Wharton

Financial Institutions Center

Life Insurance Firms in the Retirement Market: Is the News All Bad?

by
Paul Hoffman
Anthony M. Santomero

98-04

The Wharton School
University of Pennsylvania

THE WHARTON FINANCIAL INSTITUTIONS CENTER

The Wharton Financial Institutions Center provides a multi-disciplinary research approach to the problems and opportunities facing the financial services industry in its search for competitive excellence. The Center's research focuses on the issues related to managing risk at the firm level as well as ways to improve productivity and performance.

The Center fosters the development of a community of faculty, visiting scholars and Ph.D. candidates whose research interests complement and support the mission of the Center. The Center works closely with industry executives and practitioners to ensure that its research is informed by the operating realities and competitive demands facing industry participants as they pursue competitive excellence.

Copies of the working papers summarized here are available from the Center. If you would like to learn more about the Center or become a member of our research community, please let us know of your interest.

Anthony M. Santomero
Director

The Working Paper Series is made possible by a generous grant from the Alfred P. Sloan Foundation

Life Insurance Firms in the Retirement Market: [1]
Is the News All Bad?

January 1998

The role of the insurance industry in the retirement assets market is examined. The popular image of the industry as one in decline is scrutinized by drawing upon various governmental and industry data sources.

Our examination begins with the traditional area of corporate pensions, specifically, Defined Benefit and Defined Contribution Plans. It is demonstrated that this segment has remained relatively flat as proportion of wealth, but has declined in relation to the retirement market as a whole. This slow relative change masks a dramatic shift away from Defined Benefit Plans to Defined Contribution Plans. The primary driver of this change is the rapid growth of 401(k) plans.

The shift from large corporate plans to individual retirement planning is most strongly demonstrated by the increase of IRA assets, such that they now comprise nearly a quarter share of the market. This trend is surprising in light of the fact that contributions have been low since a tightening of the tax code in 1986.

More germane to our examination is the annuities market. With 55 million contracts in force, and total assets of $1.2 trillion, the insurance industry's domination of this area would seem to speak well of their present and future prospects. Indeed, annuities have grown as a percentage of wealth, but within the retirement sector, they have been outpaced by other instruments. This fact should be worrisome to insurance companies, as they have grown increasingly dependent upon annuities as a proportion of premium income.

In summary, the picture for insurance companies is not as dire as the press has portrayed. But, comfort should not be taken in this fact. Individual retirement planning is driving the rapid growth of retirement assets. Annuities are, by and large, insurance companies' sole entry in this competition and, as of late, their record has not been exemplary. The low loads associated with mutual funds and their flexibility set a difficult paradigm for insurance companies to emulate. But, a lack of a successful effort will relegate insurance companies to the role of bit players in the retirement market.

---

[1] Paul Hoffman and Anthony M. Santomero are at the Financial Institutions Center of the Wharton School, University of Pennsylvania.

I. The Popular Image: The Dying Insurance Dragon

The popular view of the role of insurance companies in the private retirement market is that of a dominant player that is rapidly fading in prominence. Mutual funds are rightfully perceived as having attracted both the general investor, as well as those planning for retirement. Banks are also seen as a threat, though to a much lesser degree. Bank entry into the insurance market is much feared but thus far, greatly exaggerated. While clearly a new competitor, the bank threat is merely one more piece of bad news, one more combatant in the war for retirement assets.

In this paper we take a more objective look at the place of insurance companies and their products in the retirement asset market. We survey the literature and available data on the products that make up this growing segment of the financial landscape. Our goal is to both understand the trends and identify opportunities.

The results are not all disheartening. The industry is clearly a central part of the burgeoning retirement asset market, with a major share of the assets accumulated so far. Its position over the last several years has been exaggerated and/or misrepresented by snippets of data that have led to an incomplete picture of the retirement asset market and the insurance industry's role within it.

Specifically, a broad overview of the private retirement asset market suggests that:

1) The market itself is growing rapidly, as "baby-boomers" appear to be saving more rapidly than the preceding generation.
2) The retirement products used by this new generation have shifted substantially over the past decade, such that
    a) pension assets are not growing as quickly as other forms of retirement assets;

b) defined benefit plans are declining both as a percentage of wealth, and as a percentage of retirement assets;

c) corporate pensions are declining in favor of individual retirement assets;

d) annuities, offered by insurance firms, have grown in importance relative to wealth and remained stable as a percentage of retirement assets.

3) The observed growth in mutual fund market share has been primarily at the expense of depository institutions, most notably in IRA and 401(k) assets.

This market overview suggests some clear requirements for the future growth and profitability of insurance firms in the retirement market. The challenges are:

1) to maintain dominance of the annuity market;

2) to recognize that the defined benefit and defined contribution pension categories are aged markets, subject to relative, if not absolute, decline;

3) to compete effectively in the 401(k) and IRA segments of the retirement arena.

Make no mistake about it, however, the retirement market as a whole is growing and as such is an extraordinarily attractive segment of the financial market. By yearend 1996, private retirement assets were nearly $5.1 trillion[1]. Retirement assets have increased their proportion of wealth from 10.6% in 1983 to 13.6% at yearend 1996, see Figure 1. It is therefore possible, given the scenario of an increasing market, for an industry segment to lose market share and yet increase sales and profits. Since 1990, this has been the case for insurance firms. Prior to this date, even their market share was increasing. Subsequently, however, their share has dramatically shifted as consumers changed the asset categories selected.

Life insurance companies were never able to achieve a significant market share in the fastest growing retirement asset markets, such as 401(k)s and IRAs. This lost share can and should be viewed as a lost opportunity. Offsetting this loss is their annuity market dominance. It has been projected, based upon historical trends and economic forecasts, that the market for individual annuities is expected to increase annually at an 8% rate[2]. Therefore, it is wise to take some of the dire predictions with a grain of salt.

Many firms track the retirement asset market. The data supplied by these data services and consultants are often the source for predictions of a collapse of the insurance industry's share of the market. In the past, headlines such as, "Insurers Lose Ground to Competitors in IRA Market," or "Insurers Losing the Retirement Asset Battle," or, to take a specific example, "Insurers Lose 401(k) Market Share to Mutual Funds[3]," have been commonplace. This last article was based upon data reporting that the insurance company's share of the 401(k) market slipped from 34% to 30% in the two-year period from 1992 to 1994. Mutual funds were declared victorious because they were able to increase their share to 37% from 26%.

Industry pundits do make some important points. For example, well known publications such as Best's Review[4] cite fundamental weaknesses that impair insurance companies from competing effectively in the retirement asset market. Life insurance products have been contrasted with those offered by mutual funds and are frequently found wanting. Some of the citations are well worth repeating.

Most insurance companies offer a limited selection of investment choices. If mutual funds are offered, insurers at times exhibit excessively conservative management behavior, not unlike the pattern exhibited with their general funds. This has lead to relatively poor investment results, or, at least, significantly less appreciation than averages achieved elsewhere during the recent stock market boom. Returns from insurance products are often further diminished by front or back-end fees, or deferred sales charges that are generally higher than competitors. In aggregate, these factors predispose poor performance, and will lead the public to move to other, better performing institutions.

The traditional stronghold of life insurers, the annuity market, is not immune to gloomy reports and projections. In thriving areas such as variable annuities, direct insurance company sales are slipping. The Variable Annuity Research and Data Service[5] reports that direct sales of variable annuities decreased to 43% in 1995 and are projected to further decline to 30% by the year 2000. Banks are identified as the primary culprit in this sales decline. But, this market is the insurance industry's to lose, they can do so through passivity, or they can fight to keep the second largest segment of the market.

Through all of these assessments, we ask that the reader keep one caveat in mind, data in the retirement market can be misleading and at times extremely opaque. Some segments of the financial sector do not clearly report assets held for retirement in such vehicles as 401(k) or IRA accounts. Others do not indicate the purpose for which purchases are earmarked. For example, annuity figures are most certainly higher than we and others report. Many annuities do not qualify for tax advantaged status, therefore, are not reported as being retirement assets. A further example is contained in the Pension and Welfare Benefits Administration's report on defined benefit and defined contribution plans; a total of $128.5 billion is reported as being held in insurance company general accounts. A significant portion of this is most certainly earmarked for annuities.[6]

Nonetheless, extrapolating from available data, with all its pitfalls, the bottom line is that the insurance industry's portion of the retirement asset market is huge. Life insurance company assets and reserves of annuities alone have increased from $172.0 billion in 1980 to $1.315 trillion in 1996[7] (these totals include non tax advantaged annuities as is the practice of the Federal Reserve). These figures represented 2.06% of 1980 wealth and 3.52% of 1996 wealth respectively. Disregarding other institutions, these figures reveal a relatively healthy insurance industry sector.

II. The Contest: The Retirement Asset Market

Any discussion of the competitive position of insurers in the retirement asset market must, of necessity, begin with an understanding of the market itself, and its trends. The retirement asset market consists of multi-year assets established to facilitate the accumulation of wealth in anticipation of decumulation upon retirement. Such assets are usually tax advantaged, with the tax liability of either, or both, principal and interest deferred until withdrawal. Because of this feature, the category itself is imprecise, as some may attempt to save for retirement beyond tax advantaged products, while others may use the products' tax advantaged status for multi-year non-retirement savings. It is for this reason that the numbers produced by different reporting entities are often at odds, and data problems represent a substantial challenge to any useful analysis of the market.

At its heart, however, the retirement asset market involves multi-year horizon investment plans by whole generations of households. For these individuals, saving for an event that will occur on the distant horizon requires discipline and foresight. Both attributes have been examined in the popular and academic spheres. It is commonly thought that the quantity of saving for retirement by the current U.S. population is inadequate to ensure acceptable living standards at retirement. An OECD comparison with savings rates in Canada, France, and Great Britain revealed that the U.S. has the lowest savings rate and the highest percentage of its population entering the retirement portion of their life cycle.[8] While giving us a relative picture, this ranking begs the question of what is adequate, and whether U.S. retirement asset accumulation is adequate in light of this generation's expectations and its existing government social programs.

A major hindrance to past research has been the lack of adequate data. The situation has improved with the advent of the Health and Retirement Survey (HRS). Beginning with Smith (1995)[9], evidence from this data series has begun to shift the view about wealth adequacy, and offers evidence that wealth is being accumulated at a faster pace than has been commonly thought. Mitchell and Moore's (1997)[10] work adds further evidence to the earlier study by the Congressional Budget Office (1993)[11] that used cohort data in demonstrating that baby boomers are saving at a faster rate than their parents did.

This is hopeful for the retirement asset market, but one should remember that in all studies there is the problem of defining and measuring wealth. We have chosen to rely on a relatively simple definition using only standard financial assets, including equity, debt, cash, and short-term instruments. Some, including Gustman et al (1997)[12], have a much more extensive definition of individual wealth, which includes such items as housing equity and retirement wealth inclusive of social security and deducting outstanding debt. Gustman et al (1997) find that households on the verge of retirement have average total assets of $499,187 and median total assets of $339,725. These numbers are $163,087 and $59,335 respectively, using our definition. The difference in the mean and median statistics in both these measures reflects the upward skew imparted by the holdings of the wealthy.

Determining whether or not these resources are adequate for acceptable post-retirement living standards is a difficult task and is investigated using many different methods. However, in every case, the problem is compounded by the differing percentage in post-retirement income needs demonstrated by different income levels[13]. The poor definitely need a higher fraction of pre-retirement earnings, known here as the replacement rate. Generally, whatever examination tool is used, the conclusion reached is that the current level of aggregate saving is inadequate for a clear majority of the general public. In addition, future changes to the social security system which put the onus on individual responsibility, will deepen the need for increased saving.[14]

There is an extensive literature on governmental measures to remedy this situation and their efficacy in stimulating saving.[15] Despite a great deal of contention, the general view is that tax advantaged programs can induce greater saving, but not nearly at the proportions desired. Samwick and Skinner (1996)[16] suggest that retirement accounts which are rolled over should require that a minimum percentage be maintained. This would decrease retirement asset slippage and may in fact be more effective than new tax advantaged vehicles, though aggregate saving would not substantially increase.

The above notwithstanding, the new evidence on accelerating savings accumulation is hopeful. This is true from a public policy point of view, as it reduces concern for the numerous aging baby boomers, and implies substantial growth for those portions of the financial sector offering retirement asset products. While evidence suggests that not all financial products have experienced proportional growth, this broad category of financial assets has been flourishing, and is likely to continue to do so.

III. The Products: Instruments of the Retirement Market

Not long ago, a listing of retirement assets would have been quite short. Pensions offered by large firms made up the bulk of non government retirement assets, with most individuals using standard depository institution deposits or retail mutual funds as additional assets earmarked for retirement. However, the last half century has seen the development of a number of tax advantaged, retirement specific asset categories which now make up the bulk of retirement savings. To begin the discussion of the relative share of these asset categories we will first review them.

A. Defined Benefit Plans

Defined benefit plans are provided by employers to their employees and promise to pay a specified benefit upon vesting and subsequent retirement. Benefit payments generally continue until the death of one or more of the covered persons, and as such, these plans are a standard insurance product. To finance the liability, employer contributions are determined actuarially. Funding by the employer is tax deductible, as long as it is a qualified plan according to IRS regulations. Once enacted, employer funding is inflexible, that is, proper levels must be maintained and the employees have certain legal rights to coverage. Employer contributions are pooled and can vary over time depending upon the investment performance of the pooled assets. However, regardless of investment performance, the employer is legally liable for benefit payouts. The firm therefore is the full bearer of risk.

From the point of view of the individual worker, this type of plan eases the difficulty of retirement planning. Benefits are easily and accurately determined. However, for the employer, the combination of the actuarial mortality risk, the vagaries of financial performance and high administration costs have made these programs increasingly burdensome. These factors have figured prominently in the movement toward defined contribution plans.

Under the defined benefit label, there are a number of different benefit plans with varying methods of payout. A worker may accrue units- which are tied to his or her compensation- or fixed dollar amounts. Other types of benefits may be tied to career average salary, or some variation, and/or linked to years of service. Payouts are generally in the form of an annuity.

B. Defined Contribution Plans

Defined contribution plans are employer sponsored plans that do not promise a fixed benefit, but rather have benefits related to contributions and asset performance. There are a wide variety of plans of this type, however, if contributions are within specified limits, they are considered tax-sheltered and are therefore deductible by both employee and employer. Generally, these plans are structured so that the firm contributes a certain sum or salary percentage per covered worker, and has no additional rights or responsibilities associated with these dedicated assets. Contributions tend to be related to salary but do not ordinarily recognize past service.

Employers favor defined contribution plans because they are not generally liable for asset performance and administration is less costly and complex. However, these are some of the precise reasons why employees may find these plans less attractive than their defined benefit counterparts. Determining expected asset levels at retirement is complex, and administration time and cost is non-trivial to the employee.

With defined contribution plans, employees can determine, indeed they are responsible for, asset selection, risk-return trade-offs and their own retirement planning. On a positive note, the compounding of interest and/or dividends can lead to large sums at retirement, but generally require long accumulation periods. However, poor asset performance can lead to inadequate retirement funds, a fact that may be lost on this generation that has never seen a bear market.

The types of defined contribution plans are quite varied and a dedicated pensions text should be consulted for full and detailed information[17]. A sampling of the form that defined contribution plans can take include the following:

-*Profit-Sharing Plans* whereby the employer payments are tied to corporate profits (within limits).In such cases, there must be a definite allocation plan and payouts are tied to account balances.
-*Employee Stock Purchase Plans* where shares of the employer are purchased, often with the employer matching a portion of the purchase price. In many cases, other equities may be purchased but at least 50% must be in employer stock.
-*Thrift Plans* in which the employee contributes a fixed percentage of their salary. There may be some degree of employer matching. The employee is often offered a choice as to how funds are invested. Funds are segregated into separate accounts and interest and dividends are reinvested.
-*401(k) Plans* in which payments are tied to firm profits. This is the newest and fastest growing portion of this category. But, in reality, it is a variation of profit-sharing plans. Contributions are considered to be salary reductions and may be matched by the employer. Assets accumulate tax free until withdrawal.
-*403(b) Plans* are the counterpart of 401(k) plans for nonprofit organizations.

While not properly described as a profit sharing plan, salary reduction and employer contributions mirror their private sector counterparts. In fact, for data purposes, these are often aggregated into the private sector 401(k) totals.

C. Individual Retirement Accounts

Beyond employer sponsored retirement plans, individuals have access to tax favored investment through individual retirement accounts, known as IRAs. Once extremely popular, they have fallen out of favor with a tightening of the tax code in 1986. Contributions are deducted from earned income and can be up to $2,000 (or total compensation, whichever is lower) for individuals and $4,000 for married couples.

However, if the employee participates in another qualified plan, the limit declines to zero in the $25,000 to $35,000 income band. Beyond this income level, contributions are no longer tax deductible[18]. An employer may contribute funds but these are considered to be compensation and taxed as standard earned income in the year in which it is paid. However, tax on all interest and dividends is deferred until withdrawal.

Funds are transferable to other providers of IRA services, but withdrawals are restricted. Assets can be invested in a wide range of investment choices including fixed-term savings accounts, certificates of deposit, annuities, mutual funds, and self-directed brokerage accounts to name a few possibilities. As is the case with all defined contribution programs, however, the benefits of these investment decisions accrue to the program recipient, for better or worse.

Recently, IRA accounts have also been used for at least two other purposes. The first of these is a lump sum transfer from a defined contribution plan, associated with early termination or an early withdrawal from the tax-sheltered plan. In such cases the employee may establish an IRA with the transferred assets and maintain their tax status.

The second area that has seen recent growth is the use of simplified employee pension plans or SEPs. This program is aimed at small employers with less than 25 employees (there has been discussion about increasing this number). Administrative paperwork is kept to a minimum by the adoption of one of two model plan documents. Contributions are essentially salary reductions and are tax deductible by both employee and employer. This retirement class has been termed “super IRAs” because of their much higher limits. The employer may contribute 15% of annual compensation or $30,000, whichever is less. The employee may contribute up to $7,000 annually. SEP creation requires a SEP-linked IRA account into which funds are transferred in standard defined contribution fashion. The point here is that the IRA market has experienced some of its growth because of its ability to participate in the rapid expansion of the defined contribution market discussed above.

D. Annuities

We single out this investment type because of the sheer size of its investment market, as we shall see below. Generally speaking, an annuity can be many things. Annuities can be both a method of payout, and an investment vehicle in itself. Annuities may begin paying benefits immediately, or payments can be deferred to some future date as, for example, expected retirement. Annuities may be purchased by a single lump sum payment, or through a series of payments over a number of years.

There are also different types of annuities depending upon contract terms over the accumulation phase. In some cases, the annuity declares a return each period based upon market performance. In other cases, the return is specified for a pre-determined period of months or years. Guaranteed Investment Contracts (GICs) offer a guaranteed interest rate for a specified period. With a multiple guarantee contract, multiple payments are made, each with its own interest rate. This market is large, but has been waning in recent years.

Recently, there has been a growing popularity of variable annuities. In these products, accretion of funds may be tied to an index, such as insurance company general fund returns, the Consumer Price Index or some other index. It may also be directly related to the performance of the segregated assets invested on behalf of the annuity. The holder is often given latitude as to how funds are invested and granted permission to transfer funds to other portions of the financial market.

The variation in the types of annuities makes it difficult to talk about the market in simple terms. However, its flexibility is one of its major benefits. Annuity contracts can be structured for pre or post tax dollars, fixed or variable terms, and fixed or variable returns. In all cases, however, these contracts include tax advantages for interest and dividends, and actuarial risk of some type. The latter has developed into both an attribute and Achilles' heel, as we shall discuss below.

IV. Recent Trends: The Dynamics of the Product Markets

The retirement asset market, as of late, has experienced rapid change. On an aggregate level, retirement assets have been growing more rapidly than either overall economic activity, or aggregate financial wealth. However, the real story is the changing shares within the market. To see this, we begin by reviewing the dynamics of individual product markets, and then move to institutional market shares. Given the nature of the data available, the breakdowns may be somewhat different, but always are the most descriptive available.

A. Pension Assets

As noted above, the term “pension” was at one time synonymous with a corporate pension plan which was provided solely by a worker's employer. This category was divided between defined benefit (DB) plans, where contributions are variable and the benefits are fixed, and defined contribution, (DC) plans, where contributions are fixed and benefits variable. It is on the defined contribution side where the picture can be a little opaque. In many cases the employee is able to contribute with the corporation matching these contributions to some degree. This employee aspect has become increasingly important in recent years. Therefore, it has become difficult to divide the retirement market strictly into employer and employee sectors. We will proceed with this in mind.

Over the period from 1980 to 1993[19] the combined assets of both DB and DC plans grew from $563.6 billion to $2.3 trillion; see Figure 2. Insurance company totals - which are usually reported separately - increase the total to $3.1 trillion. With inflation and wealth increasing over this period, these figures do not convey much more than that the retirement market has grown precipitously. The combined market benchmarked against total wealth has fluctuated in the 10.62% to 13.62% range over the period 1983 to 1996. The general trend has been upward with the single exception of the period 1985 to 1988.

However, the decidedly upward drift conceals a dynamic shift in the makeup of this sector. As Figure 3 illustrates, the market has demonstrated a strong shift away from defined benefit plans toward defined contribution plans. In 1980, defined benefit assets were 2.5 times that of defined contribution assets. By 1993, the last date available, defined benefit assets were only 1.17 times that of defined contribution plans. The trends indicate that the two plans are likely nearly at parity at the present time.

The rise of individual saving for retirement, through such vehicles as 401(k) accounts, further alters the analysis. Gross defined contribution figures include 401(k) balances in the totals. If one deducts 401(k) assets, we arrive at the data reported in Figure 4. This reveals that the percentage of wealth represented by other defined contribution plans has declined slightly over the period. More importantly, it is apparent that the total employer-related portion of the retirement assets market is declining. Defined benefit programs have been declining precipitously from 5.41% to 4.41% of total wealth over the reported decade, as DC plans have drifted only slightly lower.

Evidence offered elsewhere by Papke (1996)[20] illustrates that DC programs have substantially replaced DB plans within the corporate pension fund market over this period. This is true even while their total is declining as a percentage of wealth. This result is hidden by the dramatic increase in 401(k) assets, but is evident in Figure 4. To investigate more thoroughly, let us examine this market more closely.

B. 401(k) Accounts

Legislative action lead to the creation of 401(k) accounts in 1978. However, this retirement program did not become popular as a savings vehicle until its operation was clearly defined by the Treasury Department in 1981. At that time, the requirements of the market were set forth. As noted above, the availability of 401(k) accounts is dependent upon employer sponsorship, but it is essentially an individual’s account. Because the employer may match a portion of the employee’s contribution, 401(k)s are listed as defined contribution plans. However, the employee's choice of contribution level, and how funds are invested, has led many to consider 401(k)s as being individual accounts.

Contributions to 401(k) accounts began at modest levels in comparison to both DB plans and IRAs. Contributions in 1984 were $16.29 billion, but nearly doubled in the next two years. However, unlike IRAs discussed below, 401(k)s were not materially affected by the Tax Reform Act of 1986. Therefore, contributions continued to increase each year over the last decade. Annual contributions in 1993 were $69.3 billion, well beyond the peak levels of IRA contributions as reported in Figure 5.

Total 401(k) assets continue to rise both absolutely and relatively. The period from 1984 to 1993 saw total assets increase from $91.8 billion to $616.3 billion. These gross dollar amounts correspond to 0.74 % and 2.18 % of total wealth respectively. While the current value of outstanding 401(k) assets is lower than its IRA counterpart, this can be attributed to a smaller time frame for contributions; see Figure 6.

C. Individual Retirement Accounts

Many view individual retirement accounts as beginning with the Tax Act of 1981. However, IRA contributions were $1.4 billion as early as 1975. But, with the Tax Act of 1981, IRA saving became tax advantaged, thereby becoming particularly attractive. At this point contributions rose from $4.8 billion in 1981 to $28.3 billion in 1982. Contributions increased rapidly until their peak of $38.2 billion in 1985. Subsequently, the Tax Reform Act of 1986 changed the code once again, this time to the IRA's disadvantage. Savers responded by reducing contributions to levels only slightly higher than were seen prior to 1981. Figure 5 illustrates the sensitivity of IRA annual contributions to the tax code changes. Notice how annual contributions declined immediately following the legislation.

The importance of individual retirement accounts is perhaps better seen by looking at total assets. In 1983, total IRA assets were $91.3 billion. By yearend 1996, total assets had swelled to $1.35 trillion. To put these figures into perspective we have normalized them by wealth in Figure 6. The 1984 figure represents 1.06% and the 1993 total represents 3.07% of wealth. So, despite flat contributions since 1987, total assets have dramatically increased. To be sure, much of the growth is a result of the gains in the equity market over this period, but nevertheless a large and vibrant asset pool is demonstrated.

The combination of large outstanding balances, transfers from other retirement asset accounts, and the rise of SEP programs (which comprised 5% of 1995 IRA assets invested in mutual funds[21]) make this an attractive market. As such, competition for the $1.3 trillion aggregate total is fierce. Within this category, rollovers and small business SEP programs are a more important active battleground than are new IRA accounts. However, the lack of data does not permit a detailed analysis.

D. The Annuities Market

Group annuities come in many shapes and sizes, but are usually purchased by employers on behalf of their employees. Group and individual annuities can be components of either defined benefit or defined contribution plans. Variable annuities differ in that their funds are usually invested in equity. They are sometimes classified as defined contribution, and can also be either group or individual.

But, by any measure, the annuity market has grown increasingly active in recent years. Sales of group and individual annuities (including taxable) were $19.45 and $15.20 billion respectively in 1982. By 1996, these figures had risen to $92.23 and $84.07 billion respectively. However, these figures disguise the fact that group annuity contributions have traditionally been greater than those of individual annuities. In 1986, they were more than double. The differential peaked during the period 1986-1990; see Figure 7.

On the other hand, contributions to individual annuities have risen steadily through 1995. By 1994, individual annuity contributions had overtaken group contributions, with a slight backing off in 1995 and 1996. A similar pattern of growth is shown in Figure 8, where annuity premiums are scaled by total wealth. Growth is obvious, with the largest relative gains over the last decade accruing to the individual annuity market.

Shifting from premium income to numbers of contracts, Figures 9 and 10 show the growth in the number of people holding fixed and variable annuities. Noticing the differential scale, it is obvious that the fixed annuity market still dominates, but the recent dramatic growth of both individual and group annuities is startling. In fact, recently reported data suggests that there are over 47 million annuity contracts in force.[22]

Turning to assets held in connection with the annuities in force, Figure 11 reports on assets and reserves of annuity contracts and shows a similar dynamic. 1980 assets and reserves were $140.42 billion and $31.54 billion for group and individual annuities respectively, while the 1996 totals were $657.06 billion and $658.35 billion (these totals include non tax advantaged annuities). Normalized as a percentage of wealth, the 1980 figures were 1.68% and 0.38% respectively. These figures have risen steadily to 1.76% in 1996. Group annuity assets and reserves peaked in 1990 at 2.32%. On the other hand, individual annuities have steadily increased to their current levels at yearend 1996 (the data from 1996 isn't directly comparable to previous years due an accounting change).

As Figure 10 illustrates, the growth in the market has been particularly spectacular in the variable annuity sector. Several factors account for this recent growth:

1) the relative decline in defined benefit plans;
2) the increased interest by the more affluent and educated baby boomer cohort,
3) the increased acceptance of equity investment for asset accumulation.

This latter point may be particularly relevant. Returns on variable annuities devoted to equity investment tend to be higher than traditional annuities because of their similarity (in spirit, if not in fact) to equity mutual funds. While the rate of inflow of funds to mutual funds has been quite rapid for over a decade, the rise in variable annuities has been even more so. Contributions have increased fourfold since 1991, rising from $17.3 billion in 1991 to $73.8 billion in 1996.

The shift to variable annuities is further demonstrated by viewing their increased share of annual premium income. In 1983 only 9.85% of premiums were for variable annuities, by 1996 the share had risen to 31.54%. While this total is still substantially below the fixed annuity counterpart, see Figure 12, the relative growth is noteworthy.

V. Market Shares: The Changing Fortunes in Retirement Products

With the changing nature of the retirement market, it is obvious that the product mix is dramatically changing. Defined benefit plans are giving way to defined contribution plans, 401(k)s, IRAs and annuities. The battlefield of future competition is going to be in these four product areas, as the defined benefit market is aged and in decline. This has several implications for the astute observer.

First, institutions that have a large part of the defined benefit market will inevitably lose their relative position in the broader retirement asset market. This means that insurance firms and bank trust departments that have traditionally been strong in this market will find it virtually impossible to maintain their relative position.

Second, the changing product mix implies that the future growth of these firms will depend upon their ability to garner market share in the four growth areas enumerated above. Further, with the move toward individual pension planning, the real contest will center around the control of the retail market. In short, the future depends upon maintaining, acquiring and/or growing assets in the IRA, 401(k), and annuity product areas. Let's look at recent trends in each of these areas.

A. Individual Retirement Accounts

During the period from 1984 to 1993, IRA assets have risen impressively from 9.93% to 23.41% of total pension assets (Figure 13). As was mentioned previously, this is in spite of the fact that direct contributions have fallen considerably since their peak in 1985. The increase in total assets can be attributed to appreciation in asset value, lump sum rollovers, and the expanded use of IRA accounts in the nascent SEP market.

The four main institutional players in the IRA market are: depository institutions (commercial banks, thrifts, and credit unions), investment brokerage firms, mutual fund complexes, and insurance companies. Figure 14 demonstrates the dramatic changes in relative share experienced by these institutions in the last eleven years. Mutual funds and brokerages have made sizable inroads into depository institutions' share. Depository institutional share has declined from 61% in 1985 to 18.4% in 1996. Mutual funds and brokerages have picked up 43.2% of this drop; mutual funds increasing from 15.8% to 37.9% and brokerages from 14.7% to 35.8%. Part of this change is explained by the appreciation of equities. At the same time insurance companies have exhibited a pronounced decline from a 10.4% market share in 1990 to 7.8% in 1996.

With contributions at a low point, competition for lump sum rollovers will likely heat up in coming years. The Employee Benefit Research Institute looked at the IRA contributions market during the period from 1987 to 1990[23]. During this period, for every newly initiated rollover account, contributions continued in 3.85 existing accounts. The pattern is reversed if we look at dollar amounts. A typical rollover account has an annual contribution which is 3.21 times that of a regular account. Of course this figure is statistically misleading since it incorporates the large initial amount which is rolled over. Both the number of accounts and the dollar amounts were moving in favor of rollover accounts during this period. The ratio of existing accounts to rollover accounts decreased from 4.92:1 in 1987 to 3:1 in 1990. The dollar ratio of rollovers to regular contributions increased from $ 1.99:1 to $ 4.58:1. IRA rollovers which are invested in the mutual fund market show a similar trend. The share of rollover assets increased from 27.39% to 34.17% of total IRA assets over the period extending from 1992 to 1994[24].

As noted above, IRA contribution rates are sensitive to changes in the tax code. At present, the majority of fee income is derived from management of the existing huge asset pool. Changes in relative institutional share will likely be dependent upon making inroads into the rollover market, and the new SEP-IRA and Roth IRA markets. However, the data suggest that depositories are clearly losing share to mutual fund complexes and brokerage firms. Insurance firms can only gain market share here by being more aggressive in the rollover competition. This implies a need to be more responsive to the desires of retail customers to participate in equity ownership, as fixed rate asset choices seem to be losing market share to equity participation across the board.

B. 401(K) Accounts

This segment of the retirement market is currently slightly over 70% of the size of IRA balances. As of yearend 1993, the most recent date available, total assets were $616.3 billion. With the downturn in IRA contributions, 401(k) accounts have rapidly taken up the slack. As noted above, annual contributions have risen uninterrupted from 1984 to 1993. Unlike IRAs, both contributions and asset levels have increased rapidly. This has lead to an increasing share of the total assets of the pension market. In 1984, 401(k) accounts represented only 6.91% of total retirement assets. By 1993, their share had risen to 16.63%. This is revealed in Figure 13 using Department of Labor figures.

Data on the institutional makeup of the 401(k) market is sparse. The mutual fund industry is the only industry that regularly reports its market share. During the period from 1986 to 1995, mutual funds have seen their 401(k) share rise from 8.39% to 38.67%. See Figure 15. The rapid growth in the 401(k) market provides opportunities for both new accounts and maintenance of outstanding accounts for all segments of the financial sector. As with IRAs, rollovers are another avenue by which to make market inroads. However, success of the insurance industry depends upon its ability to offer products which permit equity participation, and offer a wide range of investment options. Depository institutions have been losing market share here because they have not offered their customers a wide range of choices. The insurance industry cannot afford to make the same mistake.

C. Annuities

Annuities represent the second largest segment of the retirement market. In the last year in which aggregate totals are available, 1993, annuities held 19.81% of the market (IRAs were first with 23.41% and 401(k)s followed with 16.63%), see Figure 13. As would be expected, insurance companies are dominant in this area. Their share of the distribution market for annuities in 1993 was 75.91%. In raw dollar amounts, annuity reserves totaled $1.041 trillion, of which insurance companies classified $733.93 billion as being retirement targeted. It must be kept in mind that these figures understate retirement annuity totals. Many individuals make purchases of annuities which do not qualify for tax deferred status. Nonetheless, Figure 16 reveals that tax deferred insurance company annuities' share of total retirement assets have declined over the current decade. Their market share has slipped from 20.38% in 1983 to 16.61% in 1996, having peaked in 1990 at 22.56%. The picture is somewhat better if we follow the Federal Reserve's practice of including non tax advantaged annuities. Insurance annuities would then start with a market share of 24.17% in 1983, rise to 30.26% in 1990, and decline to 25.89% in 1996. Using these totals, annuities displace IRAs as the largest retirement asset instrument.

Annuities are sold through many avenues in addition to direct sales by insurance companies. Banks are a new and increasingly important distribution channel. An ominous note for insurance companies is that their share of initial sales fees may be declining. Their share of revenue in the increasingly popular area of variable annuities was 55% in 1994 and decreased to 43% in 1995. It is projected by some to drop to 30 % by the year 2000[25]. This trend could be compounded by the announced intention of banks to create and market their own annuities, as opposed to merely selling those of insurance companies.[26]

VI. Looking Ahead: The Future of the Insurance Industry

At $5.1 trillion in assets and reserves, the private retirement market is massive. It is growing both absolutely and relatively. Millions of workers are dependent upon it for their livelihood. Millions more are dependent upon it for their future.

Much has been written about insurance companies' slipping competitiveness in the retirement asset market. While not as severe as portrayed in the popular press, their share has been decreasing. Overall, from 1983 to 1996 insurance company share slipped from 22.74% to 18.03%; see Figure 17. This long term trend has accelerated in the last six years with a decline of 8.35% from their peak in 1990. Insurance companies should be troubled by the recent greater than one percent decline per year.

In their traditional stronghold of annuities, insurers remain preeminent. The numbers of annuity holders, reported in Figure 18, demonstrates this. Many investment firms and banks have proclaimed their intention to challenge the insurance industry in this area, but have yet to do so with much visible success. Of greater relevance is the industry's own need to maintain effectiveness and cost efficiency in its delivery systems to remain competitive. In areas such as variable annuities, they are under increasing attack by mutual fund houses that wish to gain market share at the expense of an insurance industry that, at times, fails to take advantage of its market leadership.

The similarity of variable annuities to mutual funds has been a major reason for their success. But herein may lie the problem. Variable annuities tend to have higher fees than traditional mutual funds.[27] As we know, part of these fees go to options such as life insurance attachments and principal protection. But, as with load mutual funds, these fees will hurt long-term performance. Performance may be further affected by low risk portfolio choices. As consumers become more savvy, these inhibitors may nullify the value of insurance attachments and variable annuities may subsequently lose their luster.

In fact, the success of insurance annuities is somewhat problematic. Annuity premium income has eclipsed traditional sources of income such as life and health insurance; see Figure 19. We have seen a fundamental shift to a dependence on the retirement market. It is for this reason that insurance companies should be particularly wary of encroachment upon their annuity share.

As far as the industry's potential in other areas, the picture is decidedly mixed. They have slipped from their IRA market share peak in 1990 of 10.8% to 7.8% at yearend 1996. However, at the same time, IRA assets' proportion of insurance company pension assets has increased from 3.34% in 1983 to 12.04% in 1996; see Figure 20. Therefore, despite losing market share, IRAs have become increasingly important to insurance companies' earnings and asset growth. They cannot afford to passively lose this market to the mutual fund industry, as depositories have done. They must compete with a wider array of products and at a competitive fee structure. Otherwise, their share will follow that of banks and thrifts in the last decade.

Finally, the explosion in the 401(k) market should be a signal to all players in the retirement market that complacency can lead to missed opportunity. This area, as with that of IRAs, is marked by rapid account turnover. The rollover market is many times larger than that of account initiation.[28] Perhaps this is the method whereby insurance companies can win back market share from mutual funds. It is a market clearly too big to ignore, and a key competitive opportunity. It remains to be seen if it is up to the challenge.

Overall, insurance companies have slipped in their share of the retirement assets market over the last decade. Their niche and strength is annuities. This segment is growing in absolute terms but is losing share relative to 401(k)s, IRAs and the retirement market in general. Insurance companies should be wary of inroads here associated with delivery system weaknesses or excessive fees. At the same time, they must look for opportunities for expansion in the IRA and 401(k) markets. Opportunity may come via traditional routes, such as the rollover market, or by creative avenues, such as product innovation. If they are unsuccessful or choose to ignore these areas, insurance companies risk becoming bit players in the retirement market. They are not likely to show a disastrous loss in market share akin to that experienced by depository institutions in the IRA market, but attention should be directed to shoring up their annuity strength and diversifying to guard against the inefficacy of these measures. They should ask themselves a fundamental question; Do they want to link their survival solely to the annuities market?

---

[1]American Council of Life Insurance, Life Insurance Fact Book (Various Years), Board of Governors of the Federal Reserve System**-** Flow of Funds Accounts 1997Q4, and the Investment Company Institute, 1997 Mutual Fund Fact Book.

[2] Joseph A. Gareis, "The Outlook for Individual Annuities," *Broker World*, February 1996.

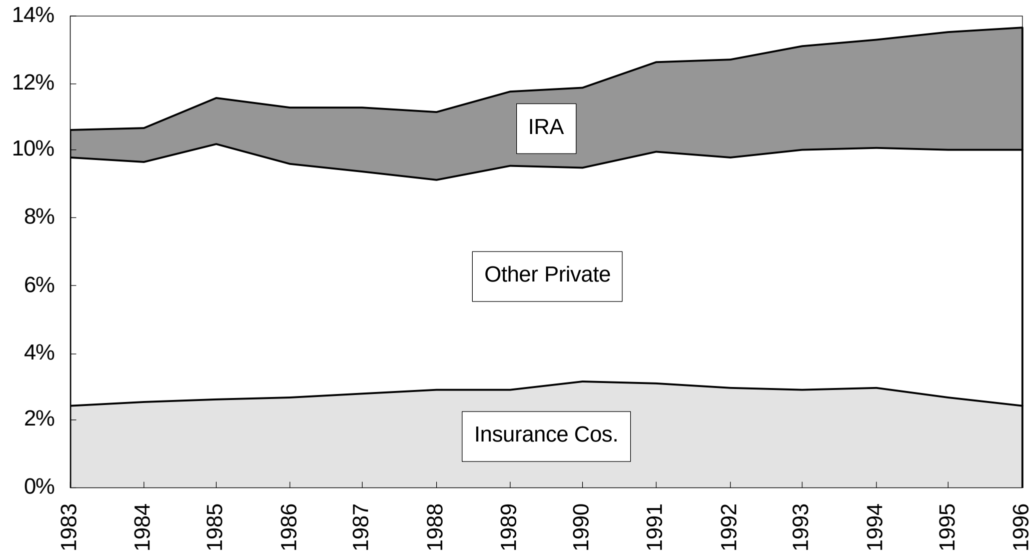
[3] Amy S. Friedman, "Insurers Lose 401(k) Market Share to Mutual Funds," *National Underwriter-Life/Health/Financial Services Edition*, November 20, 1995.

[4]Stephen J. Butler, "Can Insurers Survive the 401(k) Shakeout?," *Best's Review**-** Life/Health Insurance Edition*, October , 1995.

[5] *Wall Street Journal, The*, "Variable Annuities May Be Mixed Blessing for Insurers," March 4, 1997.
[6] U.S. Department of Labor- Pension and Welfare Benefits Administration, Private Pension Plan Bulletin-Abstract of 1993 Form 5500 Annual Reports.
[7] American Council of Life Insurance, Life Insurance Fact Book (Various Years).
[8] Skinner, Jonathan, "Individual Retirement Accounts: A Review of the Evidence," Working Paper No. 3938, *National Bureau of Economic Research*, December, 1991.
[9] Smith, James, "Racial and Ethnic Differences in Wealth in the Health and Retirement Study," *Journal of Human Resources 30*, Supplement 1995, p. S158-S183.
[10] Mitchell, Olivia S., James F. Moore, "Retirement Wealth Accumulation and Decumulation: New Developments and Outstanding Opportunities," Working Paper 97-12, Financial Institutions Center, The Wharton School.
[11] Congressional Budget Office, Baby Boomers in Retirement: An Early Perspective, U.S. Government Printing Office, 1993.
[12] Gustman, Alan S., Olivia S. Mitchell, Andrew Samwick, Thomas Steinmeier, "Pension and Social Security Wealth in the Health and Retirement Survey," Working Paper, *National Bureau of Economic Research*, February, 1997.
[13] Venti, Steven F., David A. Wise, "The Wealth of Cohorts: Retirement Saving and the Changing Assets of Older Americans," Working Paper No. 5609, *National Bureau of Economic Research*, June, 1996.
[14] How to deal with inflation without social security's COLAs is examined in Bodie, Zvi, "Pensions As Retirement Income," Working Paper No. 2917, *National Bureau of Economic Research*, April, 1989.
[15] See Gale, William G., John Karl Scholz, "IRAs and Household Saving," *The American Economic Review*, December, 1994; Poterba, James M., David A. Wise, "Individual Financial Decisions In Retirement Saving Plans and the Provision of Resources For Retirement," Working Paper No. 5762, *National Bureau of Economic Research*, September, 1996, for an excellent overview.
[16] Samwick, Andrew A., Jonathan Skinner, "Abandoning the Nest Egg? 401(k) Plans and Inadequate Pension Saving," Working Paper No. 5568, *National Bureau of Economic Research*, May, 1996.
[17] See for example, McGill, Dan M., Kyle N. Brown, John J. Haley, Sylvester J. Schieber, Fundamentals of Private Pensions, 7th Edition, 1996, University of Pennsylvania Press or Dearborn, R & R Newkirk (Publishers), Pensions and Profit Sharing, 6th Edition, 1994.
[18] The income bands for deductible IRAs are to be raised in 1997. In addition, a new IRA Plus account will be created.
[19] These figures are calculated by the Department of Labor from Form 5500 filings with the IRS. The process has not been automated and is therefore subject to a lengthy delay of approximately three years.
[20] Papke, Leslie E., "Are 401(k) plans Replacing Other Employer-Provided Pensions? Evidence From Panel Data," Working Paper No. 5736, *National Bureau of Economic Research*, August, 1996.
[21] Investment Company Institute, 1997 Mutual Fund Fact Book.
[22] American Council of Life Insurance, 1997 Life Insurance Fact Book.
[23] Employee Benefit Research Institute, EBRI Databook on Employee Benefits, 3rd Edition, 1995.
[24] *National Underwriter, Life and Health/Financial Services Edition*, "Retirement Assets Invested In Mutual Funds- Summary Table," January 29, 1996. Source: Investment Company Institute.
[25] *Wall Street Journal, The*, "Variable Annuities May Be Mixed Blessing for Insurers," March 4, 1997.
[26] For a discussion of the banking industry in the insurance market, see Santomero, Anthony M., "Banking and Insurance: A Banking Industry Perspective," Financial Management of Life Insurance Companies, J. David Cummins and Joan Lamm-Tennant, editors, Kluwer Academic Publishers, 1993.
[27] *Wall Street Journal, The*, "Variable Annuities May Be Mixed Blessing for Insurers," March 4, 1997.
[28] Employee Benefit Research Institute, EBRI Databook on Employee Benefits, 3rd Edition, 1995.

Figure 1

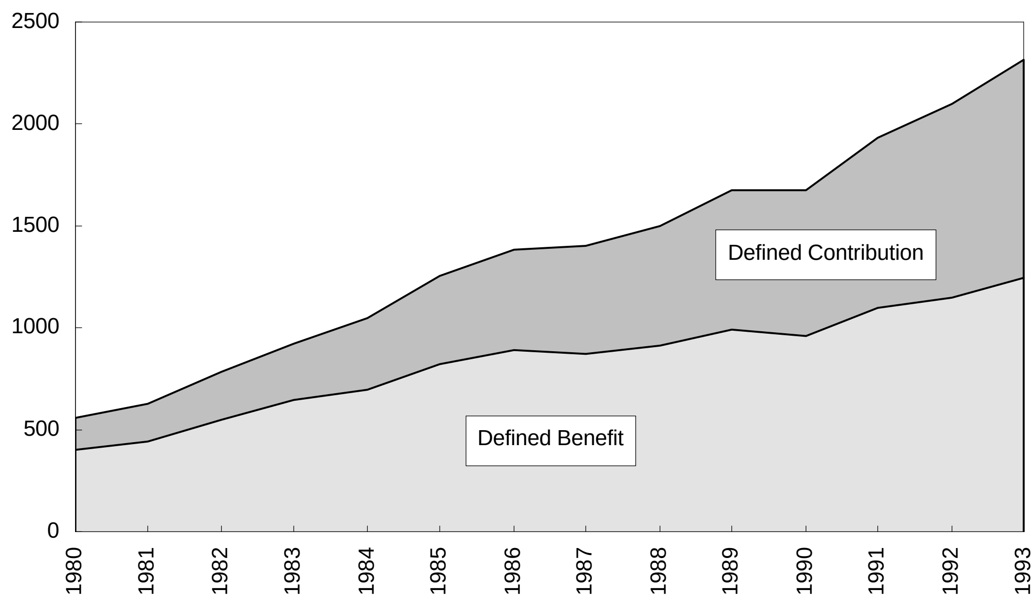
Retirement Asset Reserves
(% of Total Wealth)



American Council of Life Insurance- 1997 Life Insurance Fact Book
Board of Governors of the Federal Reserve System- Flow of Funds Accounts 1997-4Q
Investment Company Institute- Mutual Fund Fact Book (Various Years)

Figure 2

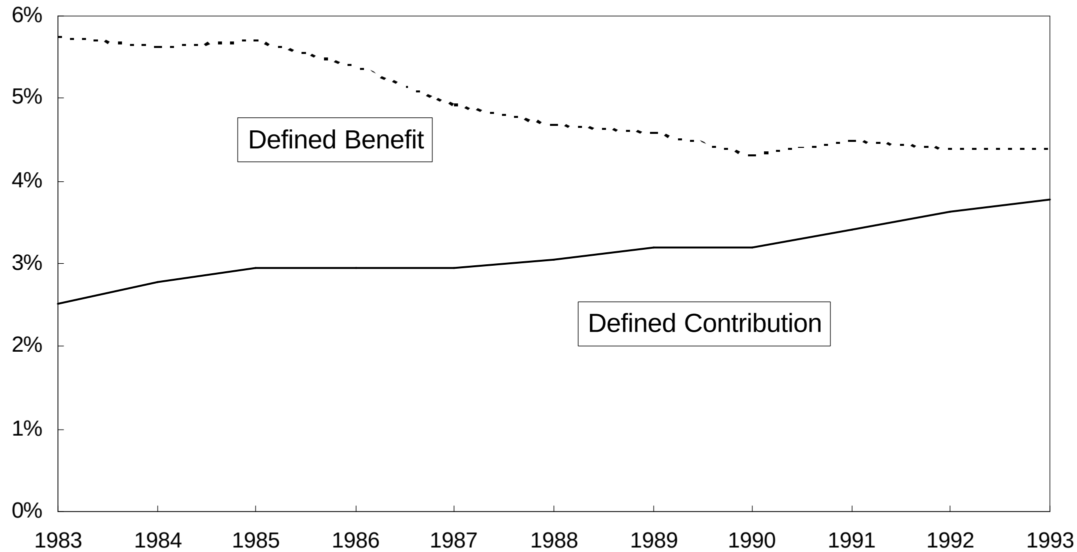
Assets of Private Pension Plans (Excluding Ins. Cos.)
($ Billions)



U.S. Department of Labor-Pension and Welfare Benefits Administration, Abstract of 1993 Form 5500 Annual Reports

Figure 3

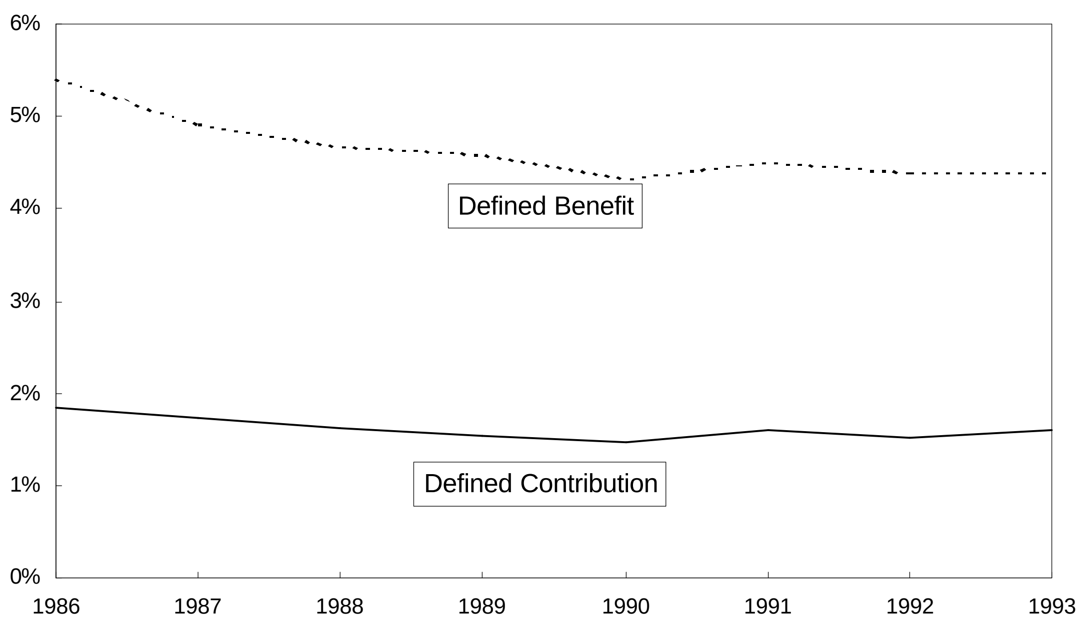
Defined Benefit and Defined Contribution Assets as a Percentage of Wealth



U.S. Department of Labor- Pension and Welfare Benefits Administration

Figure 4

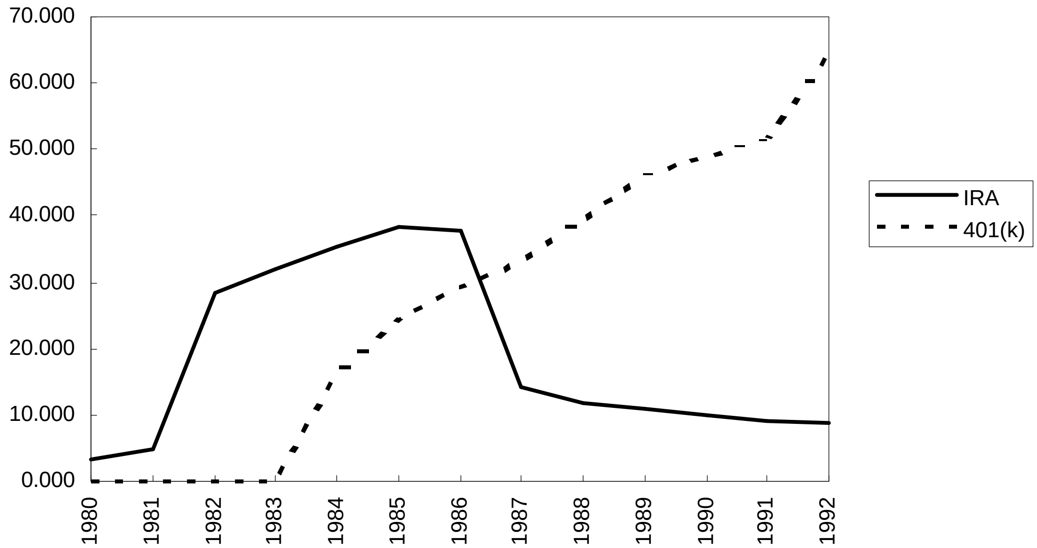
Modified Defined Benefit and Defined Contribution Assets (% of Total Wealth)



U.S. Department of Labor- Pension and Welfare Benefits Administration

Figure 5

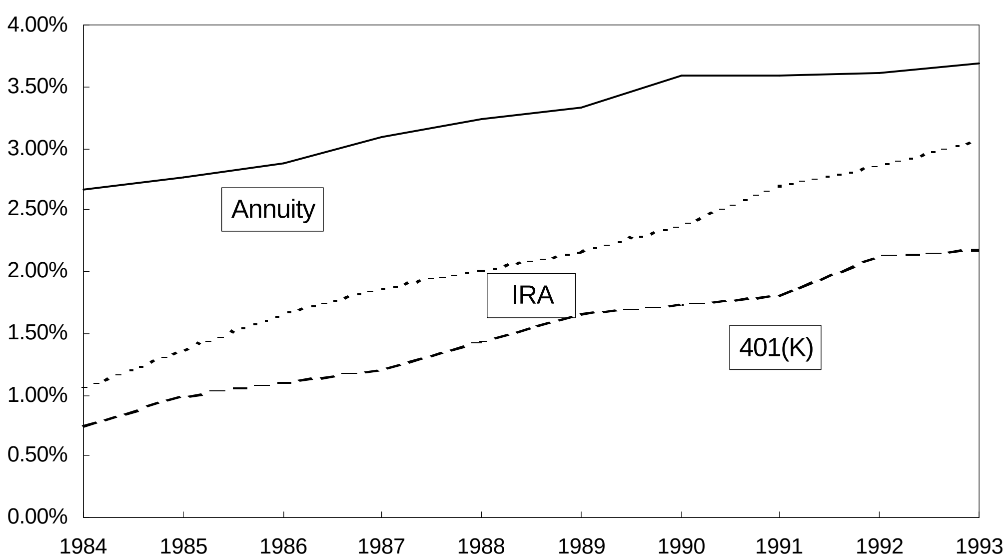
Annual 401(k) and IRA Contributions ($ Billions)



U.S. Department of Labor- Pension and Welfare Benefits Administration
Employee Benefit Research Institute- EBRI Databook on Employee Benefits

Figure 6

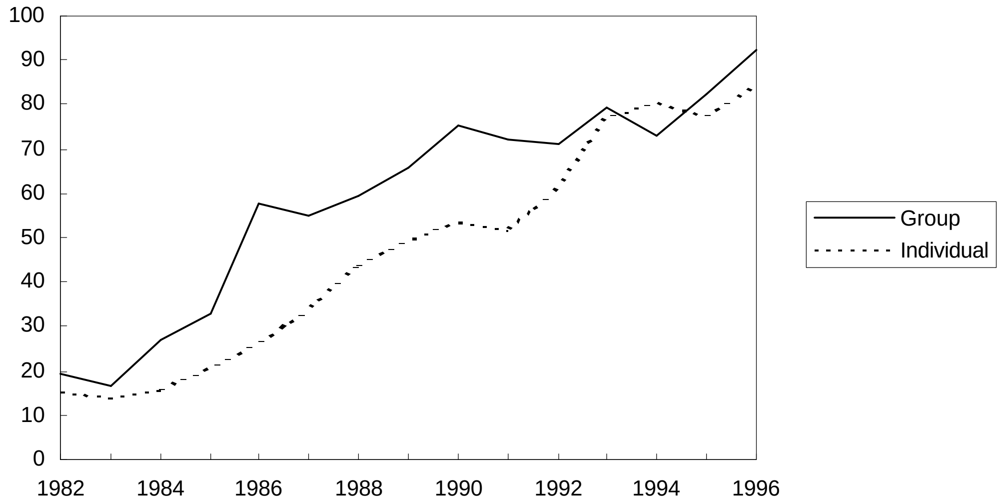
IRA, 401(k), and Annuity Percentage of Wealth



Investment Company Institute- Mutual Fund Fact Book (Various Years),
U.S. Department of Labor- Pension and Welfare Benefits Administration,
American Council of Life Insurance- 1997 Life Insurance Fact Book

Figure 7

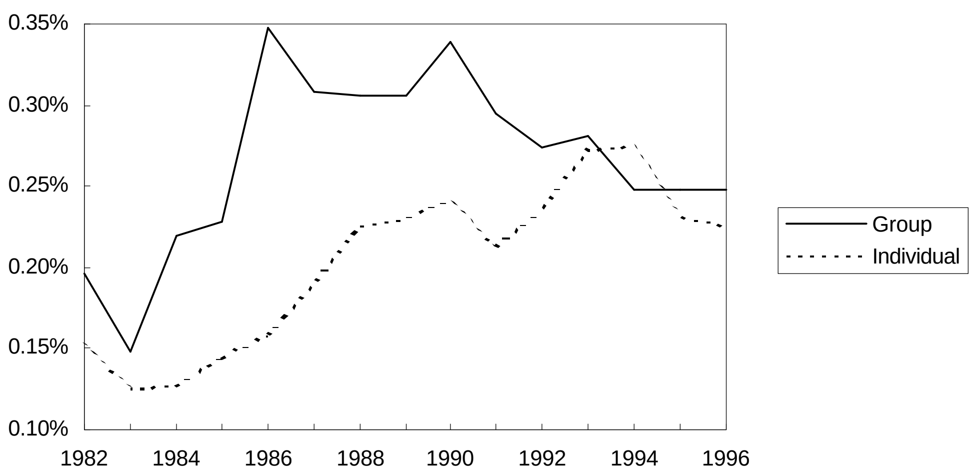
Annual Annuity Premiums Received
($ Billions)



American Council of Life Insurance- 1997 Life Insurance Fact Book

Figure 8

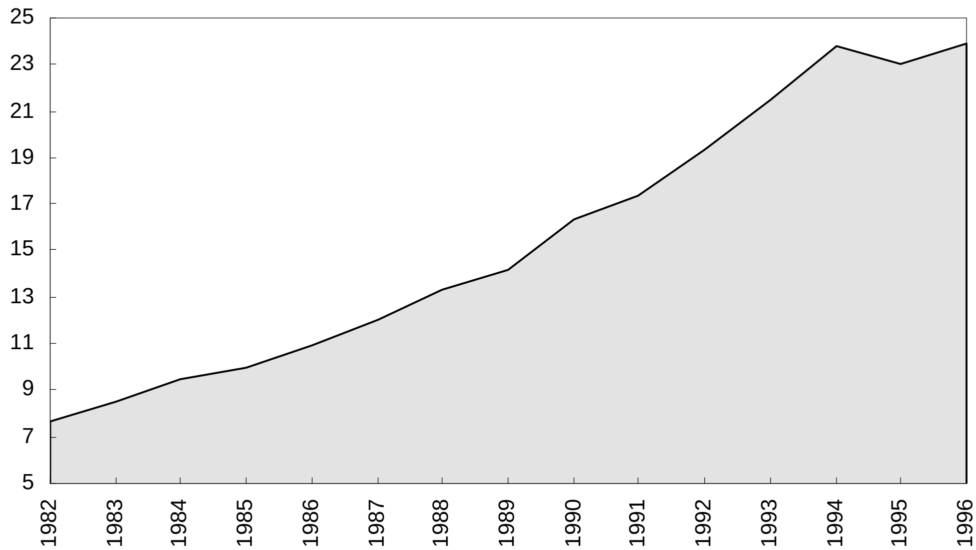
Annuity Premiums as a Percentage of Total Wealth



American Council of Life Insurance- 1997 Life Insurance Fact Book

Figure 9

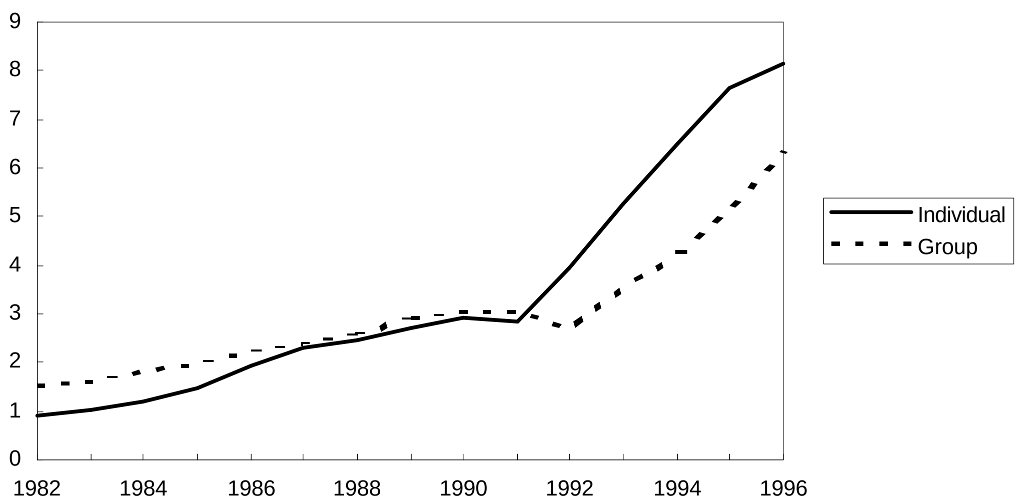
Number of Fixed-Individual Annuities
(Millions)



American Council of Life Insurance- 1997 Life Insurance Fact Book

Figure 10

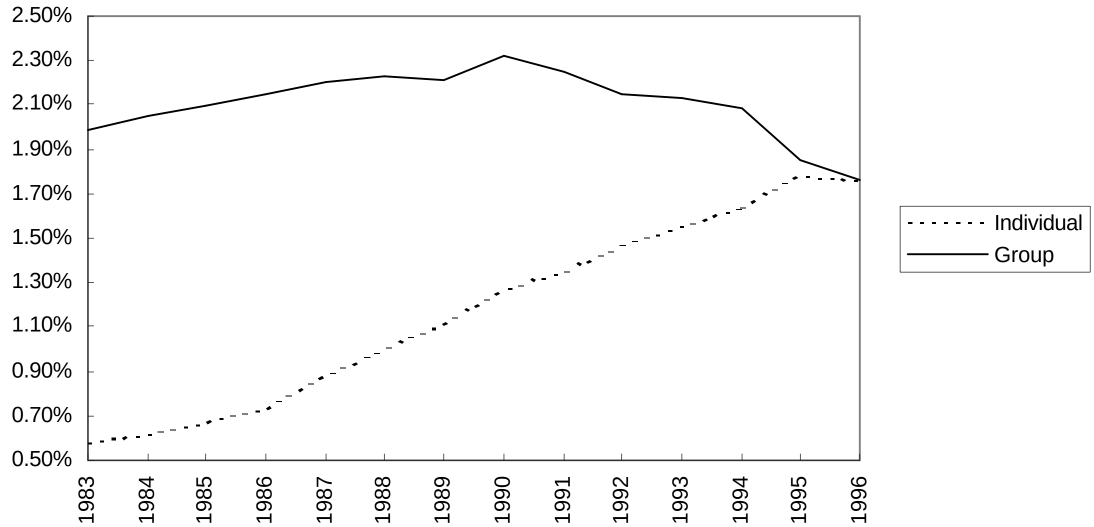
Number of Persons Possessing Variable Annuities
(Millions)



American Council of Life Insurance- 1997 Life Insurance Fact Book

Figure 11

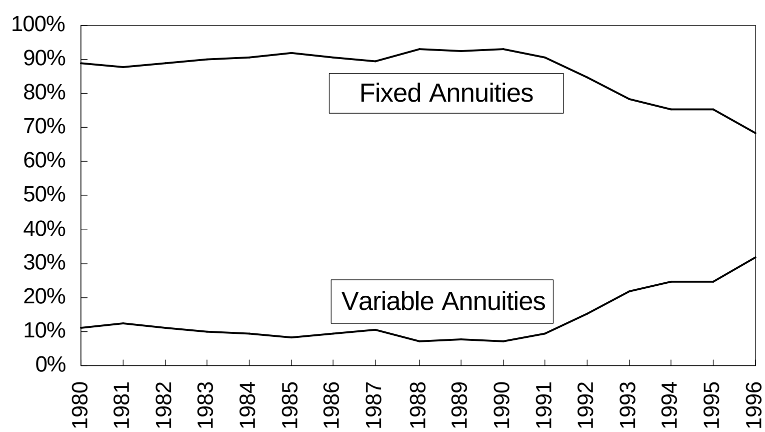
Total Annuity Assets of Life Insurance Companies (% of Wealth)



American Council of Life Insurance- 1997 Life Insurance Fact Book

Figure 12

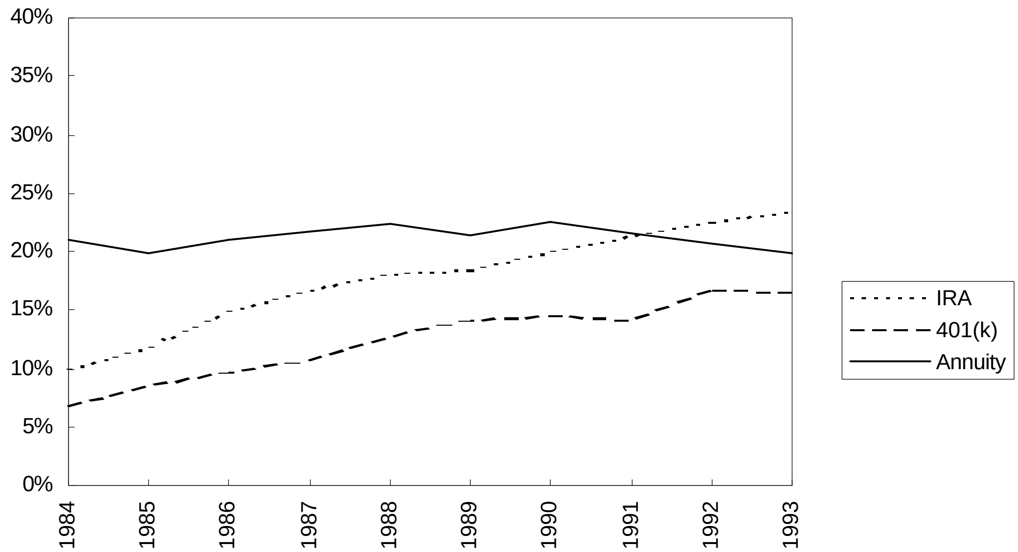
Life Insurance Annuity Premiums



American Council of Life Insurance

Figure 13

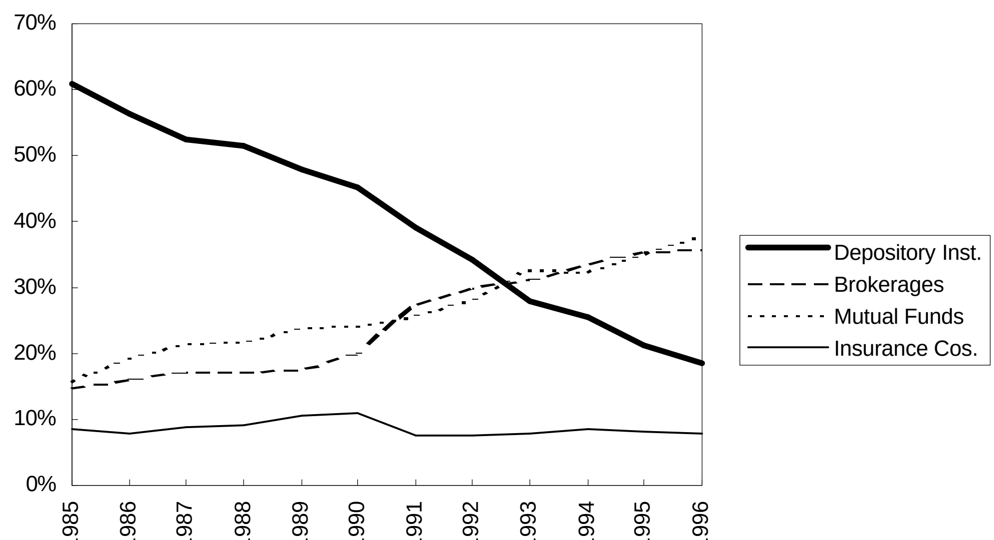
Instrument Share of the Retirement Asset Market



Investment Company Institute, U.S. Department of Labor- Pension and Welfare Benefits Administration, American Council of Life Insurance

Figure 14

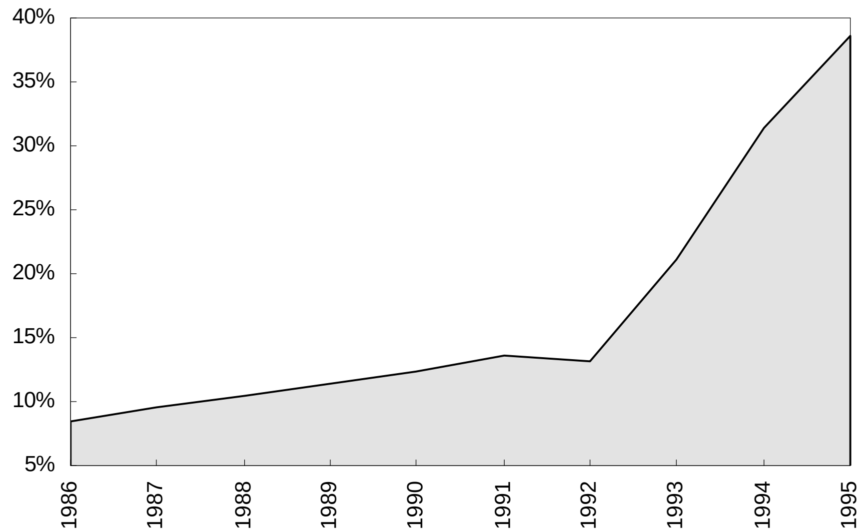
Institutional Share of the IRA Market



Investment Company Institute- Mutual Fund Fact Book (Various Years)

Figure 15

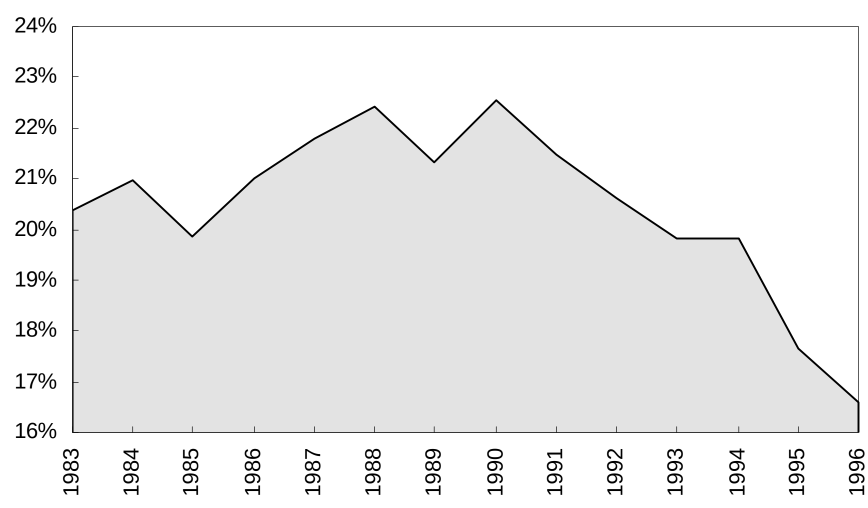
Mutual Fund Share of 401(k) Assets



Investment Company Institute- 1997 Mutual Fund Fact Book
Note: Calculations are based upon the lower ICI 401(k) totals

Figure 16

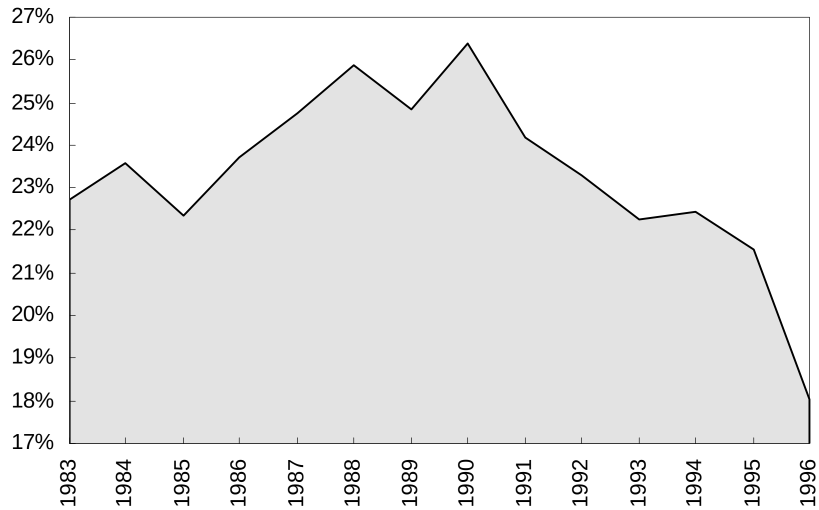
Insurance Co. Annuities- Share of the Private Retirement Market



American Council of Life Insurance- Life Insurance Fact Book (Various Years)

Figure 17

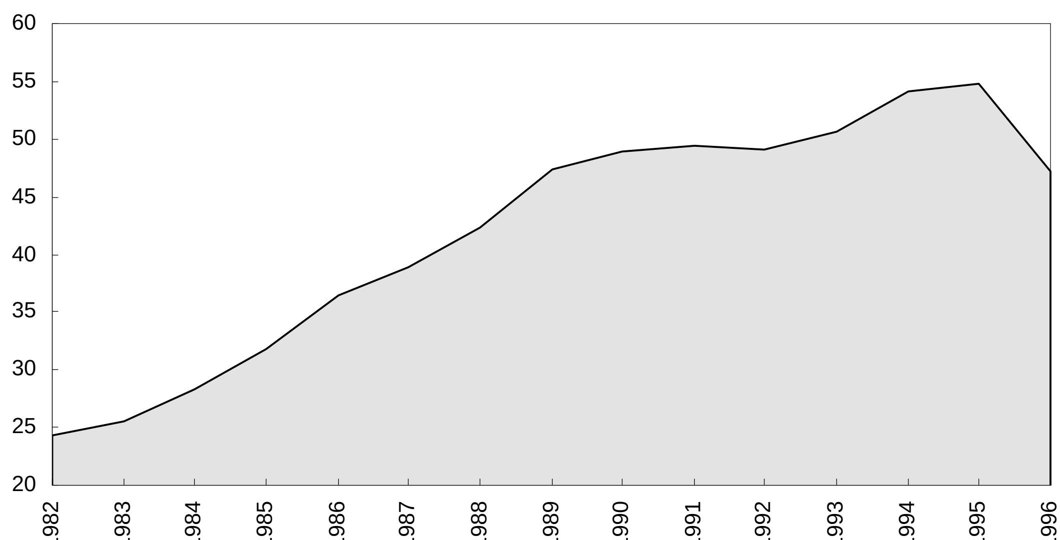
Insurance Company Share of the Private Retirement Market



American Council of Life Insurance- Life Insurance Fact Book (Various Years)

Figure 18

Life Insurance Retirement Annuities (Number of Persons- Millions)

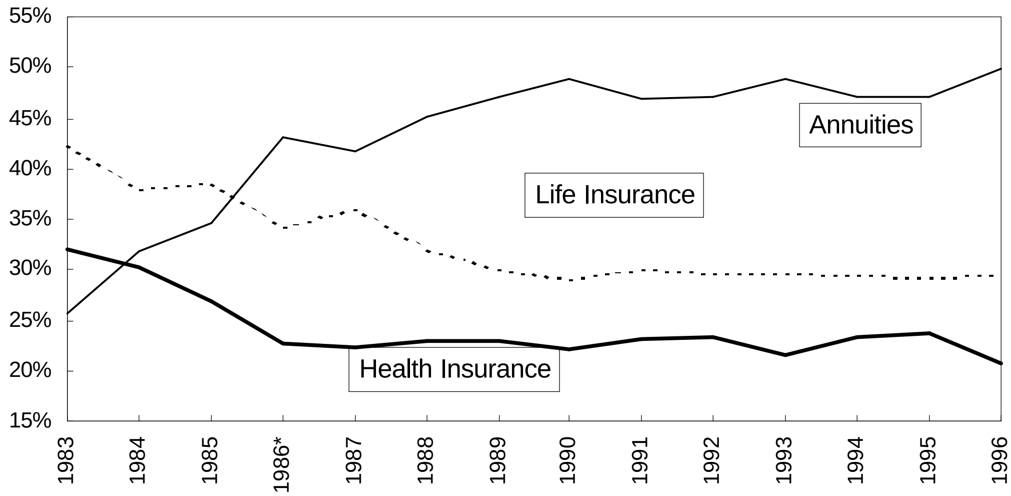


American Council of Life Insurance- Life Insurance Fact Book (Various Years)

*****The 1996 figures are not directly comparable to previous years due a change in treatment of separate account annuities.

Figure 19

Premium Income of Life Insurance Companies

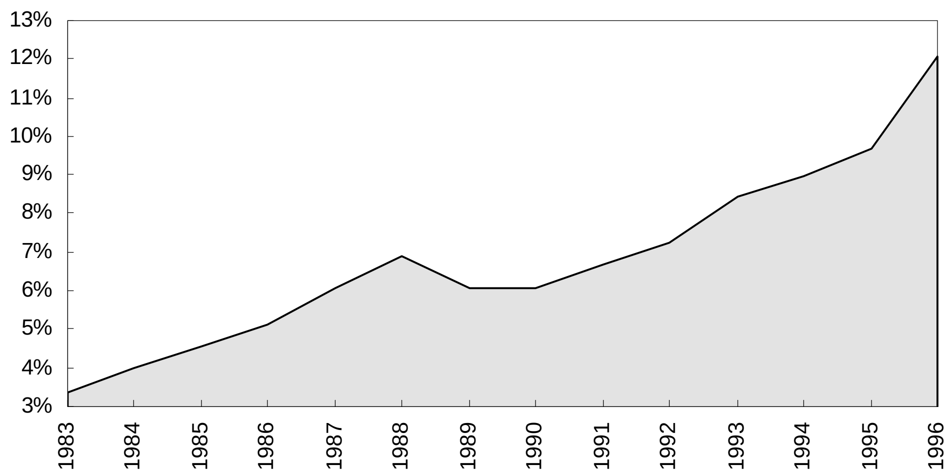


* Unusually large increase in annuity premiums in 1986 was due to an NAIC-mandated change in statutory reporting methods.

American Council of Life Insurance- 1997 Life Insurance Fact Book

Figure 20

IRA Share of Insurance Co. Pension Assets



American Council of Life Insurance- Life Insurance Fact Book (Various Years)