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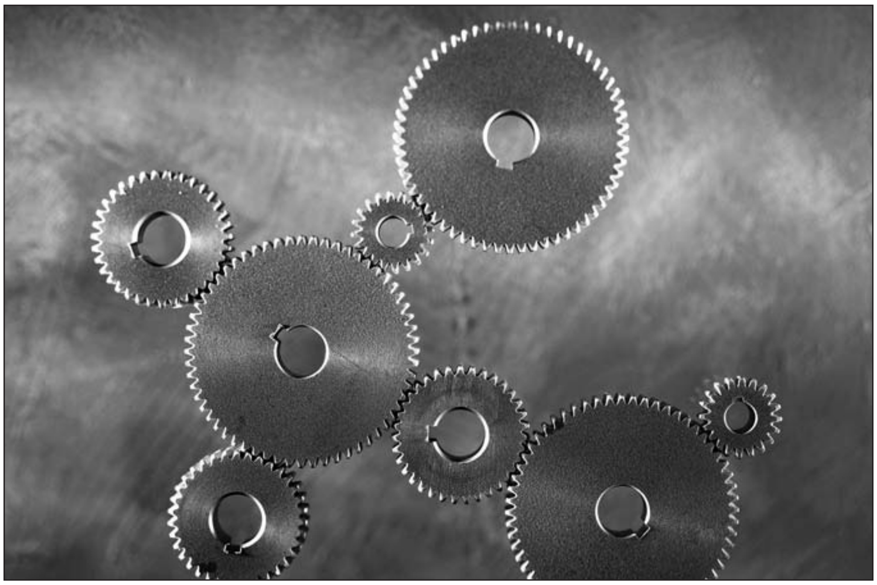
Is the Timing Right for Equity-Indexed Immediate Annuities?

by Susan J. Sell



The popularity of equity indexed annuities (EIAs) has exploded over the last few years. According to Advantage Compendium, EIA sales in calendar year 2004 were $23.4 billion, a 64 percent increase over 2003 EIA sales. New companies entered the EIA market, bringing the total number of companies that comprise the market up to 33. These companies have a strong understanding of how the equity index component works in a deferred annuity product. Systems, hedging and processes are in place to support equity-indexed products. Reps and customers have become more comfortable with EIAs, and their level of understanding has also increased. A logical progression in this market may be expansion into the income side of the business.

Is now the time to consider introducing an equity-indexed immediate annuity (EIIA) to the market? Currently, many carriers are focusing on the retirement income market. They are trying to figure out how to address the many issues that continue to haunt current payout annuity products. One issue that the retirement income market faces is the lack of inflation protection. Single premium immediate annuities (SPIAs) generally do not address this issue, unless a costly cost-of-living rider is attached. Variable payout annuities do provide upside potential, but at the price of exposure to downside risk. Downside protection is available on variable payout annuities in the form of guaranteed payout annuity floor riders. Such riders may be costly. Further, there can still exist volatility of the variable payout annuity benefit from period to period at levels above the floor. Similar to the deferred EIA, an equity-indexed immediate annuity can provide upside potential with a guaranteed floor on the payment amount. EIIAs are non-registered products under the same core principles as deferred EIAs.

How would an equity-indexed immediate annuity work? One approach is to calculate the base payment in a manner similar to the calculation of a SPIA payment, but with recognition of amounts needed for the EIA hedge budget. One way to reflect this budget would be to reduce the interest rate that is used to calculate the payment amount by an amount that represents the hedge budget (e.g. 1 percent). This base payment represents the minimum benefit amount that is payable for the duration of the benefit option.

One of the issues to consider in developing an EIIA is how the payment amount reflects the gain in the selected index. Several options are available, but the approach is likely dependent on the averaging method used to determine the gain. Another factor is the frequency of reflecting the gain in the payment amount. Payments could vary on a monthly basis (for monthly mode business) or could be held constant for a 12-month period and varied on an annual basis. The latter approach is similar to annual benefit stabilization methods used in variable

income products. The approach used to reflect the change in the index in the payment amount is not dependent on the frequency of reflecting the change. If there is no gain in the index, the base payment is not adjusted. This is the downside protection offered by the contract. Any index growth in the contract could be:

a) Amortized over the remaining benefit period using then-current interest rates, or
b) Amortized over the next year or the frequency of reflecting the gain in the payment.

The former approach increases all future payments by the same dollar amount. If the gain is not amortized over the remaining benefit period, there is a risk that payments could decline. Similar to variable income payments, frequent ups and downs in the payment amount could be unsettling for payees.

One of the perceived barriers of income products, in general, is the lack of liquidity. Some level of liquidity should be considered for EIIAs to improve their appeal to agents and policy owners.

In theory, compensation for EIIA products should be higher than that paid on SPIAs. The product is somewhat more complicated than a fixed payout annuity. Ongoing service may be required to explain the changes in the payout amount.

Carriers have been trying for years to ignite the payout annuity market, and the market seems ripe for this opportunity with the current focus on retirement income. Perhaps equity indexed immediate annuities will be the spark needed to start the momentum. ☐

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Does an actuary truly need to give up his or her Jedi Knight training received from the SOA to join the "dark side" of sales? The answer is clearly no, as Jon Davis has shown. His business today is growing. Success is truly occurring for this entrepreneur.

But did Jon truly go to the dark side? I think not. We can all learn a great deal from someone like Jon who can help us see there are many aspects of the business we don't truly understand. Listening to the customer, making things simple, adding value, and doing things right, these are all the attributes that we as actuaries seek to follow. Jon Davis is showing that working in sales and marketing is not at all evil. On the contrary, it is a very noble endeavor. We should all spend a day in the life of an agent; we could learn some very invaluable lessons. And we can become even stronger Jedis.

May the Force (of mortality?) be with us all. The Force is truly with Jon Davis. ☐