A DIA with Dividends

By Kerry Pechter *Thu, May 30, 2013*

The distinctive aspect of Northwestern Mutual's Select Portfolio deferred income annuity is that the contract owner can earn income-enhancing, inflation-protecting dividends over the life of the contract. (Photo: Northwestern Mutual's flagship building in Milwaukee.)

Many financial services companies believe themselves to be, or claim to be, *the* retirement company. One of them is Northwestern Mutual, although the Milwaukee-based firm ranked just 18th in variable annuity sales in 2012, with $1.43 billion in premium.

But as a mutual insurer, the 155-year-old concern, which once called itself the "Quiet Company," doesn't need to impress Wall Street with top line numbers. It worries more about how well its career agents satisfy their clients' needs. And, increasingly, those clients say they need guaranteed income.

Consequently, the firm is now one of the eight or nine life insurers that offer deferred income annuities (DIAs), a new class of product that enjoyed a 147% increase in sales in 1Q 2013 year-over-year. (Another eight companies are building DIAs, according to a recent LIMRA-CANNEX survey.)

Northwestern Mutual introduced its Select Portfolio Deferred Income Annuity last October exclusively through its 7,000-member career force. Its initial sales were strong for this category: $63 million in the final quarter of 2012 and $94 million in the first quarter of this year. Total industry sales in 1Q 2013 among six reporting carriers were $395 million, LIMRA said. The sales leaders are MassMutual, New York Life and Northwestern Mutual, another source said.

Dividends are the difference

The distinctive aspect of the Select Portfolio is that, while the basic income under the contract is fixed, the contract owner earns annual dividends over the entire life of the contract. The guarantee is 2%. They start low and gradually scale up. After the 10th contract year, they equal the dividend that Northwestern Mutual declares for the contract.

"If somebody gives us $100,000 at age 55, we might start the dividend at 3.5% and grade up by 20 basis points each year to 5.5% after 10 years," Greg Jaeck, Director, Life and Annuity Product Development, told *RIJ*.

In today's yield-starved environment, he expects that kind of sweetener to attract attention. The dividend strategy is designed to give the contract owner more income, an opportunity for cash out, or inflation protection. At the time of purchase, the company assumes a 2% account growth rate in order to calculate the monthly payment the contract owner will receive on the income start date.

As dividends accrue, the contract owner can apply any excess (above the 2% guaranteed accrual) to enhance the income stream or receive it as cash during retirement. The dividend rate for DIA owners starts below the regular policyholder dividend rate, Jaeck said, to reflect the dilutive effect of new premia on the general account assets and to protect the interests of existing policyholders.

Exactly how the dividends for each contract owner are calculated and how they translate into income payments is not entirely transparent. Independent advisors might call it a black box. But independent advisors don’t distribute the product, so that particular marketing/communication problem never arises. (Career agents don’t need to worry about “annuicide” either.)

Unlike DIAs from other big mutual insurers like Guardian, New York Life and MassMutual, Select Portfolio DIA isn’t offered on the Fidelity DIA platform, where consumers can buy direct. The Select Portfolio DIA differs from most other DIAs in other ways. It has a deferral period of up to 60 years. It is a single-premium product. Like others, it offers a death benefit during the deferral period, a joint-and-survivor option, and period certain options. (Northwestern Mutual introduced a less flexible DIA, without dividend accrual, in May 2011, and still offers it.)

Two illustrations

How does Northwestern Mutual’s Select Portfolio DIA work under hypothetical conditions? The product brochure offers two examples.

Scott, age 50, $250,000 premium, 15-year deferral

In the first hypothetical, 50-year-old “Scott” uses $250,000 from a 401(k) account at a former employer to buy a single life contract with a 10-year period certain and a death benefit during the deferral period. (The death benefit entitles him to delay his start date if he wishes.) The premium allows him to lock in a fixed floor income of $14,805 starting at age 65. But because he applies all of his dividends to his income during the 15-year deferral period to future income, his guaranteed floor income at age 65 climbs to about $21,000.

Wait, there’s more. Starting at age 65, Scott uses 20% of his annual dividends to enhance his income payments and takes the remaining 80% in cash, in the amount of about $12,000. So, according to the illustration, his starting income at age 65 on the $250,000 initial purchase premium is $33,190. He maintains that strategy, and his income plateaus at about $35,000 for the next 35 years—perhaps because his dividend payout shrinks as his original premium is paid out.

Chris and Jennifer, both age 60, $350,000 premium, 5-year deferral

In the second hypothetical, a 60-year-old married couple, Chris and Jennifer, want their income payments to begin when they reach age 65. Jennifer uses the $350,000 in her rollover IRA to buy a joint-and-survivor contract with a deferral period death benefit. Like Scott, she applies 100% of her dividends to the income payments during the five-year deferral period and takes 80% of the dividends in cash during the income period.

Their income floor during retirement will be $15,159. The dividend enhancement brings it to $21,855 at the start date when both are 65. Dividends will raise their income to a peak of about $28,000 at age 75, and then subside slightly to a plateau of about $25,000 after age 90.

The average premium so far for the product has been about $200,000, Jaeck said. That's about double what some other DIA issuers report receiving. The fact that the Select Portfolio DIA is a single-premium product and others are flexible-premium may be a factor, but it's impossible at this point to say for sure. About half of the contracts are joint-and-survivor, the average age of purchase is 59. Clients are deferring income for an average of 8.3 years; 87% of deferral periods are less than 15 years.

DIAs are safer

With sales of virtually all other types of annuities declining in the first quarter of 2013, relative to the first quarter of 2012, the rising sales of DIAs and the increasing number of insurers, both publicly owned and mutually owned, that offer DIAs, has given the annuity industry something to cheer about this winter.

Behavioral economists have long maintained that many people view annuities favorably when annuities are presented or "framed" in terms of the absolute monthly income they can deliver and not in terms of their internal rate of return on the purchase premium (usually based on the assumption that the contract owner lives to his or her average life expectancy). DIAs don't necessarily frame annuities any differently from the way single-premium immediate annuities frame them.

Annuity marketers have long noted how difficult it is for people to sacrifice liquidity by exchanging up to hundreds of thousands of dollars in growable savings all at once for a fixed monthly income from a single-premium immediate annuity. From a behavioral perspective, the key features of the newest DIAs may be that they separate the purchase date from the income date and offer growth potential during the deferral period.

The growing supply of DIAs may also reflect the fact that they're safer for life insurers to manufacture than variable annuities with guaranteed lifetime withdrawal benefits—while satisfying a similar hunger among Boomers for delayed retirement income with downside protection and (in some DIAs) upside potential. As Jaeck explained, Northwestern Mutual can decide to lower or raise its annual dividend as markets allow and as it sees fit.