Retirement Income
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Prudential’s New Edge: Dynamic Rate-Setting

By Kerry Pechter *Thu, Feb 27, 2014*

To reduce interest rate risk exposure, Prudential has adopted a protocol that allows it to change roll-up rates and payout rates on its living benefit riders within a month, if necessary. Other insurers applaud, but one broker-dealer hopes the practice doesn't spread.

Our February 13 report on the new 3.0 version of Prudential’s Highest Daily variable annuity income rider failed to reveal the critical role played by Prudential’s relatively new “dynamic rate-setting” process. Annuity issuers seem to applaud this development; broker-dealers, not so much.

We had never heard of dynamic rate-setting. But in a conversation with *RIJ* last week, Bruce Ferris, the head of sales, distribution product management and marketing for Prudential Annuities, explained.

Dynamic rate-setting means Prudential can tweak the rider’s payout rates and roll-up rates as frequently as every month, if necessary, Ferris said. In the past, the insurer needed nine months or so to change certain rates. (There can be no *retroactive* rate changes, he noted. New rates affect only contracts issued after each change.)

This kind of flexibility is valuable. It narrows the product’s window of exposure to interest rate volatility to just 30 days. With less risk exposure, the carrier can afford to strengthen the benefit. Indeed, because of dynamic rate setting, Prudential was able to raise the new rider’s annual payout rate to a more competitive 5.0% at age 65 for single contracts, from 4.5% in the 2.1 version of HD.

(The new contract has additional risk management measures. It requires at least a 10% allocation to a fixed return account, and the entire portfolio is still subject to Prudential’s risk management algorithm, which automatically shifts money in or out of equities when equity prices rise or fall, respectively.)

Ferris said the shift in strategy required infrastructure modifications, but not regulatory or legal changes. Some of those modifications were internal, others between the carrier and broker/dealers. With annuities, “the essential element of speed to market is speed to the broker/dealers,” observed Joan Boros, a securities and insurance attorney in Washington, D.C.

‘Sweet spot’

“We didn’t change our fees, our step-up frequency, our minimum issue age and, at introduction, our roll-up rate. We merely introduced the same rate-setting process that we used for our PDI (Prudential Deferred Income) product,” Ferris said. “This allowed us, at launch, to raise the withdrawal rates at age 65 to the sweet spot of 5% level for single and 4.5% for spousal contracts. It lets us control our interest rate risk.”

PDI is the company’s entry in the three-year-old, $2.2 billion deferred income annuity (DIA) market, currently dominated by New York Life and Northwestern Mutual Life. PDI is essentially a portfolio of bonds with a guaranteed lifetime withdrawal benefit attached.

"We developed PDI with the idea of creating a dynamic rate-setting ability for it. The need to do that was a function not just of the volatility but also the absolute value of interest rates. We had been living in an environment where rates of 5% to 6% were normal. Then they dropped to 1.45%," Ferris said.

"That was new. It caused us to rethink our infrastructure and our product design for PDI. The original PDI roll-up and withdrawal rates were 6% and 6%, and even though interest rates pulled back later, we could afford to pull back our roll-up and withdrawal rates to only 5.9%. Without dynamic rate-setting, we would have needed to make a larger reduction.

"Now we're doing the same thing with the variable annuity as with the PDI. That's good news for the marketplace and for the consumer. It lets us be sustainable over the long-term," he added.

Prudential's new procedure is noted in the latest contract prospectus, dated February 10, 2014. A cover sheet announces that "This Rate Sheet Supplement Prospectus" supersedes all previous supplements. It makes clear that the current 5% roll-up and 5% payout rates for singles ages 65 to 84 apply only to applications signed between February 10 and March 14, 2014.

On page 44 of the prospectus, there's a further disclosure that, for people who sign a contract now but elect the income rider later, "the Withdrawal Percentages and Roll-Up Rate applicable to your optional living benefit will be those in effect at the time you elect the optional living benefit, which may be different than the Withdrawal Percentages and Roll-Up Rate available at the time your Annuity is issued."

Ferris said he expects other annuity issuers to adopt dynamic rate-setting, if they haven't already. But, while others know about it, they haven't necessarily begun to use it. At Lincoln Financial, which competes with Prudential in the VA space, a spokesman told RIJ, "We're aware of Prudential's approach. But we can't provide input on Lincoln's future plans."

An executive at a major mutual life insurer told *RIJ* in an e-mail, "I am aware of what Pru did and I think it makes great sense. The cost of providing the guarantees can fluctuate considerably. If manufacturers can be more dynamic in reacting to changing conditions they don't have to set prices as conservatively. That should benefit investors. I agree it will be a more widely adopted practice."

"I'm not hearing any specifics about whether other companies will offer similar features," said a Washington, D.C. attorney who counsels life insurers. "To the extent it represents a product evolution that is financially attractive to both carriers and customers, it would be logical to assume that other carriers will consider offering something similar."

But not everyone is cheering dynamic rate-setting. One broker-dealer executive told *RIJ* in an e-mail, "I can certainly understand why they want to do this, but I hope it doesn't become a trend. It creates some operations issues for the broker/dealers.

"First, there needs to be a process to lock in the current rates prior to them changing. We do this for fixed and indexed annuities (when rates and caps change) now and we have had to do it with VAs when they change their product. But it's never been a regular thing on the VA side.

“Next you have to make sure the advisers know what the current rates are. Again, this is not different from what we do for fixed and indexed products, but it’s new for VAs. Finally, several broker/dealers have tools that calculate the guaranteed minimum income from all of the VA riders they offer. Something has to update this tool every time Prudential changes rates. None of this in itself is a big deal, but it’s just one more headache.”