SOCIETY OF ACTUARIES

Article from:

Small Talk Newsletter

November 2000 – Issue No. 21

Deferred Annuities: A Tiger by the Tail

by James R. Thompson

Intoduction: Many smaller life companies sell a mixture of permanent life and fixed annuity policies. Some are trying to sell life insurance but have kept a traditional annuity around and not paid that much attention to the pricing. Suddenly in the past year, money is pouring in, almost without asking for it. Was it considered an unexpected bit of good news? The reason lies in the other market places. The past two years have seen some surprising shocks by the Federal Reserve, which lowered interest rates to levels not seen for decades. The high returns in the stock market a few years ago have been replaced with lowered stock prices as well as low yields in the bond market. Furthermore the interest available on bank CDs has dropped to practically nothing for the short term.

Many stock life insurance companies, which are active in the deferred annuity market place, do regular pricing studies and keep track of their own investments and the competition. Their rates for interest guarantees on new SPDAs are often below 4 percent. Some stock companies sell CD annuities which have a short guarantee of 1-5 years, after which the annuity renews. In the last year, the typical one year CD annuity has dropped its interest rate from about 3.25 to 0.5 percent and its 5 year guarantee from 4.25 to 3.25 percent! Overall fixed annuities have gone from 5.25 percent to 4 percent.

Comparison Between CD Annuities and Traditional Portfolio Priced Annuities

Traditional annuities are relatively simple. There is a back-end surrender charge lasting five to ten years, and the credited rate is based on the Company's overall portfolio regardless of whether the money is a new policy or in-force policy. Sometimes, there is a first year bonus. An annuity more commonly found in the brokerage market is called a CD annuity. This has a level interest guarantee for as long as there is a surrender charge. Then the contract renews, and the guarantee is the same as if the contract had been purchased for the first time. Sometimes different interest guarantees are offered, say one, three, five and seven years. The surrender charge for each guarantee disappears at the end of the guarantee. Naturally the shorter guarantees have lower interest rates. Because this was such a popular contract type, the lowered interest rates caused the interest guarantees to drop way below 3 percent for the shorter terms.

This is what triggered the crisis in deferred annuity pricing and one reason why the regulators acted twice to change the annuity nonforfeiture law. The other concern was that companies with flexi annuities in effect were creating an option for policyholders to put money to the company at guarantees which they could not afford to cover, perhaps so high that they could not even earn that much! This year I have encountered companies which had a 4 percent, and even a 4.5 percent, contract guarantee, but many are changing to the 3 percent.

New SNFL

Because of this crisis, the National Association of Insurance Commissioners (NAIC) created a temporary fix by allowing an interest rate of 1.5 percent but this had a sunset date, which varied from state to state when they adopted it, as many did. This year they passed the revision to the Standard Nonforfeiture Law for Individual Deferred Annuities. The heart of this is the indexing of the guaranteed interest rate. It is capped at 3 percent and given a floor of 1 percent. It is indexed to a five year maturity treasury rate less 1.25 percent.

There is a redetermination process. After the initial period, the interest rate can be redetermined based on a more current value for the five year maturity treasury. The purpose of this is to allow CD annuities to reflect current conditions. If a company offers a conventional annuity, it can let the initial period run until maturity, and effectively, forego the redetermination.

The consequence of this is that, if we continue in a low interest environment, the guarantee can be kept lower, and there will be a profitable pricing spread between the earned rate and the guarantee. The lower guarantee will not be hard to sell since it will only occur in an environment where rates are low. Thus comparatively speaking it will be reasonable. We do not want companies to have too tight a pricing spread between the earned rate and the guarantee; otherwise, they will go bankrupt. If interest rates move back up, the index will move up and will be capped at 3 percent.

I attended many of the conference calls where this was discussed. I noted the enthusiasm for passing it. Once it passed the NAIC, state adoptions have been following fairly quickly. Nine states have adopted it with effective dates in 2003, including Connecticut, Iowa, Minnesota and Texas. North Dakota's effective date is

There is a temptation to invest in longer maturity bonds since they generally have higher yields.

in 2005, and that for Oregon is 2004. Five more states are planning to adopt, including Wisconsin and Massachusetts. About three dozen states have the 1.5% minimum or something similar. A significant state not planning to adopt either law is Florida, which contains a lot of older people, who are prime candidates for buying annuities.

Both the financial management and marketing sides of a company should be following this. If there is a trend towards the 1.5 percent guarantee, you need not maintain a higher one. If there is a trend towards the indexed rate, you will have to learn how to monitor the treasury rate and the competition to keep your guarantee legal and competitive.

Actuarial, Investment and Marketing

Another problem is determining the crediting rate. You want to have a rate which will keep your current policyholders happy, attract new ones and still not lose money. Although first year bonus rates are popular, ultimately you must still make money from the spread between earned and credited. You are probably finding that new investments earn less than your current portfolio.

Does that mean that your new policyholders will get less than your current policyholders? Many smaller compnies do not do this. But if you credit both the same while new investments are earning less, the new policies will cause an overall lowering of the earned rate and hence the credited rate. Do you really want all this new business? Yet, the crediting rates on your in force policies are looking generous in the market now and are likely to retain policyholders.

There is a temptation to invest in longer maturity bonds since they generally have higher yields. This poses a danger if the interest climate should suddenly turn upward. Then, even the long bonds would not keep up with current new money yields and your portfolio rate would become non-competitive. Policies would lapse and you would lose because the sale of the bonds backing them would be worth less in the rising interest environment. What to do? It seems you are between a rock and a hard place. The new annuity sales are a tiger by the tail! You must seek a balance and study your investment approach.

Another strategy is to balance your annuity sales with life sales. Perhaps you should consider restricting new annuity money or selling more permanent life products. Should you shut off all annuity sales, or should they be restricted to be some proportion to life premium? Management and the field should have a common understanding of any steps taken.

Conclusions

Many brokerage-oriented insurance companies have been managing annuity money for years through up and down interest environments. They continue to do so. Our aging public continues to look for places to put their retirement savings, both for qualified money like IRAs and non-qualified. If the smaller and less sophisticated companies are going to continue accepting annuity money, the annuity line cannot be left on the back shelf to manage itself. Management must decide to spend time understanding and monitoring investments, regulatory developments and pricing spreads.

James R. Thompson, FSA, MAAA, is an actuarial consultant working in Crystal Lake, IL. His email address is jimthompson@ameritech.net.●

James R. Thompson. FSA, MAAA, is the newsletter editor and is employed with Central Actuarial Associates. He can be reached at 815.459.2083or at jimthompson@ameritech.net