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Fixed Annuities in a Low Interest Rate Environment

by Susan J. Sell

The recent economic environment has presented difficult choices for investors. With the equity markets weak and interest rates low, most investment choices do not appear attractive. Many investors have taken a "flight to safety" and opted for a guaranteed return in a fixed annuity, even at yields as low as 3 percent annually.

Despite the challenges in the fixed annuity market, including some downgrades from the rating agencies, there has been a strong increase in fixed annuity sales. Such products have gained ground on variable annuities (VAs) over the past two years. Some distributors, like stockbrokers, have been selling more fixed annuity products than ever. Increases have been realized in all types of fixed annuities—book value deferred annuities, market value adjusted annuities (MVAs), equity indexed annuities (EIAs) and

fixed immediate annuities. According to LIMRA International, EIA sales in the third quarter of 2002 were 88 percent greater than those in the same period of 2001. Similarly, book value annuities, MVAs and immediate annuities showed increases of 60 percent, 61 percent and 44 percent respectively, over the same period. EIA sales have grown the fastest, perhaps because they are the first refuge for purchasers retreating from VAs.

In recent times, multi-year rate guarantee fixed annuities have dominated the fixed annuity market. Some include guaranteed stair-step credited rates where credited rates are guaranteed to increase by a stated number of basis points each year of the guarantee period. Such stair-step increases have ranged from 10 bps to 25 bps. These types of products have been popular in the bank channel since bank customers are attracted to the certainty of an increasing credited interest rate over a specified period of time despite starting at a low level.

Many of the multi-year designs include a market value adjustment. MVAs have increased in popularity since credited rates may be as much as 25 bps higher than for a book value fixed annuity, due to lower capital requirements and a reduction in interest rate risk. Nearly one-fourth of recent fixed annuity sales have been MVA sales. MVAs have been popular both as standalone products and as fixed accounts within VAs. A number of carriers are developing their first MVA products and are entering the market. Other carriers are dusting off their MVA products and marketing them again. Because insurers are finding it difficult for one-year and three-year interest guarantee periods on MVAs to be attractive (given low investment yields), the focus has moved to longer guarantee periods. In addition, with the exception of the bank channel, compensation has been lowered on many MVA products in order to increase crediting rates.

First year bonuses provide an initial softening of low interest rates. Bonuses in the range of 1 percent to 2 percent still appear on fixed annuities and help to bolster sales. Many EIA products now include a first year percent of premium bonus. According to LIMRA, more than 55 percent of EIA sales in the third quarter of 2002 included such a bonus.

Fixed immediate annuity sales in the third quarter of 2002 equaled $1.3 billion, according to LIMRA. Sales for calendar year 2001 were $3.6 billion. Pricing in the large case market has gotten more competitive recently. Some agents have taken a cut in commissions in order to boost payouts. Immediate annuity mortality assumptions appear to be getting more aggressive. From a surplus strain standpoint, it is a favorable environment to sell immediate annuities since statutory valuation interest rates are greater than pricing interest rates.

Fixed accounts within VAs have also attracted more dollars. Fixed account assets were at their highest levels since 1997. Some investors have purchased variable annuities specifically to invest in the fixed account. According to VARDS, fixed account allocations increased from around 22 percent as of December 31, 2001 to nearly 30 percent as of September 30, 2002.

VA fixed account growth has occurred despite the fact that many VA carriers have been forced to take drastic measures due to the volume of allocations to the fixed account. In general, the availability of fixed accounts within VAs is becoming more limited. A number of VA carriers have found it necessary to close down the fixed accounts in their C-Share (no surrender charge) VAs because the combination of 3 percent interest guarantees and no surrender charge provided an overly generous offering. Recently, fixed accounts have been closed down on some L-Share VAs. (L-Share products are also fairly liquid and include a short surrender charge period of three to four years.) An increasing number of VAs have closed down the shorter guaranteed periods of the fixed account.

The Standard Nonforfeiture Law for Individual Deferred Annuities requires that the cash surrender value be at least as great as the net premium (90 percent of gross on single premium products and 65 percent first year and 87.5 percent renewal on flexible premium products) accumulated at 3 percent annually. This creates a de facto floor to interest crediting that can squeeze pricing margins to the point of unprofitability in some cases. At the request of the life insurance industry, the NAIC has taken steps to make nonforfeiture requirements more responsive to the interest rate environment.

In actuality, even without the NAIC actions, insurers have an alternative to achieve lower future crediting rates than 3 percent; however, it is only a partial solution and is seldom used. Lower rates are workable if the cumulative credited interest on the gross premium exceeds the cumulative three percent on the net premium. Several states may, however, require the 3 percent minimum as a year-by-year minimum credited rate.

In early 2002, the NAIC gave its support to having states reduce the nonforfeiture interest rate to 1.5 percent on an interim basis (the legislation is only effective for two to three years). Because only 19 states have changed their laws in this fashion, few insurers have taken advantage of the change. There is general reluctance by many insurers to credit less than 3 percent, especially if competitors still are crediting 3 percent.

The development of a revised model Standard Nonforfeiture Law for Individual Deferred Annuities is progressing and may have already been approved by the NAIC at the time this article is published. The result should be a greater opportunity to offer shorter guarantee products in low interest rate environments.

The uncertainty of the economic markets will continue to present challenges and opportunities to both investors and insurers. The shape of the current yield curve gives fixed annuities an opportunity to offer products that are more attractive than other financial instruments. The added flexibility from nonforfeiture revisions should broaden opportunities further. ☐

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