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MDRT Minute

Financial Risk Management in Today's Variable Annuity Market

Financial risk management in the variable annuity industry has evolved considerably over the last two decades for a number of reasons, but perhaps most significantly because of the rapid pace of variable annuity product innovation. How does an advisor begin evaluating the risk management capabilities of a variable annuity provider?

Overall strategy

Traditional. Risk is managed primarily through hedging programs and by maintaining sufficient capital. Variable annuity providers pursuing this strategy are attempting to achieve two objectives. First, they are attempting to reduce financial risk by offering simpler products with reduced guarantees. Second, they are using simpler and lower cost products to appeal to clients who have generally not considered variable annuities because of concerns about fees or the perceived complexity of variable annuities. The adoption of this strategy by some variable annuity providers has accelerated after the financial crisis.

Product-based. Variable annuity providers pursuing this strategy offer products with strong guarantees, a high degree of client flexibility, industry average pricing and a product-based risk management feature. One risk management feature is a "self-governing" mechanism that helps reduce risk in response to external market conditions. Examples are: a) a guarantee whose benefit growth rate is tied to an index such as Treasury rates; b) the use of a predetermined mathematical formula to transfer clients' assets between equity and fixed-income investments based on the impact of market fluctuations on clients' account values; c) the linkage of variable annuity rider fees to an external index, such as the Chicago Board Options Exchange Volatility Index (VIX). Similar to the traditional strategy, companies using the product-based risk management strategy also made product changes, such as reducing guarantees or increasing fees, after the financial crisis.

Product design

Product design plays a central role because it impacts both the types and the levels of risk that a provider bears. At the same time, product design determines how attractive a product is to advisors and clients. "Less risky" products enable providers to absorb significant asset flows into their products while maintaining financial risk at manageable levels. Also, less risky products reduce a variable annuity provider's dependence on outside risk mitigation practices, such as hedging programs and capital. Finally, a product that balances risk management and benefits to clients will be more attractive in the marketplace.

Risk management

Risk budgeting is the process of matching one's "risk revenues" (fees) with the risk management costs associated with the risks transferred. A risk budget can help guide product development efforts as to how much risk a provider is able and willing to absorb. The level of the budget is impacted by a number of factors, such as capital availability and a provider's overall risk tolerance. This budget consists of three risk buckets:

1. Longevity risk (also called mortality risk) — the risk of people living too long
2. Client behavior risk — risks related to how clients utilize variable annuity product features
3. Market risk — includes equity, interest rate and credit risks

Today, greater attention is being paid to how an insurance company manages its variable annuity risks. As a result, advisors must now incorporate risk management considerations into the already complex variable annuity selection process that they undertake on behalf of their clients. Understanding the major building blocks of financial risk management within the VA industry will help you feel more confident in the variable annuity products you offer to clients interested in guaranteeing a portion of their retirement income

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