With New Indexed Annuity, Nationwide Takes a Walk on the Wild Side

By Kerry Pechter *Thu, Apr 17, 2014*

In February, Nationwide introduced New Heights, a fixed indexed annuity with an enticing "uncapped" crediting strategy and a novel living benefit rider for the b/d and independent agent channels. It's designed by Annexus to maximize what investors care about most.

Nationwide isn't known for selling fixed indexed annuities, but the big re-mutualized insurer introduced an FIA two months ago with the audacious name of New Heights. This product can be explained in only two ways: briefly and at length.

The short take: Nationwide has partnered with Annexus and its actuarial affiliate, Genesis Financial Development, to market a variation of a similar balanced index annuity that Annexus and Genesis first built for Aviva (now Athene) back in 2006.

The longer version: It will require many paragraphs of text and a link or two to describe the accumulation and income phases of this 10-year product, whose collaborators are betting that its uncapped equity exposure, the generous-looking payout percentages of its living benefit and Nationwide's strength (A+ rating from A.M. Best) will generate wide interest.

There are no slam-dunks in this business, of course. New Heights will still have to compete with top-selling FIAs like Allianz 360, which uses dynamic index allocation, and Security Benefit TVA, which is pegged to a volatility index.

It's also unclear whether this ambitious product, whose design (like that of most FIAs) may strike traditionalists as an unnecessarily complicated way to get exposure to the equity premium and generate retirement income, will make FIA-believers of the many remaining skeptics in the broker-dealer and wirehouse channels.

The timing is obviously favorable. Given the 50% spike in FIA sales in the second half of 2013 (thanks in part to modest interest rate relief), along the life insurers' reduced appetite and capacity to sell variable annuities with living benefits, and the Boomer income wave, it may be a no-brainer.

Mike Morrone, Nationwide's associate vice president of individual products and solutions, thinks so. "Every carrier sees that the FIA market is growing fast," he told *RIJ* this week. "And it will only continue to grow at this pace. We thought it was the right time to enter that market."

Morrone stressed that New Heights, like all FIAs, should be thought of a substitute for fixed income investments, not stocks. But references to equity performance are hard to avoid in any discussion about FIAs.

“The uncapped design helps maximize upside potential,” he said. “It will take advantage of big ups and downs in the market. If you think equity prices will bounce around in a tight range, this design may not be for you. It harnesses volatility.”

An ‘uncapped’ accumulation strategy

FIAs can be thought of as structured notes in insurance wrappers. The managers classically invest more than 90% of the available assets in bonds and the rest in call options on an equity index. The bond returns protect the principal and the options, by appreciating when equity prices go up, offer upside potential.

But creative actuaries can tailor the outward features of FIAs in countless ways. With New Heights, Nationwide currently offers a choice of three “uncapped” strategies with two-year terms. The three strategies promise investors three levels of “participation” (up to 70%) in the gains of the S&P 500 Index that are in excess of a “spread” of up to 1.85%. In addition, a portion of the account value grows at a declared annual rate of one percent.

Nationwide explained how the crediting calculation would work if you used the 60% participation rate and the 1.85% spread. Suppose, for instance, that the S&P 500 rose 30% over two contract years. You’d multiply 30% by 60%, to get 18%. Then, to find the two-year return from the fixed account, you’d square one percent (and get 2.01%, or 1.01 squared minus 1) and multiply that by its participation rate (40%). The result would be 0.804%.

Add those two and you get 18.804% over two years. To annualize that return, you’d take the square root of that number (the square root of 1.8804, minus 1) to get 8.997%. You would then subtract the 1.85% annual spread from that number and get 7.15%. Finally, you would square 7.15 (1.0715 squared minus 1) to find the two-year credit of 14.8%.

The uncapped crediting strategy (also known as “term yield spread”) appears at first glance to promise a greater potential for upside gain than FIA crediting strategies, such as participation rates or capped rates do. It doesn’t necessarily.

According to Jack Marrion’s classic 2003 book on FIAs, *Index Annuities: Power & Protection*, “the participation rate method produces more credited interest in fair markets, the yield spread approach maximizes returns in great markets, and they come out about the same in good markets.”

Aside from the fear of missing out on the next bull market, New Heights addresses other perceived client concerns. “We tried to take care of some of the pitfalls that we see in current FIAs,” Morrone told *RIJ*. “Clients today expect to see if their investments have appreciated or depreciated each day. They can’t see that in current FIAs. They’re black boxes. In point-to-point contracts, no daily values are available. We thought that was a defect. People should be able to see the contract value daily.”

“Because we evaluate the performance daily, we can calculate the full gains to date. People can see what their values are.” That allows another innovation: If the client takes a penalty-free withdrawal of no more than 7% of the contract during any of the five two-year terms of this 10-year product, he or she gets the credit earned up to that point, as if it were the end of the term.

Anxious investors have access to another stress-reliever. If they think the market is going to drop, they can freeze the crediting process at any point during a term and lock in the accrued gain. This feature addresses potential investor concern about using a two-year crediting term instead of the more common one-year term.

New Heights' living benefit

The product's guaranteed lifetime income benefit is also structured in an innovative way. Most living benefits on VAs and other FIAs offer annual increases (roll-ups or deferral bonuses) that double the benefit base (the amount used to calculate annual income payments) after a ten-year deferral period. With its High Point 365 New Heights reaches a similar payout level by a different route, Morrone said.

The roll-up is only two percent per year for 10 years, instead of the usual seven. But the annual payout percentages at age 65 or 70 can be higher than the five percent that's common with seven percent roll-ups. In addition, there's an opportunity for daily increases in the benefit base, as opposed to annual or quarterly increases. (Income can't be taken before the five-year contract anniversary).

A table of examples in the New Heights product literature for a single-life contract shows that someone who bought the contract at age 55 would qualify for an annual payout rate of 6.65% after 10 years and 9.4% after 15 years. A 60-year-old purchaser would receive a payout rate of 7.4% after 10 years and 11.40% after 15 years. Payouts of joint contracts would be lower.

The basic High Point 365 rider costs 95 basis points a year. The cost increases to 1.25% for contract owners who elect a 3% bonus to the contract value, the benefit base and the return of purchase payment guarantee. The rider can only be elected at purchase and generally can't be dropped as long as the contract is in force.

The FIA 'gospel'

The same caveats that apply to other FIAs also apply to New Heights. The product brochure promises "unlimited growth potential," but broker-dealer reps and their clients could be disappointed if they purchase this product and get average earnings that are only a few percentage points more than bonds. Nationwide's Morrone insists that New Heights isn't intended for people looking for equity-like performance.

The profusion of options that New Heights offers will probably strike some advisors and clients as a welcome source of flexibility. But for others the number of choices could represent unwelcome complexities. It's clear no two contract owners will experience exactly the same results.

The actuaries who built this product made some interesting cost-reducing choices. They extended the crediting term to two years; two-year options are cheaper than one-year options. To allay liquidity concerns, they credited earnings to mid-term withdrawals. They also cut the annual penalty-free withdrawal percentage to seven percent from the usual 10%, and required contract owners to choose either a living benefit or death benefit, not both. These adjustments created room for lower spreads, which translate into higher crediting rates, and a reported seven percent commission.

One FIA marketer interprets the recent hockey-stick increase in FIA sales and the entry of companies like Nationwide into the FIA market as signs of a gradual but inevitable thaw in attitudes toward FIAs.

"I've been preaching the FIA gospel since early 1996, and I never thought I'd see them treated as just another annuity in the annuity space, as a peer with variable annuities," said Paul McGillivray of CreativeOne, a prominent insurance marketing organization. McGillivray is responsible for wholesaling FIAs, including New Heights, to broker-dealers.

"But I knew things were changing when I was accepted on the program of [last week's] LIMRA Retirement Industry conference," where he gave a presentation on FIAs. "I'm still in shock." He believes that Boomer demand for longevity protection, which VAs and income annuities alone can't satisfy, will continue to drive FIA production and sales.

"I have recently heard three times from three different people that the demand for annuities and lifetime income will far exceed the capacity of VA issuers," he told *RIJ*. "So it's natural that more carriers would take a serious look at the FIA."