Episode #346 - How Annuity Carriers Set and Renew Rates

Welcome back, my name is Kyle. This episode right now is timely not only because of interest rates and how attractive that makes annuity products, but this episode stems from a recent case I worked on where an individual wanted to purchase a fixed index annuity for safe accumulation, and he was looking to contribute a large sum money. One of the questions that stuck out was “Kyle, I understand there's a 12% cap on this 10-year product, but what's the likelihood that that cap rate is going to sustain throughout the next 10 years?” My answer was short and I said it depends because it's not as straightforward as most think. The purpose of this episode is to kind of walk through the mechanics of this, so you have a basic understanding of how the insurance carriers set those initial rates, and then how those rates renew thereafter.

Let's look over to the board. What happens when you give and contribute premium into a fixed index annuity? The insurance carrier is going to take that money first and foremost and place it inside their general portfolio, which is made up of highly graded investment bonds, and fixed-income securities that are safe, reliable, and AAA-rated. That general portfolio is going to earn 5% and that's a consistent yield. They're going to match that yield with the duration or the liability of the policy, whether that's a 5-year surrender, 7-year surrender, or 10-year surrender. They get a 5% yield on those bonds that they're purchasing. What happens thereafter?

Insurance carriers run a business too. I'm sure you've heard the term pay yourself first, and insurance carriers are really good at that. Right off the top, which is part of the spread, is a 1% allocation towards the actual profit from year to year. Now that might seem small, but they have the economics of scale, and when there's $100 billion in the general account,

1% isn't too bad thereafter. Second piece is operating costs, right? They have payroll. They have costs to run a business, brick and mortar, so another 1% is earmarked towards keeping the business alive and sustaining. Then that leads to the most fun of them all, the options budget.

The options budget is your opportunity to earn index gains inside the contract without taking on any negative volatility risk. What's happening behind the scenes is the insurance security actuaries are buying call options based on an index which, like I said before, is going to provide that positive performance. A 3% options budget theoretically will give you a 6%, 7%, or 8% S&P 500 cap, meaning that our maximum upside is 8% with a floor of 0. If we think about it, since that general account is yielding 5% and that's consistent, a couple of things really won't change, right? It's the profit and operating costs will remain the same and so will that options budget. Theoretically, if all of this is equal and the sam, then you should see that 6%, 7%, or 8% cap at issue not fluctuate whatsoever, right? Not quite.

Let's look on over to the other side of the board once we enter years 2 and onward. We talked about how insurance carrier issued those new rates for that first contract year, but what happens thereafter? We talked about that options budget remaining the same throughout the life of the contract or for that liability that the carrier has. One of the biggest influences is whether or not we're going to see that same consistent cap renew the same, or higher, or lower is going to be contingent on what's called the options cost. Pretty simple, right? The higher something costs, the less we're able to obtain. What we don't want is the options cost to rise during the life of the contract because that means that we're going to receive lower renewal rates.

There are two things that drive options cost. One is volatility and the other is interest rates. The more volatile an index is, the higher the options cost. The higher the interest rates are, the higher the options cost. The same is true on the other end, the lower the volatility, the lower the option cost and you'll be able to see those caps remain high. Interest rates go

down, same thing, the options costs go down. You'll be able to see those again caps renew similar to what was at issue.

Now insurance carriers are smart, right largest companies in the world and they get pretty creative. If we know that we're vulnerable to interest rates and volatility, what can carriers do? The answer is they can create what's called an engineered volatility-controlled index, which does two things. It reduces volatility and stabilizes interest rates all within the index. When they're able to do that, they're able to not see those large fluctuations around what's called options cost. Now where are we at today?

Let's land this plane. We talked about how important the general portfolio is, which creates a spread to run a business, profit being first and operating cost being second. The difference is what's left in the options budget where the insurance carrier is going to buy call options on your behalf behind the scenes, which is going to give you a cap of some sort ranging from 6 to 8% with a floor of 0. That is going to provide you your opportunity to earn positive interest. At the end of the year when they reset those contracts and renew those contracts, the fluctuation of those tabs and participations are all contingent on options cost. We want them to remain low because we know volatility and interest rates are what impact that cost and our renewal rates altogether. We talked about a little bit of the engineered volatility-controlled index, which is an option on most contracts today.

At the end of the day, you work with a financial advisor, you don't have to be an expert at this. There are two things that you have to figure out when working with your advisors. Number 1 is "Is the carrier reputable? Do they have strong rates?" That's an absolute must. It must be AAA-rated with high COMDEX scores. The second is for renewal rate history. Some carriers publish that, others do not. Work with your financial advisor to determine, "Am I getting a good deal? Am I going to see these rates fluctuate significantly after that first year?" It's all contingent on the index that you're using and how the insurance carrier prices it through their

options budget, starting more importantly with their general portfolio. My name is Kyle. I threw a lot at you today. I appreciate your tuning in. We'll see you next week.