Cannex’s Tamiko Toland explored current practices and innovation in annuity design and product development with Elliott Shifman, Consulting Actuary. Elliott is a Fellow of the Society of Actuaries who specializes in the design and structuring of principal protected solutions and has held a number of senior management positions within the insurance industry over the last 25 years. Recently, he led the development effort as a contractor for individual retirement products in the United States for Legal & General. Prior to striking out on his own, Elliott established the Registered Investment Advisor channel at the Security Benefit Group and helped grow assets under management to nearly $2 billion.

Elliott talks about the details of pricing and managing fixed annuities, particularly fixed indexed annuities. He also discusses the use of offshore reinsurance, which may give insurers a pricing advantage but that many view as a risky practice.

You can connect with Elliott on LinkedIn.

Q&A

How is an FIA different from a variable annuity? .................................................. 2
How does an insurer actually manage fixed annuities and determine the rate? .......... 2
Why don’t insurers just invest in higher-yielding bonds to give higher rates? .......... 3
Can you describe pricing for an FIA assuming 4% revenue on the bond revenue? ..... 4
How can insurers increase either their own profit or client value? .......................... 4
How can an offshore insurance structure reduce cost without increasing risk? .......... 5
Can’t investors build an FIA guarantee on their own? .......................................... 5
Do you have any annuity “pet peeves”? ................................................................. 6
What do you miss about the past? ........................................................................ 6
What do you look forward to for the future of the industry? ................................. 6
How is an FIA different from a variable annuity?

All fixed annuities, including FIAs, are based on a promise, not the performance of certain assets. The insurer has an investment strategy for all fixed annuities that involves bonds and may, as in the case of FIAs, also use options. However, the insurer’s obligation to the client is based on the original promise, not the performance of those investments, Elliott explained.

“If you own a fixed indexed annuity, which is a general account product, whatever guarantee the insurance company promised you, regardless of how the assets backing the guarantee are invested by the insurer, you’re guaranteed the promise.”

How does an insurer actually manage fixed annuities and determine the rate?

General account products like fixed annuities are typically backed by bonds. The insurer starts by using models to match the bonds in the portfolio to the expected and promised cash flow from the annuity. In the case of a very liquid annuity with no surrender restrictions, this would mean investing in shorter-duration bonds. On the other hand, contracts with longer surrender periods, nine or more years, would invest in a portfolio of bonds with a longer duration, likely seven to 10 years in duration.

The insurer uses current yields on bonds, net of expenses, and an expected default margin, in order to figure out the targeted credited interest to clients and project expected revenue and expenses. Revenue includes surrender charges, if any, that the insurer expects to receive from people surrendering their policies early, and is expected to be a “small factor in pricing,” Elliott mentioned.
The insurance company has to cover a variety of different expenses:

- Policy-related: issuance (setting up in an administration system, generating and sending out the policy), and maintenance
- Miscellaneous: charter fees, accounting and reporting fees
- Distribution: commissions
- Capital costs: regulatory capital held to back the guarantee

“In order for the insurer to set a credited rate, the insurer needs to estimate the expected yield of the investments backing the policy.”

**Why don’t insurers just invest in higher-yielding bonds to give higher rates?**

Because the insurers base their credited rate off of current bond yields. Since higher yields are more attractive to clients, you might expect insurers would pick the highest-yielding bonds. However, Elliott pointed out that after the lower quality, higher yielding bonds are reduced for the expected (higher) default rate, the additional yield typically vanishes. Furthermore, an insurer using higher-yield bonds would also have to adjust its regulatory capital.

“There are no free lunches in pricing. More yield typically is accompanied by more expected risk and, therefore, the expected default rate of those instruments would be higher.”
Can you describe pricing for an FIA assuming 4% revenue on the bond revenue?

If you assumed 4% in revenue from investments (plus expected surrender charges), hypothetically an insurer may allocate 2.5% towards supporting the crediting strategy. Administrative expenses hypothetically run 0.25% per year and 0.75% towards the commission (even though it is usually paid up front, as an illustration, the cost is spread out over time). The cost of regulatory capital is illustrated at 0.25%.

Following this through, this equates to a net profit of around 0.25% per year depending on the actual investment and client experience.

“Twenty-five basis points (0.25%) is a good high level illustration of revenue minus expenses.”

How can insurers increase either their own profit or client value?

An insurance company located outside the United States can expect lower capital requirements that allow that cost of capital to be lower than 0.25% and therefore increase the opportunity for profit or giving clients more interest.

Elliott explained that he recently talked to a private equity firm about this and he believes that there will be significant interest in this path for others in the next few years. Lower interest rates and higher volatility both put the squeeze on insurers and private equity firms see an opportunity to expand into the insurance business.

“The biggest opportunity for higher profits in the revenue-minus-expenses equation is either to hold less regulatory capital and/or to create less costly hedging strategies through volatility controlled indices.”
How can an offshore insurance structure reduce cost without increasing risk?

The fact is that many insurance companies are already doing this through a captive reinsurer offshore. Many offshore reinsurers operate in Bermuda which, like the United States, has equivalency with Europe’s Solvency II requirements.

Evaluation of the scenario testing is therefore a crucial part of the insurer’s process to determine whether this is a viable path for their businesses.

“It comes down to whether the scenario testing of the regulatory authorities offshore is sufficient enough to cover the expected losses.”

Can’t investors build an FIA guarantee on their own?

While it’s possible for an individual investor to reproduce the floor guarantee and index participation of an FIA, there are benefits to professional management. For one, insurers buy millions of dollars’ worth of options at once and therefore leverage that purchasing power to effectively get a discount on those options. For another, the insurer takes on the risk of managing the selection of options correctly. Furthermore, the options associated with low-volatility indices are simply not available in the retail market.

Elliott pointed out that an individual embarking on this strategy would eliminate the distribution cost, which was 0.75% in his example. However, the brokerage commissions on bonds and options would likely exceed that savings. As an institution, the insurer benefits from pricing efficiencies compared to retail brokerage.

“It’s not an easy task and somebody with the proper expertise can do that themselves, but having a professional manager put the package together adds real benefit. Insurers also offer riders with lifetime guarantees that could be bought separately by policyholders.”
Do you have any annuity “pet peeves”?
Elliott said that commissions and sales loads are not compared fairly. For example, critics of fixed annuities argue that up-front commissions are too high and unfair to the client. However, consider if a client holds either a 6–8% commission fixed annuity or a mutual fund with a 1% trail for 10 or 12 years. The discounted value of the annual 1% load could be higher than the single up-front commission.

“My biggest pet peeve on the annuity industry is that commission structures and sales loads are not compared on an apples-to-apples basis.”

What do you miss about the past?
“I miss higher interest rates and lower volatility because, enabling insurance companies to develop products that ultimately are much more valuable to the end policyholder.”

What do you look forward to for the future of the industry?
When it comes to the future, Elliott looks to the past and the origins of the annuity industry. For his entire career, he has worked on longevity solutions and recently worked with a U.K. insurer on a project innovating in that realm.

“An income for life reducing the risk of outliving your assets is still one of the greatest risks that a retiree now has.”

Cannex supports pricing, analysis, and presentation of annuities for industry partners. Contact us for more information on our platform or custom services.
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