



Variable Annuities

Tigran Kalberer, Kannoo Ravindran

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Variable Annuities provides an overview of all the relevant aspects of variable annuity (VA) products from an insurers perspective. It is a collection of contributions from several authors, co-ordinated in such a way that it covers all relevant areas with minimal overlap and a consistent level of detail. The market is of huge interest for US, European and Japanese insurers.

For several hundred years, the insurance industry has offered a tremendous variety of life insurance products. Some of these life insurance products are aimed at providing investment possibilities, such as with-profits endowments and annuity products. These products typically provide substantial investment guarantees, which is one of their main advantages, along with tax privileges and the fact that the assets are managed prudently.

The success of these products can be traced back to the fact that together with the distribution model, directly approaching potential customers, these products are ideal for the clients that are either less sophisticated in planning for their retirement, or do not want to invest efforts in this planning or have avoided to address this topic at all.

But there are some clear disadvantages, which may not be relevant to all, but to some customers and the forces of competition lead companies to develop new products, which addressed these disadvantages, which are:

- The opaqueness of the investment process
- The lack of customer-control over the investment process
- The not sufficient profit sharing of returns above the investment guarantee – and the opaqueness of this profit sharing mechanism

Over time it has become apparent that there is an additional disadvantage from a company perspective, which is the substantial required risk capital these products generate due to the guarantees they provide.

All these problems can be addressed with so-called unit linked products – at the expense of not providing investment guarantees any more.

Unit-linked products invest the savings part of the premiums of the policyholder transparently in investment vehicles, mostly internal or external funds and let the policyholder participate fully in the investment returns of these funds – the upside as well as the downside.

While these products clearly address the issues mentioned above they typically do not provide any investment guarantees any more.

The obvious step now is to build investment guarantees into unit-linked products – this is what Variable Annuities provide.

Variable Annuities combine the advantages of traditional life insurance products – long term investment guarantees, with the advantages of unit-linked products – transparency of the investment and full upside participation.

This of course comes with a price:

- The policyholder has to pay a premium for the additional investment guarantee
- The shareholder has to manage the substantial risks generated by such products

Nevertheless these products have had a tremendous success in the US and in the past few years we have seen these products being offered in the European markets. These products are new to Europe, except in some locations, where they have been widespread, e.g., Switzerland, and have generated a lot of interest as they can address the weaknesses of the traditional life products.

New sales volumes are encouraging and we can witness the creation of a new product class, after the unit-linked products have entered the European market some decennia ago.

The book covers:

- * History of the VA market
- * Current VA market environment in North America, Europe, Australasia
- * Valuation of VA contracts
- * Risks and Risk Management of VAs
- * An analyst and rating agency's view of a VA writer
- * Insurance regulations governing VAs
- * Liquidity in global derivatives markets
- * Effectiveness of hedging programs during the market turmoil

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