Episode #185: A Complete Guide to Fixed Index Annuity Cap and Spread Renewals

Video Transcription

Hello, and welcome to another edition of "Money Script Monday." My name is Sean Brady and today's topic is "A Complete Guide to Fix Indexed Annuity Cap and Spread Renewals." If you're in search of a long-term financial product, a fixed indexed annuity offers you tax-deferred growth potential, and the reassurance of a death benefit for your beneficiaries, as well as a guaranteed stream of income in retirement. When you purchase an FIA, the insurance company is going to issue and establish and declare and guarantee a cap, spread, a fixed interest rate, and they're going to guarantee that for the contract's year. Every contract anniversary, the insurance company is going to declare and guarantee a new cap, a new spread, a new fixed interest, and this is going to happen year after year after year. What determines those cap and spread and participation rate renewals? Three main factors decide that, and the three factors are general account investment results, hedging costs, and contract owner behavior. Let's dive a little bit deeper into each of these individually.

The first factor, general account investment results. The general account or the general portfolio of an insurance company is going to pay for the product's benefits and the product's guarantees. The general account or general portfolio is comprised of investment-grade corporate bonds, typically that were purchased with the initial premium of the issued annuity contracts. Then the insurance company is going to go around and then determine the annual renewal rates based on the amount of interest that they earn from their general portfolio or their general account investments. Bond defaults happen. When that happens, the insurance company's investment income's going to be lower. All that means is that the insurance company is going to have less money to spend on product benefits and interest rates and all that good stuff. What they're going to do is lower the cap, lower the fixed interest rates, and maybe increase the spread. Ways that the insurance company mitigates bond default risk is they're going to invest in a diversified high credit quality portfolio. That's the number one factor, general account investment results.

The second factor is hedging costs. Insurance companies spread and cap renewal rates. They're generally sensitive to the changes in the one-year risk-free interest rate, which is the one-year treasury bond rates and the one-year volatility. When an insurance company experiences these types of changes, basically the cost of the options that the insurance company uses for hedging changes as well. In turn, the cap or spread that they typically offer will change too.

The higher the cap or the lower the spread, those types of caps and spreads are going to be more sensitive to rate changes. If the one-year risk-free interest rate, for example, changes in comparison to the last contract anniversary, if the risk-free rate interest rate were to increase, the client should expect that their cap's going to decrease, their fixed interest is going to decrease, and their spread's going to increase. Conversely, if there's a decrease, then they're going to experience a cap increase, fixed interest increase, and a cap decrease. That's what happens if the one-year risk-free interest rates were to change. Next, the one-year volatility, which's a measure of the expected variability of returns of a particular index over a year. If there's a change in the one-year volatility, then that could change option cost, as well.

Index and index-creating methods have some influence on the direction and the magnitude of that particular change. For example, if the one-year volatility were to increase, then some of the allocation options will experience a decrease, but some of the other allocation options may experience an increase, or they might just stay the same. Multiple factors play a role in the impact of the volatility within a particular product, and that includes things like index characteristics, presence of or exposure to equities, presence of a volatility control mechanism, a particular crediting method, and where the current rates are at, the current level of rates, the caps and the spreads. That's the second factor. We talked about the first factor, general account investment results. We talked about the second factor, hedging costs.

Let's talk about the final factor, contract owner behavior. All annuity issuers make certain assumptions about their contract owners. They make assumptions about how they're going to use their annuity benefits, and they actively monitor these assumptions that they're making about you, the contract owner. Some of those assumptions and some of those things that they monitor are free withdrawal privileges, income benefits, the timing of when benefits are taken, level and timing of surrendered contracts, and timing of death benefit distributions. As blocks of business start to age, the insurance company is going to compare their assumptions that they've made with the actual benefits that have been used. The usage of that block of business. If there are deviations from the pricing assumptions that happened, it could change the cost of the product details. All that means is that the insurance company's either going to have more or they're going to have less to spend on interest crediting. That's it, folks. Those are the three main factors that decide FIA renewal rates. The three main factors being the general account investment results, the hedging costs, and the contract owner behavior.

I hope you liked today's presentation. I hope you found it of value. We'll see you again next time on "Money Script Monday."