CANNEX RESEARCH

Conversations with CANNEX Q&A: Bobby Samuelson of Life Innovators

Cannex's Tamiko Toland had the opportunity to talk about the true cost of annuities with annuity pricing guru Bobby Samuelson, who now runs Life Innovators, an independent life insurance and annuity product development firm. Bobby dives into questions of fees and profits on fixed indexed annuities (FIAs), variable annuities (VAs), registered index-linked annuities (RILAs, also known as structured or variable indexed annuities). If you've wondered about the true costs of annuities, tune in to the replay to go even deeper than the summary presented here.

Q&A

If an annuity has no fees, is it free?

Fixed annuities and many RILAs may have no explicit fees, but there are still underlying costs that the insurance company has to cover. A typical VA may have an M&E of 125 basis points, which is in line with or even lower than the fees built into an FIA. The effect of the fee shows up in the rates, which are lower than they otherwise would be. There is direct evidence of this in fee-based (advisory share) FIAs or RILAs and the respective B-share. The difference in rates reflects that fee, which is absent in the advisory share because advisory fees are taken outside of the contract fees.

"There's no such thing as a free lunch. There's no such thing as a free annuity."

Which is better: explicit or implicit fees?

It's understandable why financial professionals would prefer to offer "free" annuities, Bobby opined. But for consumers, the implicit fee structure lacks transparency and accountability and buries key elements of the cost structure that could help them make a decision. For a client, having a higher rate in conjunction with a declared fee would allow for a clear comparison of these two factors separately that would help the client understand the basic pricing dynamics. He further explains that an explicit fee would better expose when a company is offering a higher rate on a potentially temporary basis or another has a lower rate but also lower inherent fees.

"The last thing the annuity industry needs to be right now is more of a trust-me product than it already is. It would be much better to show a client how it worked."

Where does the money go from variable annuity fees?

It goes to all the logical places you would think that it goes. RIAs often criticize the high cost of annuities and may estimate that the management fees run around 100 to 200 basis points. In fact, the M&E (mortality and expense) fee on a fee-only VA runs on the order of 25 basis points which is comparable to an actively managed mutual fund or ETF. Variable annuities are actually fairly efficient wrappers and insurance companies are not charging exorbitant managements fees for themselves, Bobby concluded.

"That's point number one: it's not like there's lots of carrier profit built in all these overhead expenses at the end of the day."

Moving on from insurer overhead to commissions, the difference isn't as stark as it seems at first blush, Bobby argued. Commissions can be as high as 7% for a contract with a 7-year surrender charge period. However, this is comparable to 1% in management fees charged by a fee-based advisor over the same period. The difference is that this is paid up-front rather than spread out over the seven years. Much of the M&E is simply commission recapture that is similar to what an RIA would have charged as an investment management fee.

"In a lot of ways, the [mortality and expense fee] is just commission recapture, which looks pretty similar to what the RIA would have charged for an investment management fee."

The most confusion comes from the rider-based benefits. The stated cost for the rider is 125 to 150 basis point, which sounds like a lot. However, there is no comparable benefit calculation that determines that the intrinsic value might be, for example, 175 basis points. Even though the insurer may be undercharging the client based on a certain set of economic projections, many people simply focus on the fees because they don't have a way to mentally model the benefits. The fact is that the benefit allows the client to transfer a significant amount of risk to the insurer at what may prove to be a very reasonable price, Bobby explained.

"We don't do a good job as an industry of explaining the real power of the benefits so people just see the cost."

Where does the money go from income rider fees?

The fee repays the capital the insurance company posts to back the rider based on the worst-case scenario, which could amount to 15% to 20% of the initial premium. Rider fees provide a return on capital for the insurer and surrenders release capital back to the insurer.

On its own, the fee does not cover losses in the event the worst-case scenario comes to pass, resulting in expenses for the insurer. However, in the better-case scenarios, the insurer receives fee-based revenue and does not need to provide payments from its own accounts. Therefore, Bobby characterizes the fee as a calibration mechanism along the spectrum of better-to-worse scenarios that balances between the drag on account value performance and return on capital.

"The value of the rider is potentially greater than what the carrier's charging you for it. It's just that a lot of people who are not in this business don't see it."

Why don’t insurers simply charge a higher price for a very rich benefit?

There is a balancing act between the richness of the benefit and the drag that a higher fee would create on the account balance. A higher fee would draw down account values even more and more likely put the rider further into the money, meaning that the value of the benefit exceeds the account value.

However, the perception of the value of the benefit based on future economic expectations may be different for the client and the insurer. If the client is more pessimistic than the insurer, the benefit may seem more valuable—and therefore underpriced—than it is to the issuing company, Bobby explained.

“Is it a good fee or a bad fee? I [ask whether] it is a reasonable fee based on the potential outlying scenarios?

How does fee compression hurt annuities?

The investment management industry has moved towards lower fees and greater transparency. For annuities with income benefits, this equates to lower fees and less guaranteed benefits. The larger problem is a history of poor explanations of what these fees are and why they’re there in the first place.

“We don’t necessarily want lower fees because lower fees mean less benefits. We want benefits for households: that’s what sets us apart.”

How does the income benefit represent a different kind of risk for insurers?

People understand that insurance companies take on risk but generally have in mind the traditional risks: mortality, morbidity, and longevity. However, with variable annuities and living benefits (as well as guaranteed universal life), they also delved into financial risk. While a GLWB does have a longevity component, the risks the life insurer assumes are primarily market-related risks: interest rate risk and equity risk.

The guarantee functions as a 30-, 40-, or even 50-year put option that never resets in price but remains on the insurer's balance sheet. Not only is it impossible to view the profitability of these products through a purely short-terms lens, but price-setting is an imprecise exercise that always results in mispricing. The question, Bobby adds, is how far off the mispricing is and in what direction.

"Essentially, these are put options. These are very long-dated, longevity-based put options priced inside the product."

Is there a novel way you can demonstrate the value of income benefits to consumers?

The way Bobby sees it, the very existence of hedging programs to cover the financial risks inherent in income benefits proves that income benefits are worth their salt. After all, insurers would not invest that effort and money in hedging unnecessarily.

"If these products did not have any intrinsic value, carriers would not feel the need to hedge them and charge these fees. The competitive market would drive that down to zero."

How should a client respond to a buyback offer for an older benefit?

Bobby shared a case study that is near and dear to his heart, an annuity buyback offer to his grandfather's 74-year-old fiancé. This older annuity had a rich benefit with no investment restrictions, all for a fee of 0.70%. Whereas she felt that she had an expensive investment account, Bobby knew she was holding a goldmine.

While Bobby joked that the very fact that the insurer was trying to buy it back demonstrated it was good, but he focused on the fact that she didn't understand what she had owned and the financial professional who had sold it to her had never explained how to use it. Many people are in a similar situation and it's incumbent on the industry to change that.

"A lot of consumers just don't understand what they bought. It's our job to make sure our clients understand what they're buying and the value of what they're paying for."

How is the profit from selling socks and annuities different?

A sock manufacturer has a good handle on the amount of profit it earns on each pair of socks. Life insurance and annuities are completely different. For example, for every person who gets hit by a bus after buying a single premium immediate annuity, there is another person who lives to 110. Bobby explained that one person feels they got the raw end of the deal while the other hit the jackpot. The insurance company pools that risk and price it based on actuarial expected return, but what is the right view of the profit on that?

A sock manufacturer takes a simplistic view of profit and costs and does not have to worry about the fate of the socks after they leave the warehouse. By contrast, the largest part of profit for an insurer revolves around the earning a return on the capital required to support the products over a very long time horizon

"I don't think people really understand that selling insurance is not like selling socks. This is a capital product that requires fees on capital, that's the raw material to make it work."

How do you respond to the "getting hit by a bus" objection to income annuities?

The client needs to think of SPIA as insurance, not an investment. There are events on the long and short end of the tail. The client exchanges the short tail risk of the bus accident for increased coverage for the long tail risk, which is longevity. Of course, death benefits on the SPIA are another way to mitigate the bus risk, Bobby pointed out. It's important for clients to buy insurance that matches their concerns and the SPIA is really designed for people who are worried about outliving their money.

"If you're planning on getting hit by a bus, don't buy an annuity because you're paying for insurance that you're never going to use… That said, if you're really worried about getting hit by a bus, go buy a life insurance policy."

What is a big threat to the annuity industry today?

As long as returns on capital are low, the sustainability of the life insurance and annuity business is threatened. Negative or even unacceptably low returns would limit the flow of capital that is required to issue new products. Insurers have to find ways to provide returns on capital so they can generate the capacity for new sales.

"In order for [the insurance company] to justify getting capital, you have to pay a return on capital. And if you can't do that, there's no reason for your business to exist. There wouldn't be any life insurance and annuities."

How are RILAs fundamentally different to clients and insurers?

The RILA (also known as a structured annuity or variable indexed annuity) is completely different from an income-oriented annuity because it is generally focused on accumulation. The buffer structure works well in a low (even 0%) rate environment because the client assumes the real risk of the sold put option in order to get more upside. The dynamic of significant losses in the buffer structure has not played out in recent history, but it eventually will.

While Bobby said he sees a distinct role for these products, he also believes that the industry should not let the focus on RILAs take away from the income story that represents the unique value proposition of annuities. While the RILA competes directly with the structured note or buffered ETFs, there is no direct competitor to the income benefits of an annuity.

"The more we tread on other financial instruments' turf, the more we have to compete on their playing field. Let's compete on our playing field, which is guaranteed income."

What does the RILA (or new ideas we haven't seen yet) have to do with old income benefits?

With mortality risk, the more policies a company issues the more it reduces its chance of an outsized event. However, the opposite is true with financial risk, where issuing more policies increases that chance. The chance that every consumer who bought an income benefit over the course of a decade will live to an extremely advanced age is nil, but the chance of a 30% market drop affecting all of those policies is nearly certain, Bobby explained.

The best way to offset this risk is actually in the design of new contracts, which explains some of the interest in RILAs. Therefore, product design may not simply reflect the current economic environment but also take into account older business that has a certain risk profile that is complementary to the new design.

> *"[Insurers may consider developing] a product that would not make any sense financially to sell on its own but makes a lot of sense to sell in the context of a bigger block that behaves a certain way, which changes the product development dynamic."*