Indexed Annuities, Unbundled

By Jack Marrion *Tue, Feb 28, 2012*

Lower prevailing interest rates have led to unbundling of indexed annuity features and, as a result, greater transparency.

As bond yields began to collapse in 2010, indexed annuity carriers reacted by cutting sales commissions, premium bonuses, and minimum interest rate guarantees. However, by autumn 2011 bond yields had sunk to a point where there was little left to cut.

As a strategic response, agile carriers are unbundling the various features—such as GLWBs and death benefits—and letting annuity buyers decide which ones they want to pay for. Greater transparency and greater flexibility—which are both good for customers, carriers, and the annuity industry—have been the results.

Beyond the mortality expense, administrative expense and minimum guarantee return, contracts have several costs. The most visable examples are higher sales commissions and premium bonuses that must be repaid from future annuity earnings.

More subtle is the cost of offering an initial interest rate or interest cap that can’t be supported by carrier earnings—although it is not disclosed as such. It has to be recaptured by lowering the contract’s renewal rates.

Other costs are even subtler. Most products include a waiver of surrender charges if the annuity owner is confined to a nursing home; some contracts extend this waiver to cover a terminal illness, and a few are triggered by unemployment. Anecdotal evidence suggests that these features are almost never used, but they nonetheless impose a cost on the annuity.

Many of these costs have been offset by adjusting the renewal rate credited to the annuity owner in subsequent contract years. The reality of the lowest bond yield environment in over 50 years is that there is no longer enough spread to recapture all of these costs from the renewal rates. This is forcing carriers to unbundle the features, specify their costs, and allow the annuity buyer to choose which ones to buy.

Redefining the annuity promise

The first unbundling occurred before rates dropped and involved guaranteed lifetime withdrawal benefits. The first two carriers to offer GLWBs, American National and Aviva, charged specific fees for this income benefit. Almost every other carrier followed their lead in treating GLWBs as an optional feature. About a year later, Aviva became the first carrier to charge an annuity owner an explicit fee* for guaranteeing a minimum death benefit.

But it wasn’t until autumn 2011, as bond yields continued to fall, that more carriers began to consider charging annuity owners fees for features that had heretofore been regarded as standard equipment. Wariness about breaking the sanctity of the annuity promise was the reason for the delay, in my opinion.

A defining element of the fixed annuity value proposition has always been the promise that you can't lose the money you already have. The industry has claimed that no matter what amount your account balance shows at the end of one year, at least that amount will be there the next year, most likely with an increase.

But this promise had already been broken. Most GLWBs were charging a fee that could cause – and in an indexed annuity context would almost certainly cause at some point – the subsequent year's account balance to be less than the previous year's.

Although the first contract to offer a GLWB, an American National product, explicitly stated that the charge would never be more than the interest credited, the second entrant, Aviva, made no such guarantee and almost every carrier has followed Aviva's example. With the advent of GLWBs, most fixed annuities offering this feature could no longer promise that the account balance would never fall.

Within just the last two months, two carriers have taken unbundling to the next level. Midland National's MNL RetireVantage series offers an optional package that includes a higher bonus, higher penalty-free withdrawals, annuitization bonus and return of premium for an annual cost of 60 basis points (0.60%). Allianz's new 365i offers an annuity rider that, at present, raises an index cap by 2% in return for a 1% rider charge.

These examples of unbundling all stem from very low bond yields—an environment that will continue to challenge carriers for at least the next few years. I view it as a positive development. It brings greater transparency to the fixed annuity world and it permits each consumer to decide whether a specific feature is worth the cost. While I believe that bond yields will eventually rise and that carrier spreads will widen, greater transparency is here to stay.

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* Index annuities may involve an "asset fee" that reduces index-linked interest credited. But this isn't actually a fee because it can never reduce the interest earned to less than zero. An index annuity asset fee is, in effect, simply an adjustment of the participation rate.