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Do FIAs Need Income Riders?

By Garth Bernard *Wed, Dec 15, 2010*

A guaranteed income rider makes as much sense on an FIA as it does on a VA and should not be dismissed out of hand, says Garth Bernard, president and CEO of Sharper Financial Group.

Almost 90% of new variable annuities (VAs) are sold with a living benefit, according to LIMRA. Two-thirds of these benefits are lifetime income riders. That the VA market is a $120 billion-a-year market attests to the popularity of lifetime income riders, which appear to satisfy the public's hunger for long-term financial safety in retirement.

The $30 billion-a-year fixed indexed annuity (FIA) market has also embraced living benefits. While there are no statistics regarding the percentage of these contracts that are issued with an income rider, anecdotal evidence suggests that the FIA market is following in the VA market's footsteps.

Does an income rider make sense on an FIA? Some observers raise the following questions, which suggest that an income rider on an FIA does not make as much sense as an income rider on a VA:

1. The income rider on a VA provides guaranteed income that wouldn't otherwise be available at the time of purchase. An FIA, as a fixed annuity, already provides guaranteed income at the time of purchase (via guaranteed minimum annuitization rates), so an income rider is redundant.
2. An FIA is a fixed annuity, so its long-term average rate return won't be much higher than a CD's—perhaps one to three percentage points higher, depending on the competitiveness of an insurer's interest crediting mechanism on the FIA—and significantly less than a VA might earn.
3. The account values in an FIA with an income rider are not likely to be depleted by withdrawals unless the clients reach a very advanced age. Most people will be paying for a benefit they don't receive.

1. Is an FIA income rider redundant?

Regarding the first question, it's instructive to ask why consumers should add a guaranteed income rider to a fixed annuity (which also guarantees most of the principal and adds interest credits) when they could very well annuitize the contract.

They do it for the same reason they would purchase it on a VA. It gives them a lifetime income guarantee *while still allowing access to underlying account values*. And because the FIA (unlike the VA) already guarantees principal, the income rider costs less on an FIA than on a VA. One could argue that an income rider on an FIA is better suited to a conservative purchaser who wants an income guarantee (with liquidity) and principal protection.

Some investors in VAs with guaranteed income riders may believe that their principal *is* protected. They may very well mistake the guarantee on the "benefit base" for a guarantee on the principal or the account value. It isn't. The benefit base is simply a mechanism for determining the dollar amount of the guaranteed withdrawals. Judging from the descriptions of the benefits base by the popular media, however, the nature of the benefit base may not be clearly understood—by journalists or the public.

2. Will an FIA offer competitive performance?

A seller of FIAs might argue, why buy an income rider on a VA when you could get it cheaper on an FIA? The answer given by the seller of a VA is that you can't expect FIAs to return much more than a CD over the long term. Fees aside, VAs have much more upside potential than FIAs, and can thus generate higher withdrawal guarantees via the commonly offered "step up" or "ratchet features.

On an after-fee basis, VAs may not actually be able to earn *significantly* more than an FIA. Think about it. VA contract fees including the cost of an income rider range from 200 to 400 bps or more per year. Equity funds aren't expected to earn the 10.5% of yesteryear. Reasonable expectations for equities might be 8.0 to 8.5% a year going forward. Long-term bonds may return as much as 6% a year.

And even these lower estimates may be more aspirations rather than expectations (See John West's "Hope Is Not A Strategy" in *Research Associates*, October 26, 2010). If that's true, a VA with a balanced allocation might net an average of only about 4.5% a year over the long term.

Not surprisingly, that's not very different from a fixed annuity. At the end of the day, financial vehicles that provide exactly the same type of financial guarantee should deliver about the same expected result over the long term. If they didn't, there's a massive undiscovered arbitrage opportunity somewhere.

To be fair, the fact that FIAs provide principal protection, separately from the income guarantee, suggests that their return should be slightly less than that of the VA with a balanced asset allocation. The difference should be roughly equal the annual cost of long-term put options protecting principal.

3. Do FIAs need another layer of insurance?

What about the assertion that an income rider on an FIA is unnecessary because assets in an FIA are unlikely to be depleted by guaranteed withdrawals within the purchaser's average life expectancy?.

It's also likely that if you removed all of the insurance fees from a VA and took the same withdrawals from an uninsured portfolio with the same asset allocation, you probably wouldn't run out of money either. The VA fees exacerbate the very risk that the income rider mitigates. Ultimately, the likelihood of depletion will be reflected in the price of the rider, regardless of whether the rider is on a VA or FIA.

Five takeaways

- A guaranteed income rider makes as much sense on an FIA as it does on a VA and should not be dismissed out of hand.
- The income riders on VAs and FIAs are equivalent financial constructs delivered on different platforms. If there's a performance difference, the FIA's principal guarantee should explain it.
- In practice, no two companies price their products the same because no two have the same capacity

or resources to manage the risks. Whatever the product, producers must exercise due diligence to decide if the benefits justify the fees.

- In an open market, free of collusion, competition should drive out excess profits or exorbitant fees. By the same token, losses will eventually eliminate companies that under-price or fail to hedge appropriately.
- Producers and distribution stakeholders need tools to assess the value of income riders on FIA and VA platforms, so that they can be properly compared.

Garth Bernard is president and CEO of the Sharper Financial Group. He can be reached at garthbernard@sharperfinancial.com.