Indexed Annuities' New Pals

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Private-equity firms are raising their profile in the indexed-annuity market, worrying some observers who fear that they are taking greater risks in increasing market share.

Apollo Global Management LLC is reportedly in the lead to snap up Aviva PLC's U.S. life insurance and annuity business, participating in a joint bid with Guggenheim Partners LLC. If the firms succeed in acquiring the unit — which earned $1.05 billion in indexed-annuity sales in the third quarter, down 22.86% year over year, according to AnnuitySpecs — they will own the second-largest indexed-annuity seller in the industry.

Neither Apollo nor Guggenheim would comment.

It is a growing trend: private-equity firms' plowing money into indexed-annuity businesses that are becoming a greater burden for insurers as low interest rates continue. Apollo already backs Athene Annuity and Life Assurance Co. Guggenheim owns Security Benefit Life Insurance Co. and EquiTrust Life Insurance Co., and is reinsuring annuities from Standard Life Co. of Indiana.

Harbinger Group Inc. also jumped into indexed annuities last year with the purchase of Fidelity & Guaranty Life Insurance Co.

CONCERNS EXPRESSED

Not everyone is thrilled with private-equity firms' expansion in indexed annuities. Some agents and others fret that the firms are expanding their market share too quickly, while others have reservations about the way they invest amid low interest rates in order to offer attractive product features.

“I'm afraid the private-equity firms are buying market share and that perhaps some of these product designs won't withstand the test of time,” said Russell Smith, an insurance agent and owner of Torimax Financial Group Inc.

“What worries me most are the promises made on income riders — when one rider promises something that's well over the market,” said W. Andrew Unkefer, president and chief executive of Unkefer & Associates Inc., a third-party independent marketing organization.

Few products are immune to extended low interest rates. Indexed annuities credit gains that are linked to the growth of an index, but clients don't fully capture that growth, as insurers place limits on customers' participation in the index and can cap the return.

Insurers' generosity on participation rates and caps largely depends on the strength of the insurers' own fixed-income investments. Low interest rates have led some companies to change their pricing — as was the case for Aviva — and to lower caps to contend with the reduced profitability of insurers' portfolios.

Nevertheless, indexed annuities have sold well this year through the third quarter, rising 6% year-over-year to $25.4 billion, according to LIMRA. Sales hit $8.7 billion in the third quarter alone, largely because of strong sales among the newcomers, it reported.

Those players have some of the most attractive benefits. For instance, EquiTrust has an Income for Life rider that expands clients' benefit base by 6.5% for up to 15 years. Its sibling company, Security Benefit, offers an income rider that "stacks" a guaranteed 4 percentage points on top of the credited interest rate. That way, if clients are credited, say, 3.5% from gains in the related index, they get that plus 4 percentage points added to the benefit base.

Agents are starting to question how companies can provide such robust benefits.

"The investment guys think they can get a better yield than anyone else, but you can easily fall off that pedestal," Mr. Unkefer said.

LOWER-RATED BONDS

Analysts at ratings agencies said private-equity firms are relying on their investment expertise to get the gains needed to offer those living benefits. At times, that requires them to go with lower-rated bonds.

"Hedge funds have reduced the quality of their investments; they are at BBB and BBB+, relying more on corporates and mortgage-backed securities," said Raj Shah, assistant vice president at A.M. Best Co. Inc. A BBB rating is still investment-grade.

Jim Belardi, chief executive and chief investment officer at Apollo-backed Athene, however, said that the firm has kept a portfolio of investment-grade corporate bonds, seeking high-quality issues and ensuring that the duration of the assets matches that of the liability.

"It's not the case for our firm," he said of the idea that private-equity-backed insurers invest in riskier assets. "Most of our portfolios are of the highest quality on a [National Association of Insurance Commissioners] basis, and that's for bonds, structured securities and anything that's rated." Bonds held at an insurer and rated NAIC 1 are the equivalent of a AAA-, AA- or A-rated issue.

"We're light on allocation toward risky investments," said John O'Shaughnessy, chief actuary and chief risk officer at Fidelity & Guaranty Life. "Under Harbinger, we began with a concentrated derisking of our credit positions."

"But the general sentiment in the market is that private-equity guys are credit guys — and that would lead you to believe that those who are strong in risk will take more of that risk."

Insurers owned by private-equity firms have made other adjustments to ensure profitability of their indexed-annuity blocks. The minimum guaranteed rate of interest applied to an indexed annuity used to be around 3% but has been hovering around 1% lately, according to Mr. Shah. These insurers are targeting spreads of about 250 basis points, he said.

Further, while these private-equity-owned carriers aren't going into assets that are totally alien to most insurers, they may have larger holdings of riskier investments in order to squeeze out yield.

“They may be taking a little more structured paper than the general-insurance writers take, and they have heavier allocations toward [residential-mortgage-backed securities],” said Bill Pargeans, assistant vice president at A.M. Best. “But they feel the investment managers have an expertise in that area, so the insurers are willing to take that into account.”

Having larger holdings in securities backed by residential mortgages doesn't necessarily bode well for companies. State regulators at the National Association of Insurance Commissioners last month agreed to require carriers to back those bond investments with more capital in the event of a downturn similar to that of 2008.

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