A study on the improvement of variable annuities for consumer protection: disclosure and back-end loading

In Korea, the first variable annuity (VA) product was introduced in 2002. Since then, the VA products have gained popularity and their sales have grown at a rapid rate. In spite of VA’s rapid growth, fewer consumers understand how a VA works, its benefits and risks, and what its commitments are under a VA contract. In April 2012, a consumer group released a report arguing that the rates of return on investment for most VA products are lower than the inflation rate. Right after the announcement, the insurance industry became the target of widespread criticism for its practices, characterized by misleading advertising, mis-selling, excessive fees and charges, and inadequate disclosures. It seems definitely time for insurers to change their practices drastically to earn consumer’s trust.

This report aims to suggest recommendations to enhance VA policyholder protection. We focus on improving the disclosures and fee structure of VA products. The disclosure of VA should be improved to ensure that customers can make their choices on an informed basis. Before purchasing a VA contract, consumers should understand that variable annuities are designed to be long-term investments, to meet retirement and other long-range goals. Variable annuities are not suitable for meeting short-term goals because substantial taxes and insurance company charges may apply if consumers withdraw their money early. To inform consumers about this essential characteristics of VA, the disclosure should include
readable information on the rate of return on investment, fees and expenses, and benefits and risks of each product. In particular, we suggest that posted return on investment should be calculated as a percentage increase over the initial purchase payment, not over the initial value of accumulation. Certainly, it should be fully explained to the customer in the selling process that suggested return does not contain benefits of VA.

Life insurance companies should design alternative charges and enhance guarantee function and set a target market suitable for VA. Firstly, regarding sales charge structure, all VAs are designed by front end charges while back end charges are not provided. Reflecting that charges are the main components determining the level of consumer satisfaction, insurance companies should consider the provision of alternative structures. Comparing with front end charges, we show how back end charges impact to return and surrender value, resulting high investible amount and return in the early years. However, due to the presence of trade-offs, the results may change depending on various factors such as persistent period, premium payment type, investment return, and etc.. Therefore, we suggest providing back end loading products in terms of expanding consumer choices and increasing consumer utility.

Secondly, to cope with the low interest rates and an ageing population, VA should be able to provide guaranteed lifetime withdrawal benefit. This feature, known as longevity risk management, offers comparative advantage compared to competing products such as program withdrawal.

Lastly, in order to increase consumer welfare insurance companies
set sales targets, accumulating assets to generate retirement income. And then it is necessary to establish appropriate sales channels to the target markets.