Episode #270: The Truth Behind How Annuity Companies Make Money

Welcome back. My name is Kyle. Today's episode, we'll be talking about exactly how annuity companies make money. To some, the industry itself, the insurance industry is considered a black box. I'm here to dispel part of that myth and provide transparency when answering this question to you whether you're a prospective client, existing policy holder, or an advisor. And I've been working with advisors now for close to 10 years, financial planners, insurance agents, and clients alike. And one of the concerns I had is how this question, more so the answer is misrepresented. There's a ton of mis and false information out there. I chose this topic to, one, provide you the truth that you deserve to know, try and set the ground straight, and share with you that there is no secrecy. It's not a black box. In fact, the answer's fundamentally sound.

How did we get here to begin with? Truth be told, insurance companies are making a boatload of money, record sales on the top line, record profits there on the bottom line. They're doing that through the combination of two external factors. One is the stock market volatility that we're continuing to experience, along with the combination of rising interest rates. When that occurs, you're seeing a large influx of money leave the stock market and enter the insurance industry where insurance companies can manufacture products such as annuities to provide fixed rates, guarantees, and peace of mind.

While some people may not like that, insurance companies are making more money, what's new? I'm here to share with you that that's actually good news. We want the insurance companies to profit because that's going to translate into more money inside your pocket. Let's look on over to the board here, and I have an example of what would happen, and how a company makes profit on the $100,000 you give them, and what they do with it.

In this example, we have $100,000 that's going to be given to the insurance company. This is a great opportunity to explain how safe insurance companies are when they take your money, because they use what's called an interest rate spread. We'll walk through that specifically, but it's different than banks where banks use leverage in how to generate return. If you give the bank $10,000, they're only required to show $1,000 on their balance sheet as they leverage the rest. We're going to show you how insurance companies take more of a safer approach and have higher reserve requirements, and are essentially the reason why they're considered the backbone to the American system as deep, strong-rated insurance companies hold up this entire ecosystem in the financials.

We're buying $100,000 of an indexed annuity. There's different types of annuities out there. We're using an indexed annuity due to their popularity. As I mentioned, that $100,000 is immediately deposited in what's called a general account. That general account is going to be yielding 5%. That 5% is going to come from highly safe liquid instruments such as bonds, corporate bonds, muni bonds, treasury bonds, some exposure to equities via stock, cash, mortgages. Insurance companies are good, and they're doing this with billions of dollars, which is going to generate right now in today's market about a 5% risk-free.

That 5% is going to yield a $5,000 return. Don't be too happy, right? That's not $5,000 that's going to be credited to your policy. This is where the interest rate spread or the technique insurance companies use to make money is then applied. First and foremost, they're taking that $5,000 and they're using it for overhead, which is going to be built into their profits. They have a brick-and-mortar company, right? They need to keep the lights on, so they're going to take out what they need to continue to run their business. Second part of that is what's considered advisor compensation. They need the distribution to continue to sell their product. We have close to 1.5% spread from the original dollar amount that we give them that is taken out of this $5,000 return right away.

What happens next? Okay, so we're left with $3,500. This is a fixed annuity that's a 3.5% guaranteed rate applied to your policy. Since we're using an index annuity, what's going to happen next is the insurance company is going to take this $3,500 and they're going to purchase options, which is going to provide us some form of upside potential typically tied to an external index such as the S&P 500, which is going to give us a 10% cap, right?

So we're always going to have a floor of never losing money, but we have the upside potential of earning a 10% return based on this cap, in this example, the S&P 500 index. We don't know exactly what's going to transpire in terms of the return projected one year out, but that's going to give the policy holder a credit at the end of the year. Now, what happens if the index actually is negative, right? And those options that we purchased will expire worthless, and we have our general account to fall back on providing us that 0% floor.

Here are a couple of things that we talked about earlier today. We talked about what happens when an insurance company received your dollar, and how that's going to a general account, yielding that 5%. We know that indirectly we are paying the advisor and we're giving them - the company some profits. So they continue running their operations and what's left over, or that net amount is what's used to purchase options, which is going to provide us that upside potential.

Hopefully, at the end of this, or after watching this episode, you are able to do a couple of things in terms of understanding more how insurance companies operate. You're able to understand what happens when the money gets put inside that general account, and also how you're indirectly paying both the fees associated, the compensation that is paid to the advisor, and the amount that's left over which is going to provide you your returns. If you have any questions, please feel free to reach out to the financial advisor that shared this video. We hope to see you back next week. Thanks.