		5 Year % Change
	$Bln	%	$Bln	% Δ	$Bln	% Δ	$Bln	% Δ	$Bln	% Δ	
Variable											
All VA	**79.3**		**74.4**	**(6.2)**	**72.0**	**(3.2)**	**69.1**	**(4.0)**	**67.0**	**(3.0)**	**(15.5)**
GLI/GDB	66.5		60.4	(9.2)	56.5	(6.4)	52.8	(6.6)	49.2	(6.9)	(26.1)
IOVA	5.6		6.2	10.7	8.6	38.7	9.1	5.8	10.9	19.8	94.6
Group	7.1		7.7	8.5	6.7	(13.0)	6.6	(1.5)	6.4	(3.0)	(9.9)
IVA	0.09		0.12	33.3	0.18	50.0	0.61	238.9	0.55	(9.8)	511.1
Fixed											
All Fixed	**39.2**		**34.0**	**(13.2)**	**32.1**	**(5.7)**	**46.8**	**45.8**	**43.7**	**(6.7)**	**11.3**
Traditional	19.3		12.6	(34.6)	10.5	(17.0)	16.0	53	13.9	(13.3)	(28.1)
Fixed Indexed	15.9		17.0	6.7	16.9	(0.6)	24.1	42.8	24.1	0.0	51.5
Income (SPIA/DIA)	4.0		4.4	10.1	4.7	6.7	6.7	40.9	5.7	(15.0)	40.8

An examination of sales over the previous five years, from the June 2015 year-to-date sales data available at the time of this writing, provides sufficient data for trend analysis. It also captures seasonal factors that tend to impact sales volume, for example sales that occur near tax season or shortly after year-end as a function of the planning process. The data reveal growth trends in FIAs, IOVAs, and income annuities—including Immediate Variable Annuities (IVAs), Single Premium Immediate Annuities (SPIAs), DIAs, and DIAs sold as QLACs. The strongest percentage growth occurred in IVA products and the highest volume increases in FIA. This trend is expected to continue as insurers devote resources to products with different risk and liability characteristics than variable annuities with guaranteed lifetime income benefits. The forthcoming DOL fiduciary rule, however, presents a significant caveat to any sales predictions – the effect on annuity sales, and in particular sales by product type, is largely an unknown pending finalization of the rule.

In summary, based on mid-year-to-date sales trend analysis from 2011 to 2015:

- Sales of FIAs have shown impressive growth since 2011, increasing by more than 50%. An uptick in interest rates sufficient to increase participation in index returns would be expected to have a significant positive impact on sales.
- While sales of variable annuities offering guaranteed lifetime income benefits have slowed, rising interest rates would likely reverse this trend. Expanded use and refinement of volatility managed strategies may also contribute to higher sales by easing risk capacity constraints.
- IOVAs will likely continue on an upward trajectory. IOVA products carry no investment or benefit liability risk for insurers, and can help insurers diversify and strengthen their product portfolios and revenue bases. At the same time, these products offer consumers additional opportunities for tax deferred investing, and outcome oriented strategies that can help advisors tailor portfolios to specific investor goals and concerns.
- Income annuities, especially IVAs, have experienced significant growth in the past five years as well. Demand for these products is likely to continue as Baby Boomers seek to develop income streams in retirement that they cannot outlive.
- Group variable annuity sales have likely reached a plateau. Group VA refers to registered variable annuities sold into a group setting, for example a 403(b) plan administered by a university for the benefit of its teaching staff and other employees. An aging employee population and replacement of annuity-based plans by plans funded with institutional mutual funds are having a slow but steady impact on the accumulation side of this market as participants convert their plan balances into retirement income.

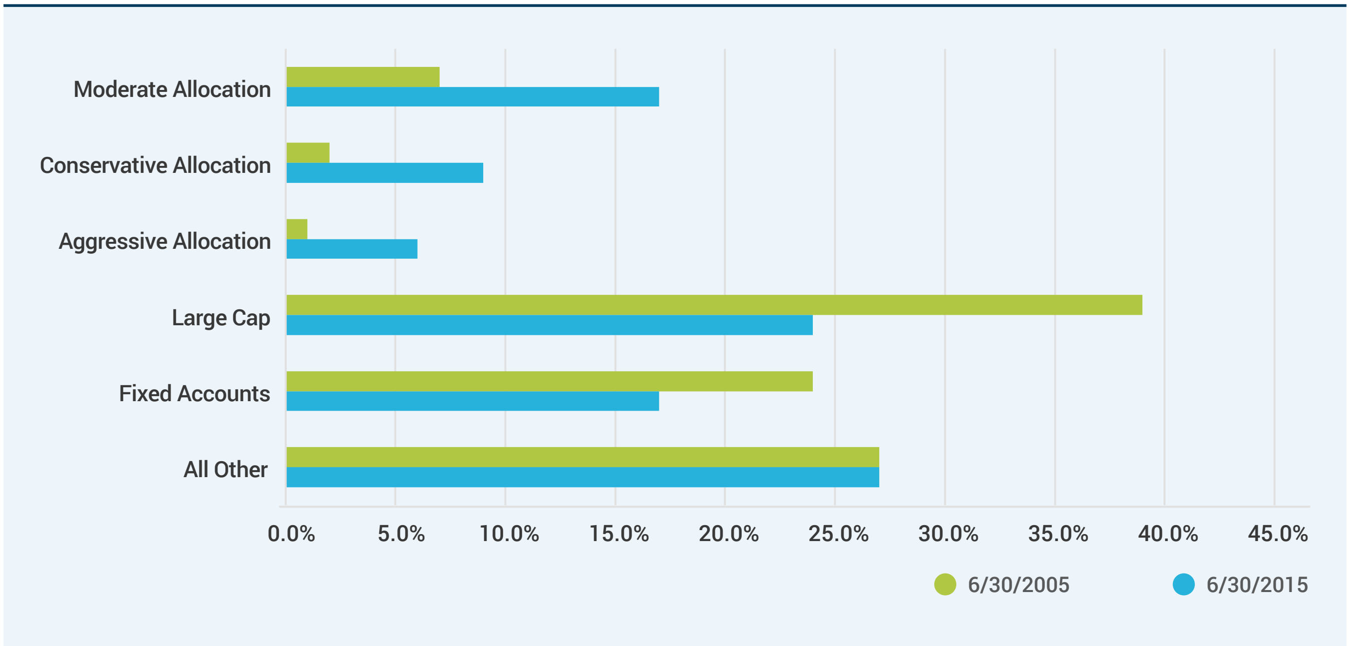
Assets under management (AUM) in variable annuities reached $1.98 trillion in the second quarter of 2015, but will likely show some pullback when third quarter data is released due to the 6.9% drop in the S&P 500 from June 30 to September 30, 2015. However, as of this writing the S&P 500 is up a little over 2 percent for the year, so absent a significant market correction before year's end, VA assets should stay near the $2 trillion mark.

Historically, variable annuity AUM has tracked fairly closely with the change in the S&P 500 Index. The correlation is not exact, of course, as many other dynamics are present, including fluctuations in sales and redemptions as well as varying returns in other asset classes. However, directionally the relationship is quite consistent, though due to the diversification effect of other asset classes, variable annuity assets typically neither lose nor gain as much as the S&P (see chart).

Growth in Variable Annuity Assets Versus Change in S&P 500

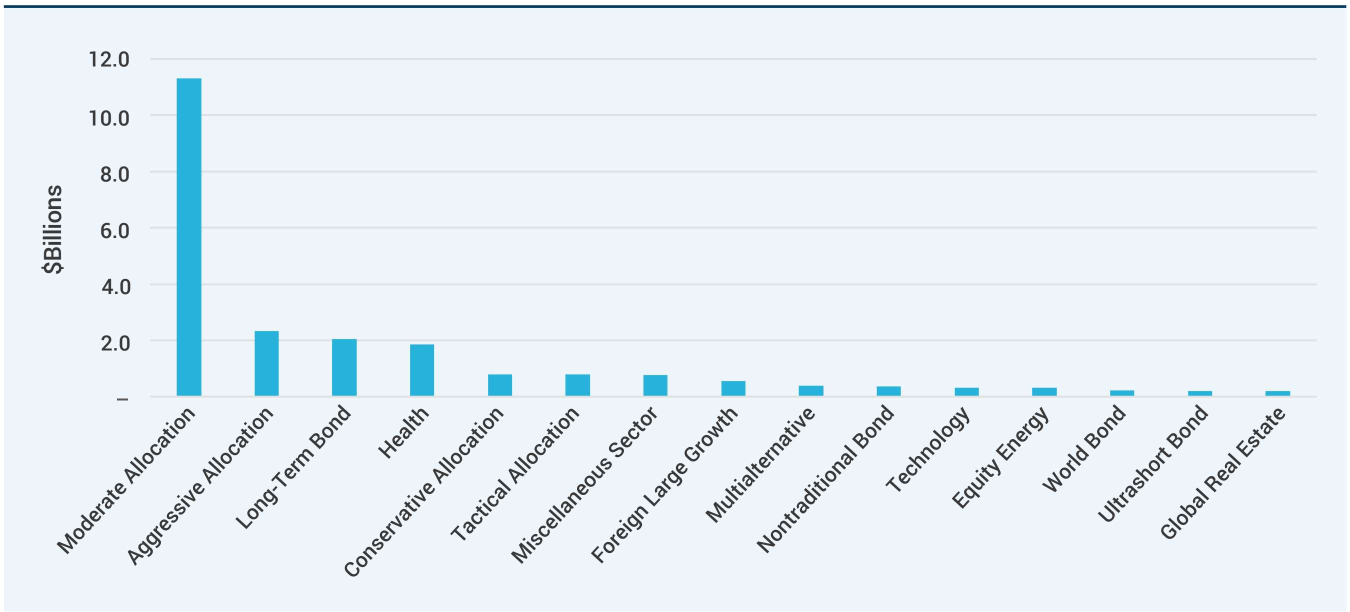
Since 2005, however, the aggregate asset allocation in variable annuities has changed, slowly but dramatically. Large cap blend, in which category are S&P 500 Index funds and other blended funds benchmarked against the S&P 500, once held the lion's share of assets. Driven primarily by the asset allocation requirements of many variable annuities with guaranteed lifetime income benefits, today the bulk of assets reside in asset allocation funds, primarily moderate allocation. Conceptually these funds provide enough equity exposure for account values to keep pace with lifetime withdrawals, and enough allocation to bonds and other lower-risk asset classes to manage excessive risk exposure. As a result of the shift to allocation funds, all else equal, expect to see less growth when equity returns are robust, but far less losses during major corrections. Additionally, about 1.5% of the assets currently in allocation funds have a volatility management overlay, but more than half of net positive cash flow is going into volatility managed funds. As a result, it is anticipated that over time variable annuity return-based asset changes will be less correlated to equity market returns.

Shifts in Aggregate Variable Annuity Asset Allocation: 2005 Versus 2015

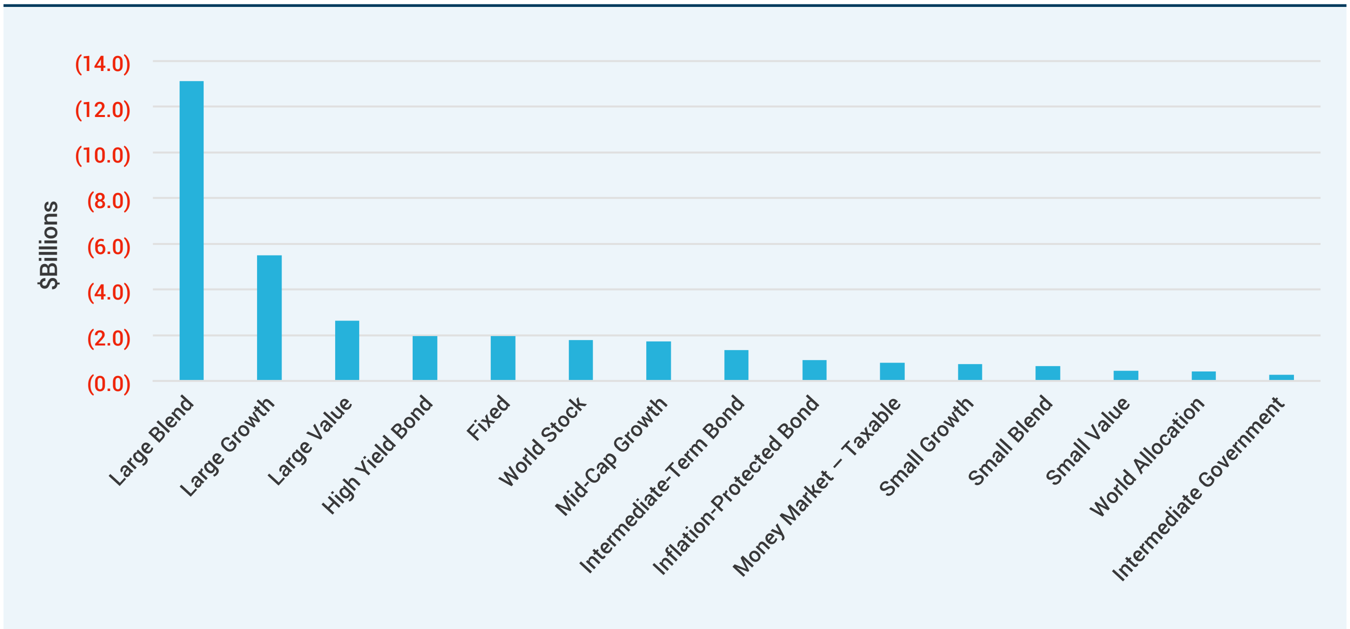


These asset changes also are evident in 2015 net asset flow — the change in assets due to aggregate cash flows. Studying these flows clearly shows the ongoing trend of net positive flows in asset allocation funds and net negative flows in large cap equity funds.

Q2 2014 - Q2 2015 Positive Cash Flows in Variable Annuities (90% of Net Inflow)



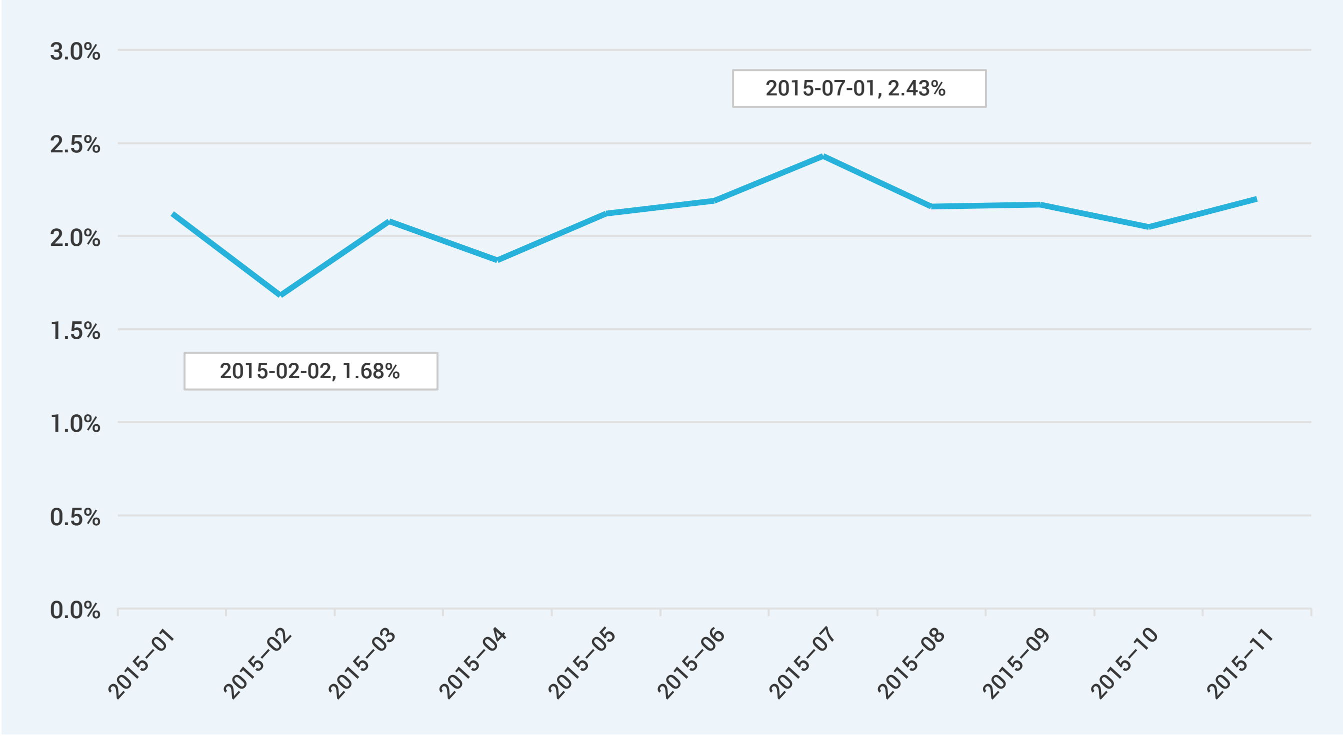
Q2 2014 - Q2 2015 Negative Cash Flows in Variable Annuities (98% of Net Outflow)



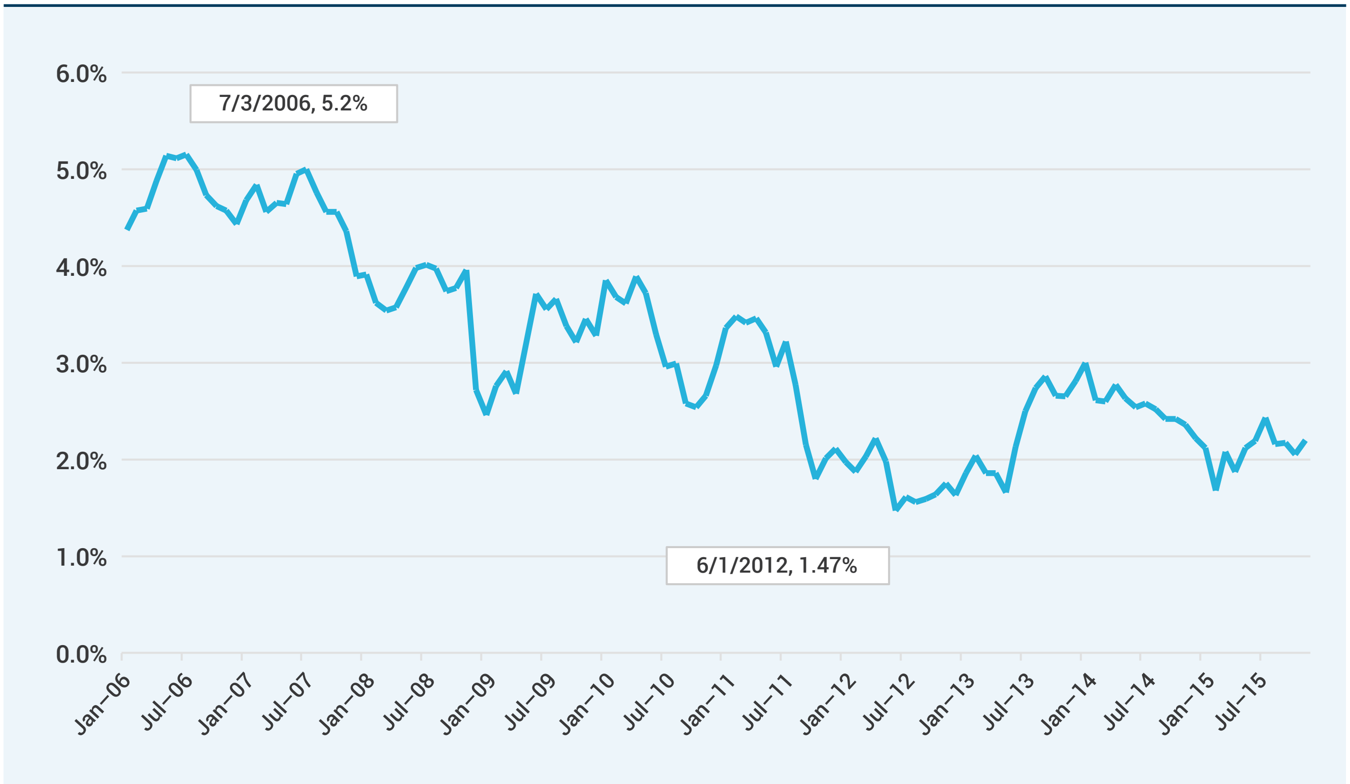
Interest Rates

Interest rates stayed in a relatively narrow range in 2015, starting the year on a downward trend but recovering to return to just a few basis points above where they began the year by early November. On a positive note, rates are about 75 basis points above their low point of about 1.50% in mid-2012.

10-Year Treasury Constant Maturity Rate in 2015



10-Year Treasury Constant Maturity Rate: 2006 to 2015



Low interest rates have impacted the annuity industry in several ways, including:

- Payout amounts decrease on income annuities, which can exacerbate anti-selection challenges. That is healthier savers, who are more likely to live longer, make up the bulk of buyers.
- Crediting rates on fixed deferred annuities decrease, which can result in consumers waiting until rates rebound to purchase. Conversely, however, fixed annuities tend to offer slightly higher crediting rates than fixed income alternatives such as Certificates of Deposit (CDs), which can boost sales of fixed annuities.
- 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.
- Fixed indexed annuities can also benefit from lower rates, both because they have the potential to earn more interest than alternative fixed income investments like CDs, and because they do not carry interest rate risk like government and corporate bonds.
- Lower interest rates can increase hedging costs and 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.

There is broad consensus in the market for rising interest rates in 2016, setting the stage for abatement of capacity constraint issues, as well as potential improvements in the generosity of lifetime income benefits and other product aspects.

Continued Financial Strength

As a whole, annuity issuers continue to project financial strength and will enter 2016 on even stronger footing than in 2015. Healthy asset levels should continue to prop up the performance of legacy VA blocks and drive profits through AUM-driven fee businesses such as pensions, mutual funds, and institutional asset management. Most insurers have focused on diversifying their product offerings to avoid over concentration in any one strategy and the risks inherent in those offerings. Many providers have also implemented investment mandates to use volatility funds with the guaranteed income benefits. This helps from a hedging and risk standpoint as it reduces volatility and the likelihood of cash values in annuity contracts being reduced to zero. Rising interest rates in 2015-16 will slowly release pressure on interest rate sensitive business, so though stable and well-positioned for 2016, insurers may still have exposure to volatility in equity markets as well as the potential continuation of low interest rates. Insurers will need to maintain risk mitigation efforts to offset these forces.

Observations on the life and annuity industry's financial trends and dynamics:

- U.S. equity market levels should continue to support legacy variable annuity blocks by holding account values close to liabilities, reducing reserve requirements otherwise forced upward by low interest rates. AUM-driven fee business also will continue to improve due to higher account values in fee-based and investment-oriented variable annuity products.
- Continued innovation to variable annuity product designs will reduce risk exposure to insurers. This includes requiring investments in volatility managed funds when lifetime income benefits are elected to manage excessive market exposure during downturns.
- Evidence continues to suggest interest rates may increase in December. Should interest rates trend toward historic norms, the increases will take time to have an effect on the industry given the longer durations of insurance company assets, so rising rates should be viewed as having a late-2016 impact on product design and/or sales.
- Improvements in the unemployment rate and incremental wealth gains should improve the overall sales picture for the insurance industry.
- Credit positive merger and acquisition activity should continue, as companies continue to move sub-scale and under-performing or non-core businesses to acquirers with the capacity to make them perform better, or to acquirers with different return objectives.

As mentioned in IRI's State of the Industry Report in December 2014, Moody's Investor Service detailed 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. The report concluded that while the industry would be stressed in a scenario where interest rates rise sharply and rapidly, its liquidity buffers and cash reserves would remain sufficient to honor policyholder claims and other balance sheet pressures. Given the absence of any significant shocks to insurer stability in 2015, IRI believes these conclusions continue to accurately reflect the strength and resilience of the sector today.

Product Development

The major developments in the retirement income industry are centered in two main areas: product diversification and risk management. In terms of product diversification, companies continue to expand their product shelf by offering Investment-Oriented Variable Annuities (IOVA), Fixed Indexed Annuities (FIA), and income annuities including Single Premium Immediate Annuities (SPIA) and Deferred Income Annuities (DIA).

In variable annuities, much product development effort is geared toward risk management, which takes the forms of investment mandates to use volatility funds, rate sheets, buy-back offers and the ability for companies to alter in-force business. Some examples of in-force changes include: ability to reduce the income payout if the account value goes to zero, the ability to alter rider fees on in-force benefits, and the ability to alter roll-up rates on GLWB's based on the 10-Year Treasury or the CBOE Volatility Index (VIX).

Observations on product development:

- **Fixed Indexed Annuities**
  - Overall FIA sales have grown substantially in the past few years.
  - The FIA with an optional guaranteed lifetime income benefit is still relatively new and gaining traction.
  - Positioning as a fixed income alternative has resonated with advisors and consumers and led to substantial growth in the current low interest rate environment.
  - Innovation in product design, including expanded use of many different broad market indexes and evolution of crediting strategies, has made the product more versatile and broadened its application as a portfolio diversification tool.
- **"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, for example 60%, is credited with interest based on the change in the index value; the remainder is allocated to a fixed, interest bearing account. 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.
  - Sales of uncapped FIA products are not tracked separately, but anecdotally are growing.
- **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 $1.15 billion in the year-to-date period ending June 30, 2015, tracking near the $2.6 billion sold in 2014.

- » The number of companies offering DIAs has doubled since the start of 2012.
- » In 2015, companies began promoting DIAs specifically for use in qualified plans in conjunction with Treasury's new Qualifying Longevity Annuity Contract (QLAC) rule. At least 11 companies are now offering QLAC products.

- **Investment-Oriented Variable Annuities (IOVAs)**
  - » Compared to traditional variable annuities, IOVAs differ in three significant ways:
    - No living benefits.
    - Lower costs, generally.
    - Many and varied investment options offered, including alternative asset classes and outcome-oriented strategies such as rising rate defense and inflation defense.
  - » Sales of IOVA products increased during 2015 as more companies entered the market. 38 companies currently offer 174 versions of IOVA products, sales of which were just under $11 billion year-to-date as of the close of the second quarter. Sales of IOVAs have risen 94% during the past five years, and now make up about 16% of total variable annuity sales
  - » Sales are expected to continue to increase as more investors seek to protect their portfolios from the impact of higher expected tax rates, and variable annuity issuing insurance companies continue to focus on them as a way to diversify their product lines and risk profiles.
- **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 now five companies offering this product type, which first appeared in 2010.
  - » Sales were approximately $1.2 billion as of the second quarter year-to-date period, trending up about 20% from 2014 mid-year sales (sales are not broken out in the table above as some are registered as VA and some are non-registered and sold as fixed products).
  - » Several companies currently offer these products with lifetime income guarantees.

Volatility Managed 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 such benefits. Nearly all of the top variable annuity living benefit writers require Vol Funds, or other account-value risk mitigation strategies, to be selected as investment options when guaranteed lifetime income benefits are included on variable annuity contracts, and maintained per the terms of the contract as long as the benefits are in force.

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 2015 draws to a close, Vol Funds account for approximately $91.4 billion of variable product net assets, up 7.3% from $85.2 billion at the end of 2014, according to data from Morningstar, Inc. (Assets are estimated based on portfolio names, as volatility management is not yet tracked as an investment category or attribute by Morningstar.)

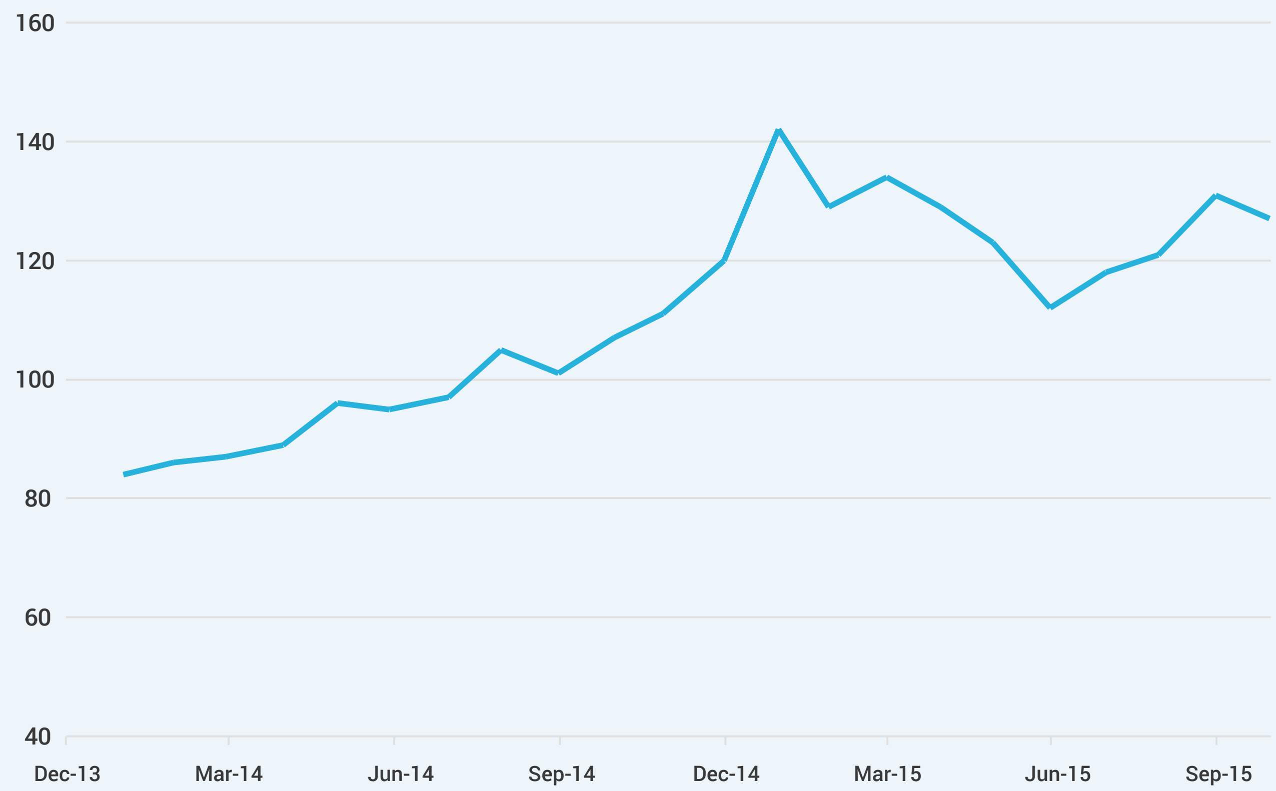
Outcome-Oriented Portfolios

Increasingly variable annuity issuers are positioning portfolio strategies within VAs that are designed to address specific risks. This is especially prevalent with IOVA products, as tax efficiency is a secondary consideration in such strategies. 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 strategies assets passively track 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. Tax efficiency when managing such strategies is a secondary consideration, if it is a consideration at all, so it can be advantageous to leverage the tax efficiency of the IOVA. 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 more than 200 allocation fund share classes created specifically for use within variable product separate accounts since the beginning of 2013 that collectively had more than $34 billion in assets under management as of June 30, 2015, and the majority of these funds offer some variation of outcome-oriented strategy.

Managing In-Force Business

Total net assets in variable annuities reached almost $2 trillion in mid-2015. While precise estimates of the amount covered by lifetime income guarantees is not available, $1 trillion or more is not an unreasonable estimate given the high percentage of overall sales accounted for by VA products offering guaranteed lifetime income benefits. When it comes to managing this in-force business, low interest rates have raised hedging costs, though the cost has subsided slightly in 2015. The Milliman Hedge Cost Index™ (MHCI) provides the estimated hedging cost for a hypothetical Lifetime Guaranteed Withdrawal Benefit block of business. As of October 29, 2015, the expected hedge cost was 129 basis points, down from a high of 142 basis points in January. A complete description of the Milliman methodology can be found at http://www.milliman.com/mhci-methodology/.

Expected Hedge Cost for Hypothetical GLWB



Source: Milliman Hedge Cost Index™

One way companies can manage this risk is through "buying out" the liabilities from current policy owners. Such offers are typically targeted to policy owners whose benefits are "in the money," i.e. the present value of the guaranteed income payments exceeds the current contract value. Typically such offers are incentives to terminate the benefit, such as increasing the account value or offering a lump sum in exchange for dropping the benefit from, or fully surrendering, the contract. Or the carrier might offer an incentive to annuitize the contract, which also terminates the benefit.

When the first buyout offers were made a few years ago they spurred negative headlines and criticism, yet such offers are rational approaches to managing and mitigating risk and may benefit certain policy owners. Buyback offers are strictly optional and clients are under no obligation to accept them, but they may provide much need flexibility to certain individuals, such as in cases when a lifetime income benefit is no longer needed due to changes in personal, financial, or health-related circumstances. In the past year buyout activity has been relatively quiet, with the few buyout programs initiated in 2015 centered on closing out old blocks of business and terminating older living benefit riders.

Mergers, Acquisitions, Business Expansion, and Divestitures

Low interest rates have increased reserve requirements and tightened margins throughout the industry, increasing the importance of business efficiency and economies of scale. At the same time, companies seek opportunities to diversity product lines and maintain a balance of different types of risk, and/or an overweight of the type of risk they are most adept at managing. A simple example is the concept of having a balance of both life insurance (mortality) and annuity (morbidity) risk on the books – if a given insurance company experiences higher or lower mortality in its client base that deviates from that predicted by actuarial tables, it can profit in one type of risk, offsetting losses in the other. In 2015 there were more than 15 mergers and acquisitions in the retirement income industry, including acquisitions of U.S. insurers by Japanese firms, purchases of in-force blocks of business, and consolidation among defined contribution plan providers in an effort to bring down plan costs through economies of scale.

The Rise of Robo-Advice

A robo-advisor is considered to be an online wealth management service that provides automated portfolio management advice, without the client interacting with a financial professional. Some regard robo-advice as a self-service asset allocation tool, but not “advice” in the sense that it does not provide an in-depth evaluation of an individual’s goals, risk tolerance, investment time horizon, general comfort level with investing, and the application of sophisticated retirement income strategies. Consulting firm A.T. Kearney estimates robo-advisor assets under management will increase 68 percent annually over the next five years to reach $2.2 trillion by 2020, with about half that growth coming from assets already invested and half from shifts of non-robo assets. As robo-advisors become more pervasive, financial advisors will need to find ways to differentiate the services they provide from these automated services. And as robo-advice continues to develop other issues will need to be addressed, such as if and how robo-advice is regulated.

Public Policy

Department of Labor Fiduciary Rule

Nearly four years after withdrawing its original fiduciary rule proposal, the Department of Labor (DOL) released a revised proposal in mid-April. The revised proposal would re-characterize virtually all individuals who sell investment products and management services (including recommendations to act or not act) to plan participants (including participants in governmental plans) and IRA holders as investment advice fiduciaries. The implications of that re-characterization are profound. Under ERISA and the tax code, fiduciaries are generally prohibited from receiving compensation in connection with the services they provide to plans, participants and IRA owners unless an exemption is available that allows the payment to be made. While the proposal does include carve-outs to the revised definition and exemptive relief, the proposal is too broad, the carve-outs are too narrow to allow for the use of commission-based compensation structures, and the proposed exemptions are unworkable.

Because the proposal does not provide a clear path for commission-based business, many believe the rule will drive the market to fee-based arrangements that are primarily used for wealthier clients and are not the best fit for many investors. As a result, middle-class savers would be forced into low-service, do-it-yourself accounts – depriving them of meaningful, personalized planning advice. In addition to restricting and limiting retirement savers access to retirement planning advice, these concerns about the viability of commission-based accounts under the proposal will limit consumers' choice regarding lifetime income products, including annuities, within IRAs.

IRI submitted comment letters to the DOL in July and September 2015, and testified twice during a public hearing held by the DOL in mid-August 2015, requesting specific changes to make the rule workable and ensure the rule does not deprive consumers of access to lifetime income options in employer-sponsored retirement plans and IRAs. In addition, IRI met with the DOL and the White House on several occasions between December 2014 and September 2015, and submitted written testimony for two Congressional hearings held in September.

Members of Congress on both sides of the aisle have expressed concern about the proposal. More than 100 Democrats (including 13 Senators) and more than 100 Republicans submitted letters to the DOL, and several hearings on the proposal were held in both chambers of Congress. In addition, Congress is considering several different legislative options to address the proposal.

The Securities and Exchange Commission (SEC) also is reportedly working on a proposal to establish "a uniform fiduciary duty for broker-dealers and investment advisers where the standard is to act in the best interest of the investor." According to the SEC's regulatory agenda for 2016, a proposal is tentatively scheduled to be released for public comment in October 2016.

2016 Outlook

The DOL is expected to issue its final fiduciary rule in early 2016, while Congress will continue to consider legislative alternatives to the proposed rule. After providing extensive comments to the DOL throughout 2015, IRI will closely review the final regulation to assess whether it adequately addresses industry's concerns, and will work with member companies to facilitate efficient implementation of the final rule through standardization and best practices.

Tax Reform

Senate Finance Committee Chairman Orrin Hatch (R-Utah) and Ranking Member Ron Wyden (D-Ore.) formed five bipartisan tax reform working groups and tasked them with preparing tax reform recommendations aimed at laying the groundwork for comprehensive tax reform. The Savings and Investment Working Group specifically identified three key goals for policymakers to pursue that IRI highlighted in its comment letter to the working group: 1) increasing access to tax-deferred retirement savings, 2) increasing participation and levels of savings, and 3) discouraging leakage while promoting lifetime income. There is strong, bipartisan support for these proposals and IRI will continue to work with Congress as the Senate Finance Committee and House Ways and Means Committee move forward with tax legislation.

2016 Outlook

With the presidential election ahead in November, IRI does not expect any movement with respect to tax reform in 2016. However, IRI does anticipate a renewed interest in tax reform after the new administration takes office in January 2017. 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 to support broad-based tax reform. IRI believes Congress should encourage retirement savings for American workers, and will therefore continue to advocate for the preservation of the current tax treatment of annuities and retirement accounts.

Promoting Retirement Security and Increasing Access to Lifetime Income

Legislation to promote retirement savings continued to gain traction in Congress in 2015. In January Senate Special Committee on Aging Chairwoman Susan Collins (R-Maine) and Sen. Bill Nelson (D-Fla.) reintroduced S. 266, the Retirement Security Act, to make it easier for small businesses to provide access to retirement plans for their workers. The bill would encourage small employers to offer retirement plans by allowing them to join multiple employer plans (MEPs) to share the administrative burden of establishing and operating a retirement plan. The bill also seeks to encourage employees to save more for retirement by increasing the cap on employee and employer "matching" contributions. Companion legislation was introduced in the House by Reps. Vern Buchanan (R-Fla.) and Ron Kind (D-Wis.).

Additionally, the Lifetime Income Disclosure Act (S. 1317/H.R. 2317) was jointly reintroduced in both the House and Senate in May. Senators Johnny Isakson (R-Ga.) and Chris Murphy (D-Conn.) sponsored the Senate bill, while the House bill was authored by Representatives Luke Messer (R-Ind.) and Mark Pocan (D-Wis.). This legislation would require employer-sponsored retirement plans to provide participants with an estimate of how much lifetime income can be generated in retirement from a worker's savings. The DOL published an Advance Notice of Proposed Rulemaking in 2013 outlining a draft rule to require the inclusion of lifetime income estimates on participant account statements. In effect, this bill would require the DOL to move forward with this rulemaking.

At the request of senior DOL officials, IRI conducted research in support of this initiative. IRI's research showed 90% of retirement plan participants want their 401(k) statements to include lifetime income estimates and want their employers to provide online retirement income calculators so they can use their own assumptions to estimate how much monthly retirement income their accumulated savings could generate. IRI presented its findings to DOL leadership during a meeting in December 2014.

With respect to the annuity selection safe harbor, the DOL issued guidance in July clarifying that the ongoing monitoring obligations under the safe harbor generally end when the plan no longer offers the annuity as a distribution option, not when the insurer finishes making all promised payments. The DOL has indicated to IRI that it recognizes the challenges for plan sponsors under the current safe harbor, expressed support for the effort to revise the safe harbor to ease those challenges, and committed to working with IRI and the industry to find a workable solution.

2016 Outlook

The DOL is expected to move forward with its lifetime income illustrations proposal and its efforts to revise the annuity selection safe harbor, while the Treasury Department will look to finalize its pending partial annuitization proposal. Both agencies 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.

Variable Annuity Summary Prospectus

Since late 2008, IRI has been advocating for the SEC to adopt a rule allowing for the use of a simplified summary prospectus for variable annuities to improve consumers' understanding of their investment choices through more streamlined disclosures. In support of this effort, IRI developed and provided the SEC with a proof-of-concept sample variable annuity summary prospectus. Consistent with the views expressed by all five SEC commissioners in a series of meetings held in late 2014, the SEC staff continues to strongly support IRI's proposal. This effort has also had the support of former Chairman Mary Schapiro, as well as Director David Grim of the Division of Investment Management and all of his predecessors.

2016 Outlook

The SEC's regulatory agenda published in May 2015 indicated that a proposal to create a summary prospectus for variable annuities is scheduled to be released in April 2016. While this is not binding and is subject to change, IRI maintains that all the work necessary to proceed with the rule proposal has been completed, and is optimistic that the SEC will move forward with a proposal in 2016.

Senior Financial Protection Proposals

In September, the North American Securities Administrators Association (NASAA) released a proposed model law entitled "An Act to Protect Vulnerable Adults from Financial Exploitation" to address issues faced by broker-dealer and investment adviser firms and their employees when confronted with suspected financial exploitation of seniors and other vulnerable adults. Most notably, the model would facilitate reporting to regulators and adult protective services, encourage firms to develop financial advanced directives for execution by clients, permit firms to delay disbursements when financial exploitation is suspected, and provide immunity from administrative and civil liability for taking actions permitted under the model. The act would apply to "adults 60 years or older or those adults that would be subject to the provisions of a state's adult protective services statute."

In October, FINRA proposed rule changes to help broker-dealers protect seniors and other vulnerable customers against financial abuse. The proposal would require firms to make reasonable efforts to obtain the name and contact information for a trusted contact person for seniors and mentally or physically handicapped customers, and would permit firms to place a temporary hold on disbursements of funds or securities when there is reasonable belief of financial exploitation.

2016 Outlook

IRI has submitted comments on both the proposed NASAA model act and the FINRA rule proposal, and IRI expects that both proposals will be finalized in 2016. IRI will continue to work with NASAA, FINRA and other regulatory bodies throughout 2016 to ensure that any new laws or rules provide adequate guidance and protection to enable firms and financial professionals to take appropriate steps to prevent financial exploitation of seniors and other vulnerable investors.

Cybersecurity

The SEC issued a risk alert in September to provide additional information on the areas of focus for the agency's next round of cybersecurity examinations, which will involve more testing to assess implementation of firm procedures and controls. Specifically, the SEC will be focused on ensuring companies have policies to swiftly terminate accessibility of computer accounts when employees leave and changing permissions when employees switch assignments. The SEC identified the installation of software patches to avoid customer information theft as the chief priority in guiding company policies relating to cybersecurity.

In October, the National Association of Insurance Commissioners (NAIC) Cybersecurity Task Force formally adopted its draft Cybersecurity Bill of Rights for insurance consumers. According to the NAIC, the document is intended to help policyholders understand what to expect if their personal information is compromised. The Bill of Rights will be made available for individual state insurance departments to publish for local consumers. IRI submitted a comment letter to the Task Force expressing concern that the document will cause confusion among consumers because cybersecurity laws and rules vary from state to state. IRI also signed on to a joint comment letter with a number of other trade groups expressing similar concerns. Despite these comments, the Task Force voted to adopt the document without making changes to minimize the risk of consumer confusion.

2016 Outlook

IRI expects the NAIC to revisit the Cybersecurity Bill of Rights and consider revisions to ensure it does not lead to consumer confusion. The NAIC will also likely begin working to develop a cybersecurity model law. IRI will work with the industry coalition and members of the NAIC Cybersecurity Task Force to guide these efforts.

National Insurance Producer Licensing Legislation

The National Association of Registered Agents and Brokers Reform Act (NARAB II) was enacted in January. NARAB II creates a national insurance licensing clearinghouse for financial professionals operating in multiple states. The creation of this clearinghouse, known as NARAB, will help increase the availability of lifetime income products by removing a regulatory barrier that is impeding broker-dealers' ability and financial advisors' willingness to distribute these strategies. By making the licensing process more streamlined and compliance with licensing regulations less onerous, NARAB will encourage broker-dealers and advisors operating in multiple states to offer insurance products such as annuities with lifetime income guarantees.

2016 Outlook

Before NARAB can commence operations, President Obama must appoint a 13 member Board, comprised of eight current state insurance commissioners, three representatives of the property/casualty industry and two representatives from the life and health sectors. IRI expects the Board to be appointed in 2016, and to become operational no later than January 2017.

FINRA CARDS Proposal

The Financial Industry Regulatory Authority (FINRA) determined not to move forward with its proposed data collection program (known as "CARDS") due to concerns about the security of the sensitive information that would have been collected.

2016 Outlook

FINRA intends to pursue the regulatory objectives of the CARDS proposal through more targeted examinations of broker-dealer firms.

State-Run Retirement Plan Proposals

Approximately 25 states are considering proposals to establish or study the feasibility of establishing state-sponsored retirement plans for private-sector employees. Uncertainty about the applicability of ERISA is among the most significant hurdles to enactment of these plans. At the direction of President Obama, the DOL has proposed rules and issued guidance to help states set up these programs.

2016 Outlook

Comments on the DOL's proposal are due in late January. The DOL will likely seek to finalize its proposed rules and/or guidance in early 2016, giving states greater certainty as to how these programs will be treated under ERISA. As a result, IRI expects to see an increase in state activity to create state-run retirement plans, particularly during the 2016 legislative sessions, most of which will end between April and June of 2016.

Contingent Deferred Annuities

The National Association of Insurance Commissioners (NAIC) made significant progress in 2015 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 (CDAs). Most notably, IRI and the industry coalition worked closely with the NAIC to develop a 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. The NAIC CDA Working Group finalized this guidance document during the NAIC's Fall 2015 National Meeting. Comments on the DOL's proposal are due in late January.

2016 Outlook

Upon final approval of the guidance document by the NAIC Executive Committee and Plenary at the Spring 2016 National Meeting, the NAIC's work on CDAs will be substantially complete, thereby clearing a path for broader availability of these products to consumers, providing another option for securing lifetime income.

State Annuity Suitability and Disclosure Regulation

In 2015 three states – Georgia, Maine and Tennessee – adopted revisions to their annuity suitability regulations based on the 2010 NAIC Suitability in Annuity Transactions Model Regulation. The current suitability model has now been adopted in 38 states. In its 2015 annual report, the Federal Insurance Office (FIO) urged adoption of the current suitability model in all states, and indicated federal regulatory action could be necessary if the states fail to implement uniform standards.

Maine and West Virginia revised their annuity disclosure regulations based on the 2011 NAIC Annuity Disclosure Model Regulation, and Wisconsin updated its disclosure rules to require use of the 2013 NAIC Annuity Buyer's Guide. The current disclosure model has now been adopted in seven states, and six other states have taken other steps to implement the transition to the 2013 buyer's guide.

2016 Outlook

Several additional states will likely consider adoption of the annuity suitability and disclosure model regulations in 2016. IRI will continue to advocate for uniform adoption, implementation and interpretation of these rules throughout the states.

Market Conduct Reform

In early 2015, the NAIC Market Regulation Accreditation Working Group adopted a set of Objectives, Guiding Principles and Goals for its initiative to develop an accreditation program for market conduct examinations and other market regulation activities. The Working Group also adopted a Proposed Timeline to complete its work, and published a draft accreditation proposal for public comment.

IRI submitted written comments on the draft accreditation proposal, offering specific suggestions to ensure the market regulation accreditation proposal will result in a more effective, efficient and streamlined process that reduces burdens on IRI member companies.

2016 Outlook

The NAIC Working Group will continue its efforts to develop market regulation accreditation standards, including a timeline for implementation of the accreditation program. IRI will continue to work with the NAIC and other industry trade groups on this initiative.

Annuity Sales in 2016

Projecting future annuity sales is a difficult exercise given the various economic, financial, legislative, and regulatory factors that influence the annuity market. Based on current dynamics and indications, IRI forecasts that demand for annuities will remain strong given the following factors: investor desire for guaranteed lifetime income, an aging population, increased longevity, and market volatility. Meanwhile, challenges to overall annuity sales, presented by the continued low interest rate environment, are expected to be eased by rising rates. In IRI's view, if interest rates are permitted to gradually ascend to a level reaching or exceeding 3% in 2016, 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. Even in a continued environment of low interest rates, 2016 should see still 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. In this scenario, the strongest growth areas will likely continue to be fixed indexed products – as an alternative to higher-risk equities and low-return CDs – and deferred income annuities. The wildcard in this forecast will remain the Department of Labor's fiduciary rule, as its final form and subsequent impact on the distribution of lifetime income strategies are not yet known.

Long-Term Outlook

The long-term outlook for the annuity industry is promising. Annuity products are evolving to meet consumer demand as Americans become more aware of their retirement income needs. Research conducted by IRI in 2015 found that only 27% of Boomers are confident their savings will last throughout their retirement years, down from 37% when the study was first conducted in 2011. Despite multiple years of stock market gains, 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. Recent research from BlackRock bears this out. In the third edition of their Global Investor Pulse survey, BlackRock found that 65% of Americans' wealth is held in cash. The opportunity for insurance companies, therefore, remains clear. As the only legal entities that can insure retirement income for a person's lifetime, annuity providers 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 estimated that beginning in 2011, 10,000 Baby Boomers will turn 65 every day for the next 19 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, healthy 65-year-old males in the United States have a 50% chance of living to age 87 and a 25% chance of living to age 93. Their female counterparts have a 50% chance of living to age 89, and a 25% change of living to age 95. For a couple aged 65, there is a 50% chance at least one spouse will live to age 93 and a 25% chance at least one spouse will live to age 97.
- ***Decline of traditional pension plans:*** In 1985, there were 114,000 private-sector defined benefit pension plans, but by 2013 there were only 23,769 of these plans remaining, according to the Pension Benefit Guaranty Corp. The March 2015 Bureau of Labor Statistics' National Compensation Survey reports that only about 19% of private-sector workers have access to a traditional pension.
- ***Large dollar amounts in qualified plans:*** The total assets in qualified retirement plans, as of the end of 2014, were $24.7 trillion, up over 7% from the end of 2013. The following table breaks down this amount by the different types of retirement plans.

Assets in Tax Qualified Retirement Plans Year-End 2014

Private Trusted Defined Benefit Plans	$3.2 trillion
Private Trusted Defined Contribution Plans	$6.8 trillion
Individual Retirement Accounts (IRAs)	$7.4 trillion
State and Local Government Plans	$3.8 trillion
Federal Government Retirement Plans for Federal Employees	$1.4 trillion
Annuities	$2.0 trillion
Total	**$24.7 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, and the Internal Revenue Service Statistics of Income Division.

- ***Concerns about Social Security and other governmental programs:*** The 2015 Social Security Trustees Report projects the combined Old Age and Survivors Insurance and Disability Insurance Trust Fund will be exhausted in 2034. The 2015 Medicare Trustees Report projects the Hospital Insurance Trust Fund (Part A) will be exhausted in 2030.

SUMMARY

As America ages and begins focusing on retirement, and with 10,000 Baby Boomers turning age 65 each day, the demographic case for guaranteed lifetime income has never been stronger. 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. These innovations include new Deferred Income Annuities that meet the QLAC criteria, new launches of Investment-Oriented Variable Annuities, and new product designs in Fixed Indexed Annuities. While variable annuity sales continue to make up the majority of annuity sales, FIA and income annuity products continue to gain steam.

Life insurance companies – via annuities and other guarantees – are the only companies legally allowed to pool risk and offer guaranteed lifetime income. These companies remain financially strong, and head into 2016 well-positioned to weather any potential financial storm. On the public policy front, the DOL's Fiduciary Rule is the most significant and proximate policy shift on the horizon. It also may be, depending on the final form of the rule, the most disruptive to the industry. All eyes across the industry will be watching as a final rule comes forward in 2016. Of macroeconomic factors, interest rates will have the most to bear on the industry going forward. In IRI's view, if interest rates are permitted to gradually ascend to a level reaching or exceeding 3% in 2016, given the wealth controlled by retirees and the demand for guaranteed lifetime retirement income, income-oriented annuity sales should see a significant boost and support industry-wide sales moving forward.

Research Sources

Supporting data for this report were derived from publicly available research from the 2015 Social Security Trustees Report; 2015 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 the Actuaries.

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Insured Retirement Institute
202-469-3000 | 202-469-3030 (fax)
membership@irionline.org | myirionline.org

@irionline
facebook.com/insured.retirement.institute