How Safe are Annuities?

August 14, 2012

by Joe Tomlinson

For many advisors, the possibility that insurance companies will run into financial difficulties makes recommending annuities a nonstarter. But annuities are the best way to mitigate longevity risk, which may pose a greater danger, and advisors can take steps to help protect clients from insurers' financial problems.

Many prominent individuals have raised concerns about insurer-solvency risk. In William Bernstein's recently published e-book, "The Ages of the Investor," for example, he compares bond ladders to annuities and concludes that it's difficult to know which risk is greater: the longevity risk associated with bond ladders or the insurer-solvency risk associated with annuities. Wade Pfau's June 20 blog post mentioned Bernstein's concerns, elaborating with discussion from readers.

I'll identify some steps advisors can take to insulate clients from the possibility than an insurer might fail, but first let's look at the degree of risk in insurance companies and what it means for policy holders.

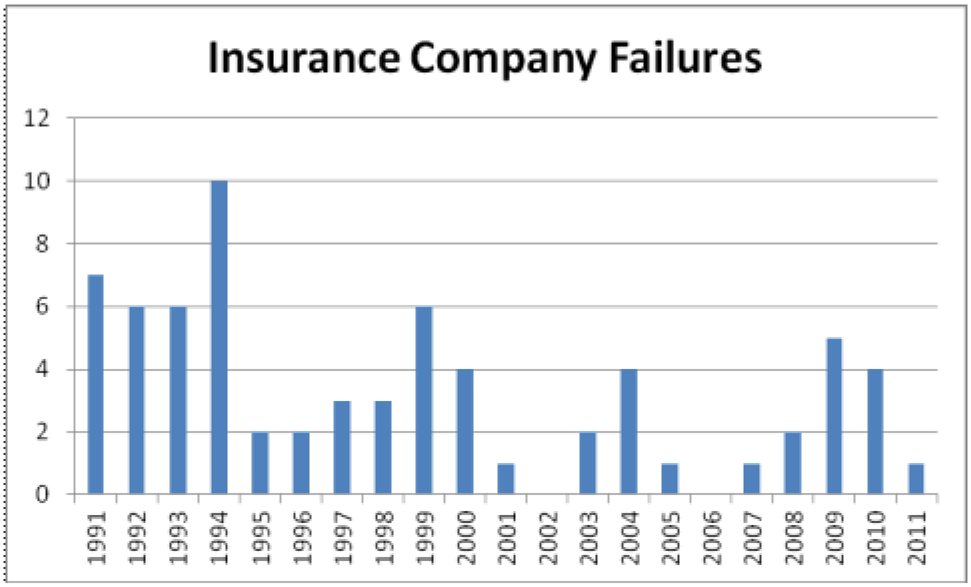
The role of guaranty associations and some history

The insurance industry is regulated by the various states, each of which has a Life and Health Guaranty Association, with annuities falling under the life category. The role of the guaranty associations is to back up the contract guarantees in life, health and annuity policies. For annuities, such guarantees include the payments for single-premium immediate annuity (SPIAs) and deferred-income annuities (DIAs), the minimum interest guarantees in other types of fixed annuities (including fixed-index annuities), and living benefit guaranties in variable annuities. States place caps on the amount they will guarantee and these vary by state, with $250,000 being a common limit applying to the present value of annuity benefits.

Funds to support the policyholders of failed insurers are collected from assessments drawn from all insurers operating in a given state. The National Organization of Life and Health Insurance Guaranty Associations (NOLHGA), the nationwide coordinating body for guaranty associations, provides a wealth of information about its constituent associations.

History shows that annuities have traditionally been an extremely safe investment. Insurance company insolvencies have been few, companies in trouble have often sold business to healthy insurers, and guaranty associations have provided an additional safety net. In my review of the historical record, I could only find a few cases where annuity owners ended up with less than their insurer promised. One resulted from the 1983 bankruptcy of Baldwin-United, which involved a takeover by MetLife and a court-ordered reduction in benefits. Another involved the 1991 failure of Executive Life, which continued to pay annuity benefits in state-managed rehabilitation mode until this year, when balance sheet deterioration led to liquidation. Going forward, owners of Executive Life annuities that exceed state guaranty caps will suffer losses.

The chart below plots the number of insurer failures each year that required NOHLGA to coordinate the rescue of policyholders—typically cases where the failed insurer operated in three or more states.



There were 70 failures in total over this period, and most of them were concentrated between 1991 and 1994, when some insurance companies became too enamored with junk bonds. There was a slight uptick in failures after the 2008 financial crisis, but that spike was hardly alarming given the stresses on the financial system. One company that did not fail, but got lots of publicity, was AIG, which deserves separate discussion.

AIG and the financial crisis

AIG stands out as the poster child for making advisors and the public nervous about insurance companies. This was the AAA-rated company that, almost overnight, found itself in need of a $182 billion bailout from the Federal government. The natural question for prospective annuity investors to ask is, "What would have happened to AIG annuity owners if the Federal government had not stepped in?"

AIG was (and remains) a diversified financial conglomerate, and the huge losses from credit default swaps were concentrated in its financial products division. The insurance subsidiaries of AIG that sold annuities remained reasonably healthy during the crisis. The losses befell a separate legal entity, which means that creditors seeking restitution for credit default swap losses could not have laid claim to insurance subsidiary assets. If AIG had tried to move assets out of the insurance subsidiaries, insurance commissioners in the various states would have blocked such attempts. So while AIG set off huge alarms in the financial system, it was not a crisis for their basic life insurance and annuity business.

Why insurers have done better than banks

Since insurance companies and banks are both major financial institutions, one might ask why the insurance industry as a whole has been much better than banks at weathering financial storms. I discussed this issue with Gavin Magor, who heads up the insurance ratings division for Weiss Ratings, a company that rates both banks and insurance companies.

Magor points out that a key difference is that the insurance industry is better capitalized. This fact was particularly important during the financial crisis. Magor also credits insurance regulators who have overseen capital requirements for insurers.

Based on my own experience as a former insurance company actuary, I would say that the risk-based, balance sheet focus, and actuarial culture of insurance companies makes a difference. It helps that insurance company obligations (i.e., insurance contracts and annuities) tend to be longer-term than bank liabilities (i.e., deposits), and that, for insurers, much of their business is life- and health-contingent and actuarially quantifiable. Banks depend more on investments, the markets for which can be driven by emotion as well as fundamentals.

Insurers certainly do have their financial problems, the most recent arising from the effect of the financial crisis on living benefit guarantees in variable annuities. But, at least so far, the industry has been able to deal with its problems and move on, unlike banking, where problems too often become national emergencies.

What about the future?

Annuity owners have historically fared reasonably well, partly due to the infrequent nature of insurance company failures. The guaranty associations depend on a healthy insurance industry overall having the capacity to rescue policyholders from the small minority of insurers that run into trouble.

But there's always the concern that the future could be different. Perhaps lurking problems could lead to financial calamity for the whole industry, overwhelming the capacity of the guaranty associations to respond. This is the specific concern that Bill Bernstein raised in his book.

I discussed prospects for the industry with Tim Pfeifer, President of Pfeifer Advisory LLC, who has consulted with insurance companies for the past 30 years. He sees persistently low interest rates as the biggest challenge that life and health insurers currently face. He notes that this is not a homogeneous problem in the industry – for each company, it depends on the interest-rate guarantees they have in place on existing business, versus the interest earnings on the supporting assets. Rating agencies are just beginning to focus on individual companies' specifics.

Pfeifer observes that the financial stresses on the industry have caused carriers to drop products and lines of business, and they have spurred M&A activity. He expects that we will see further consolidation in the industry, with the 100 or so good-sized companies today perhaps shrinking to 75 or so. He cites the advantages of scale in the insurance business, particularly as companies develop more complex products. His hope is that companies will respond to financial pressures by addressing some of the fundamental problems that have been with the industry for a long time, such as the misalignment of sales incentives and long-term company profitability. Despite the significant challenges, Pfeifer does not see an industry on the verge of collapse, but instead sees generally well-capitalized companies that will need to respond to the difficult environment but have the capacity to do so.

Magor, of Weiss Ratings, assesses the situation similarly. He notes that 2011 was a terrible profit year for the big life insurers (down 84% from 2010), largely due to insurers' need to strengthen reserves in the face of lower interest rates. His rating agency will be watching 2012 with a great deal of interest. He notes that the industry remains well-capitalized, however, as long as profits improve in the next year or so, and does not see calamity looming ahead.

Advice for advisors

Regardless on one's assessment of insurance industry prospects, there are steps advisors can take to help make safe annuity recommendations. Here are a few of the most important:

1) *Go with the bigger insurance companies* – Small companies have run into problems more frequently than large companies. Advisors should recommend products from large, well-recognized companies that sell products in all or most states and offer well-diversified product lines. The smaller companies do not typically offer better pricing, so there is no benefit for the client from taking a chance with them.

2) *Pay attention to rating* – The large insurance companies are rated by Moody's, S&P, and Fitch, which rate all types of companies; Weiss Ratings, which rates banks and insurance companies; and A.M. Best, which rates only insurers. Some rating agencies certainly had issues related to not anticipating the financial crisis, but I believe they have learned from that experience. Look at a number of different ratings and underlying rationales, rather than trying to pick a favorite rating agency.

3) *Be aware of insurer flexibility to adjust payments or charges* – There are some products like SPIAs and DIAs where payouts are fixed at the time of purchase, and other types of fixed annuities where the insurer can adjust credited rates, subject to a minimum guarantee. If an insurer experiences financial problems, it will likely reduce credited rates to the minimum levels, so advisors need to be aware of how much flexibility insurers have. This flexibility can also be a consideration regarding the caps on charges in variable annuity contracts.

4) *Understand guaranty association rules and limits* – For most annuity owners, their state of residence determines which state has jurisdiction, so advisors who recommend annuities should be aware of the rules that apply to states where their clients reside, or might reside in the future (e.g., if they plan to retire to Florida). The individual state provisions can be found on the NOLHGA website. The National Association of Insurance Commissioners (NIAC) model law provides the basis for state laws, so there is a lot of similarity among the states.

However, there are important differences. Most states now cap annuity benefits at $250,000, but for some states the cap is as high as $500,000. Some states apply the caps on a per-policy basis, while others set caps per individual. Advisors should note such distinctions in determining whether to recommend annuities from multiple insurers or whether to recommend that husbands and wives own separate annuities. While it is important that advisors understand how guaranty associations can protect their clients, they also need to be mindful of what might seem like an odd provision in state laws—a prohibition on using the state guarantees to promote or sell business. This prohibition puts advisors in an unavoidably awkward position—they need to understand the rules, but cannot use the existence of the guarantees to sell products. It is worth carefully reading the language in state law.

Conclusion

One cannot forecast with certainty the financial health of the insurance industry 20 or 30 years from now. But I do not see any indications that the future for the insurance industry augurs serious problems for annuity owners. Unfortunately, there are no retirement decisions that are free from risk. Weighing the various risks, I remain comfortable recommending annuities.

Joe Tomlinson is an actuary and a financial planner and is managing director of Tomlinson Financial Planning, LLC in Greenville, Maine. His practice focuses on retirement planning. He also does research and writing on financial planning and investment topics. He wishes to thank Gavin Magor and Tim Pfeifer for helpful insights.