FIA EDUCATION SERIES

NAFA has created this series to promote education on how FIAs work and important factors to consider when buying one.

ANATOMY OF A FIXED INDEXED ANNUITY

JUNE 2024

NAFA®

NATIONAL ASSOCIATION FOR FIXED ANNUITIES

Educate. Advocate. Integrate.

LETTER FROM THE CEO

As the CEO of NAFA, the National Association for Fixed Annuities, I am pleased to introduce the latest in the Fixed Indexed Annuity Education Series. The Series is designed to help consumers better understand the inner workings of fixed indexed annuity (FIA) products and to develop an awareness of how they might fit into financial and retirement plans. NAFA's goal for this educational series is to help demonstrate how FIAs can provide enhanced returns for consumers while limiting downside, or losses, with their guaranteed minimum interest rates, a concept which becomes extremely important when planning for retirement. As previous pieces in this Series have illustrated, fixed indexed annuities are insurance products that provide downside protection from loss of principal, with a guarantee that the interest earned on the annuity contract can never go below zero. In an FIA, the return or rate is determined based on an interest crediting formula or method established by the issuing insurance company that is linked to the performance of a market index, such as the S&P 500. It is also important to understand the risks and rewards of various products when planning for your financial future. In this piece we illustrate how an insurance company creates, manages, and administers an FIA over the life of the product. All pieces in this series are available at https://nafa.com/education/consumer-materials/. NAFA is the premier trade association exclusively dedicated to fixed annuities. We are committed to providing information and education regarding the value of fixed annuities and their benefits to our members, journalists, and the general public to help Americans plan for a lasting and safe retirement.

Charles J. DiVencenzo, Jr.
President & CEO

The FIA Education Series is produced on behalf of NAFA by Tamiko Toland and Branislav Nikolić.

Tamiko Toland

Tamiko is a seasoned thought leader on retirement and annuities in both the individual and institutional markets. In 2023, she launched Toland Consulting and is co-founder and CEO of IncomePath, which offers retirement income planning software and training.

Branislav Nikolić, PhD

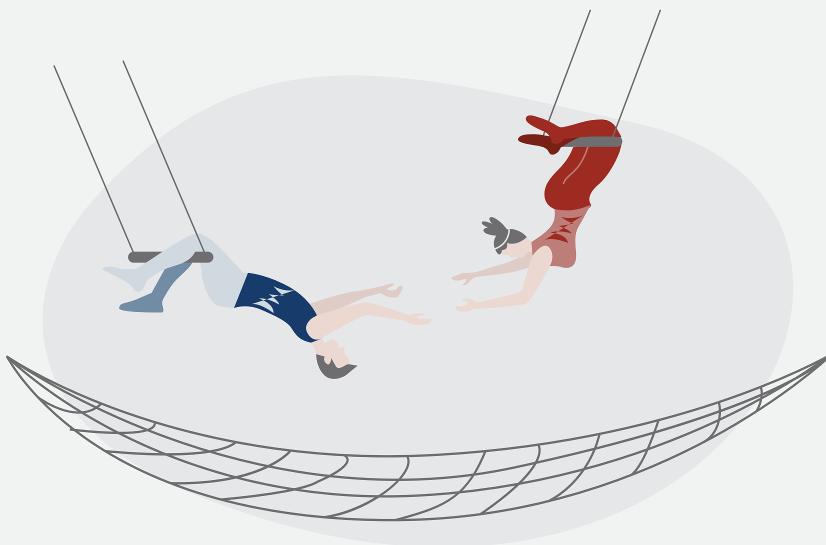
Branislav is Managing Director, Head of Insurance, at The Index Standard. An established thought leader specializing in annuities and retirement income planning, he has a PhD in applied mathematics from York University in Toronto, where he is also a lecturer in finance and mathematics.

INTRODUCTION

You may consider different kinds of annuities depending on your needs. When you look at variable or registered index-linked annuities (RILAs, also known as buffer annuities), you get exposure to stocks with the potential for both growth and loss. Fixed annuities help concerns with stability and allow you to avoid negative returns.

Fixed indexed annuities (FIAs) and traditional fixed annuities are both types of fixed annuities that offer returns with no risk of negative returns. FIAs use different indices and crediting strategies, so they look more complicated than traditional fixed annuities that offer a simple interest rate. While there are some important differences between the two, you might be surprised at how similar they are.

No matter what kind of fixed annuity you buy, you can expect the credited interest to be similar to fixed income, like bonds or bank CDs. With an FIA, you may receive higher credited interest in some years but there are others where you will receive less than a guaranteed rate. Even though an FIA crediting strategy may link to an index that often includes stocks, you should not expect stock-like gains.

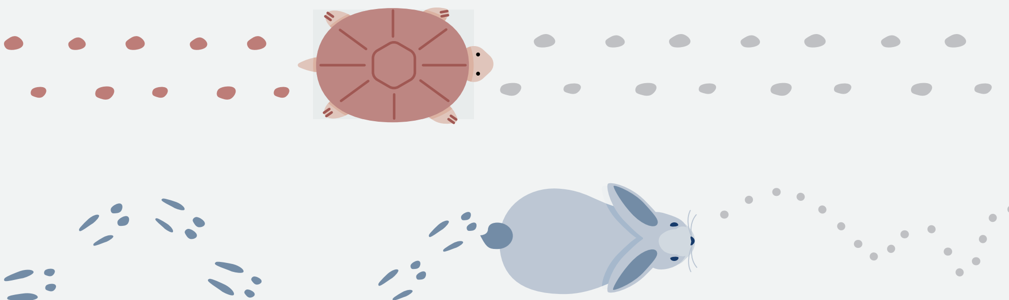


DIFFERENT TYPES OF FIXED ANNUITIES

Fixed annuities and fixed indexed annuities are both fixed annuities. They work slightly differently but people should generally think about them the same way: they both offer a return with a principal guarantee that relies on the backing of the insurance company. In both cases, the insurance company must set aside money—both the customer's premium and its own—and manage it for that promise.

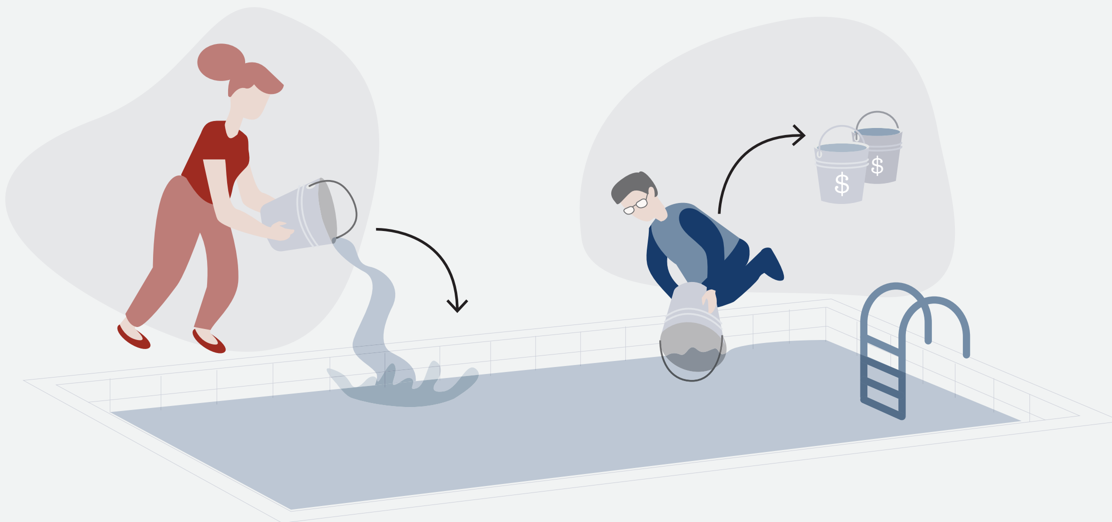
HOW MUCH CERTAINTY DO YOU WANT?

With a traditional fixed annuity, the insurer tells you the interest rate you will get ahead of time. This means that, no matter whether their investments do better or worse than they thought, you will get the guaranteed rate. With a fixed indexed annuity, the insurer offers you the crediting strategy for any given index and promises only that the rate the insurer offers for that strategy will not change over a given period of time. Overall, you may do better than you would have with the fixed rate, but there's also a chance that you get no interest credited. With both an FIA and a simple fixed annuity that does not guarantee the rate for the length of the contract, the insurance company may change the rates or strategies available down the road. Any annuity rate is good for a certain period of time, or term. At the end of the term, the company offers a "renewal rate," which may be different from the original one.



WHERE MOST OF YOUR MONEY GOES

How exactly does an insurance company manage a fixed annuity? When you buy a contract, most of your premium goes into what is called the insurance company's general account, which combines money from different sources of insurance premiums to make sure it can pay on its promises to all of its clients. When your money goes into the general account, it's like adding water to a swimming pool. The insurer guarantees you it will return your money with extra gains and scoops that out of the pool, but it doesn't keep track of which dollar was originally yours. By managing all these assets together, the insurance company can make investments that most people don't have access to and can diversify among many different fixed income investments, usually high-grade (low risk) bonds.



Different kinds of fixed annuities may look very different to the naked eye, but the insurance company puts more than 90% of the premium received for any fixed annuity into the same general account!

WHERE DO FIXED ANNUITY RATES COME FROM?

No, the stork doesn't deliver annuity rates to the insurance company! There are similar considerations that go into figuring out the rate on any kind of fixed annuity. For example, the company must think about things like how long people will stay in the contract, the charge for cashing out early, and many other factors.

For all fixed annuities, the insurance company must figure out its costs, which includes operating expenses, the computer systems, legal fees, distribution (sales), and the salaries of all the people who have to do all of this work.

The company also has to include a profit margin for providing the annuity. A big part of this is compensation for the use of the company's own money that it must set aside for the guarantees to clients. This requirement is part of insurance regulation, and it makes sure that the company can make good on its promises.

Generally speaking, there are also management decisions that the insurer makes for any kind of product, no matter what kind of annuity or other insurance. They manage different products and have priorities that can change among them. They may decide that it helps their business to sell more of certain products and be willing to earn less money—or the opposite. Sometimes, they respond to competition.

A big part of the profit margin is compensation for the use of the company's own money that it must set aside for the guarantees to clients.

HOW SETTING THE RATE FOR AN FIA IS DIFFERENT

The insurance company invests fixed annuity premiums completely in the general account (after expenses) and the annuity offers a guaranteed rate it feels it can support through its investment strategy. The portfolio might perform a little better or worse, but the insurer will still pay what it promised from the beginning.

While the company invests more than 90% of the FIA premium in the general account, it also uses some of that money for what's called the option budget. This budget is how much the insurer can spend and is the first step in determining the rate for any FIA crediting strategy.

If fixed annuities have no fee, how does the insurance company make money?

The insurer actually makes its money the same way with a fixed annuity and a fixed indexed annuity! In both cases, it calculates how much it needs to earn in exchange for using its own money to back the guarantees it makes to customers. This happens when it figures out the rate or an index-linked crediting strategy it offers in the first place.

How is that possible? Because the insurer buys "option contracts" to match the design of the crediting strategy. Finance experts figure out which option contracts it needs to pass the gains on to its customers as credited interest. This way, the insurer can make a promise to the customer without taking on the risk related to the index performance.

A lot of people think that the insurer pockets the difference between the performance of the index and the crediting rate, so the company benefits from lower caps or participation rates when the index does well. In reality, the insurer doesn't make any more or less money based on how the index performs!

WHAT IS AN OPTION CONTRACT?

Option contracts are a way to benefit from the increase or decrease in prices of underlying assets (stocks, bonds, or indices), without investing in them directly. Option contracts are useful for managing risk, but they are only available to sophisticated investors because they are somewhat complicated. Some options are available on the markets and others can only be bought directly from the banks that sell them. This is especially true for custom (multi-asset and volatility-controlled) indices like many of those used for FIAs.

HOW THE INSURER USES THE OPTION BUDGET

The insurance company starts by figuring out which option contracts it needs for the crediting strategy it's offering. Then, the rate depends on how much of those option contracts it can buy using the option budget. The cost of the option contracts depends on the nature of the index, which is why participation rates can be so different depending on the index.

The less predictable the returns of an index, the more expensive the option contracts are, so the insurance company can buy less. This is like the "catch of the day," where you don't know exactly what you'll get and you have to pay market prices.

Options for an index with more predictable returns are less expensive, so the company can use the same budget to buy more. Assuming the same option budget with this type of index, you know how much you'll get, translating into more consistent participation rates year over year—like a prix fixe menu. This is why indices that have more predictable returns can have participation rates that are high, even exceeding 100% of the index return. However, this does not mean that you can also expect to get higher credited interest because the index itself also is likely to have lower returns.

RENEWAL RATES

Both FAs and FIAs have renewal rates at the end of each term. People often wonder why the renewal rate on an existing contract may be lower than the rate on a new annuity. Some fixed annuity contracts announce a higher rate in the first year or so to encourage people to purchase the contract, but this is not always the reason that rates change.

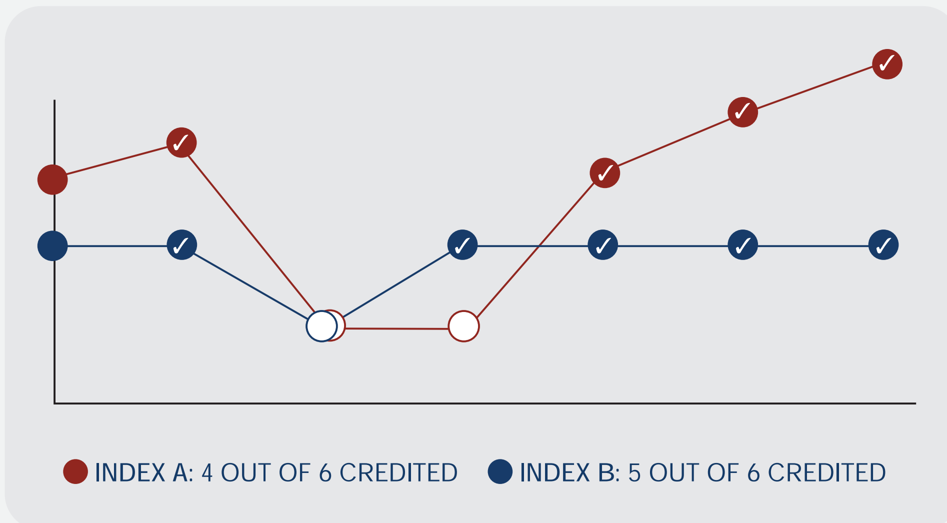
The insurer invests the premium from your contract in the bonds that are available at the time, **which means that the economic conditions at the time of purchase affect the same contract in future, even after the first term expires**. On one hand, if rates go up after a year or two, the insurer can't take advantage of new, higher rates, so your contract's renewal rates will always be based on the returns the insurer could get when you originally bought it. On the other hand, it may have "locked in" higher rates if rates go down after you buy your contract. So, the commitment to investing for a longer period of time can help an annuity buyer, too. This is true for any fixed annuity.

Because FIAs rely on option contracts on the indices, the price of those option contracts is a critical factor in the rates that the insurers can offer, and these rates can change when the time comes. As mentioned earlier, option contract pricing is directly related to how much people expect the index price to change. Certain indices have prices that are less likely to change, so the price of the option contracts for them is also less likely to be different when a new term starts. On the other hand, the option contracts for indices like the S&P 500 change in price more dramatically, so renewal crediting rates are also more likely to change.

Some indices have more stable renewal rates because the option costs are less likely to change.

THE BOTTOM LINE: WHAT YOU CAN EXPECT FROM AN FIA

1. The design and concept behind an index affect the price of options today and in the future. That means that you can expect an index to have lower returns that are also more stable. When returns are more stable, so are renewal rates. It also means that, even if the participation rate is higher, you can expect an index like this to pay credited interest for the FIA that is consistent, but lower, like Index B. On the other hand, an index like the S&P 500 may pay credited interest that is higher but experiences more years with no or very low returns, like Index A. The difference between the two is less about the participation rate and more about earning some interest more often.



NAFA® NATIONAL ASSOCIATION FOR FIXED ANNUITIES

2 Remember that the economic conditions at the time you buy the contract stay with the rates you are likely to get in the future. Even if rates go up on new annuities, you are not likely to benefit through renewal rates. However, if rates on new annuities are lower, your renewal rates may be cushioned against a similar decline.

3 Fixed annuity returns mostly depend on safe investments that the insurance company makes in its general account, so people should have similar expectations. The FIA may pay higher credited interest than a simple fixed annuity, but it also might pay less. It all comes down to the crediting strategy and index performance.