NAVA outlook

Equity-Indexed Annuities and Variable Annuities—Similarity in Name Only

BY ROB STONE

"You can know the name of a bird in all the languages of the world, but when you're finished, you'll know absolutely nothing whatever about the bird…so let's look at the bird and see what it's doing—that's what counts. I learned very early the difference between knowing the name of something and knowing something."

–Richard Feynman

EQUITY-INDEXED ANNUITIES (EIAs) are receiving significant attention in the current financial services market. EIA sales continue to rise, suitability issues with respect to annuity sales (EIA and other) are being discussed, the NASD has provided guidance to its members on sales supervision of non-registered EIAs, and the SEC is gathering information on how EIAs are marketed. The 11% share of total annuity market sales[1] commanded by these products is itself notable to the variable annuity (VA) industry. Of additional interest, however, is the fact that the name "equity-indexed annuity" has led some of the insurance-buying public to believe these products are comparable to equity-oriented variable annuities. Yet aside from the features that make each an annuity, the two products are entirely different. In this article, we'll take a look at EIAs and contrast them to VAs.

Before proceeding, however, let's make a name change. EIAs are really fixed annuities. It has become more common for insurers and marketers to emphasize the fixed aspects by referring to the products as fixed-indexed annuities (FIAs), and we will do the same.

FIAs are products that guarantee a minimum credited interest rate (generally 0%), provide a guaranteed floor value, and offer the opportunity to earn additional fixed-interest credits based on the performance of a stated market index (usually an equity index such as the S&P 500). Unlike a variable annuity, however, where the policyholder actually invests in subaccounts of an insurer's separate account and experiences the subsequent investment performance, the FIA owner does not actually invest in the securities markets. In an FIA, the market index is nothing more than a measuring stick used in an interest-crediting formula. And unlike a VA, where the policyholder assumes the investment risk associated with a chosen investment strategy, the FIA owner takes no direct investment risk. This risk is instead assumed by the insurance company.

An FIA can have many operating parts. The value of the FIA at any point in time is the greater of a guaranteed floor value or an accumulation value less a surrender charge. Under the new nonforfeiture regulation, the guaranteed floor is 87.5% of premium compounded at a rate based on the 5-year Treasury yield (no less than 1%, usually no greater than 3%). The accumulation value is the account value derived from the crediting strategy or strategies chosen by the policyholder. Some contracts offer a policyholder several index-

[1] NAVA's 2005 Annuity Fact Book.

based, interest-crediting options as well as a more traditional fixed-interest option. Guaranteed minimum interest credits on the various options that are applied to the accumulation value may range from 0% (for index-based accounts) to 1.5%-3.0% (for fixed-interest options).

The various index-based, interest-crediting options can themselves have several operating parts.

INDEX. Products in the market have one or more interest-crediting options tied to the S&P 500, Nasdaq 100, Dow Jones, Russell 2000, S&P 400, or one of several bond indexes. These generally exclude dividends, which distinguishes them from the underlying investments of VAs.

CREDITING METHOD. Common methods in today's market include point-to-point (index values at the beginning and end of a specified period are used to calculate the index-based interest credits) and averaging (averaged daily, weekly, or monthly index values are used to calculate the index-based interest credits). High water mark methods (the highest index value as measured on specified days in a period is used with the beginning index value to calculate the index-based interest credit) are less common.

CREDITING PERIOD. This is the period over which the index-based interest credit is calculated. Often the crediting period is one year, but two- and three-year periods can be found as well. Less prevalent are seven- and ten-year terms.

PARTICIPATION RATE. This is the percentage of the calculated index gain credited to the policyholder as interest. This can be contractually guaranteed or eligible for periodic reset.

CAP. A cap is the maximum index-based interest credited to the policyholder. Caps can be guaranteed or eligible for periodic reset.

SPREAD/MARGIN. This is a percent by which the gross index gain is reduced before crediting to the policyholder as interest. These too can be guaranteed or eligible for periodic reset.

Many misconceptions exist about the meaning of participation rate, cap, and spread. When a company offers an FIA, it invests a vast majority of the assets backing the contract in fixed income securities to support the guaranteed floor value. The remaining portion (the "option budget") purchases hedging instruments related to the FIA's offered indices. Since the option budget is normally insufficient to provide 100% of the actual index increase as an interest credit, a contractual means for limiting the index-based interest credit is needed. Participation rates, caps, and spreads (and combinations thereof) are the result. It is important to understand, however, that there is no portion of the index gain being "kept" by the company. The company is merely crediting every bit of the index-based interest the option budget can afford.

An additional feature in the FIA market that is familiar to VA aficionados is the premium bonus. Premium bonuses are a percent of policyholder premium added to the contract as an up-front boost to the contract value. The cost of the premium bonus is recouped via a combination of reduced interest crediting, reduced commissions, and less than 100% vesting of the bonus for early contract surrender. This is similar to the practice on VAs.

On the surrender charge front, FIAs work similarly to VA contracts, albeit usually with higher surrender charges and longer surrender charge

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PRESIDENT'S MESSAGE

Mark J. Mackey, President & CEO, NAVA

NAVA Preparing Educational Course for the NASD

Last year, NAVA formed the Insurers and Distributors Leadership committees to provide the board of directors with advice and to recommend action on policy issues of critical importance to the industry.

One of the initiatives recommended by the committee was the development of an educational course for NASD personnel on variable annuities and how they are sold. The course has been developed as a half-day session comprised of five sections: market overview; demographics of a typical annuity owner; insurance benefits; suitability; and equity-indexed annuities.

A main focus of the course will be explaining the insurance features of the product—living and death benefits, and annuitization. More specifically, the course will explain the insurance protections provided by each of the features, why they are important, and how they are priced. Examples will be provided to illustrate how the death benefit and each type of living benefit work. Having demonstrated the value proposition of these features, the course will then discuss how variable annuities can be appropriate (i.e. suitable) in sales to seniors, qualified plans, 1035 exchanges, and bonus products. Finally, similar information will be presented with regard to equity-indexed annuities.

The course has been submitted to the NASD for its review and approval. We expect to begin course presentations this spring.

Mark Mackey

A Fresh View of the Retiree Market

BY CHUCK YANIKOSKI

THE FIRST BABY BOOMERS have already started to retire, but as a group, they are simply not prepared.

If the boomers are not ready for retirement, neither are most of the financial providers they depend on for help. The old answer (persuade people to save more while they are still working) is clearly only part of the solution. When time runs out, we must address what happens if people have not saved enough, or if they are not sure whether they have saved enough. This is a nut that has yet to be cracked.

In the end, retirement readiness is a problem to be solved person by person. What happens when working people retire varies enormously from one household to the next. The annuity industry can help in many of these situations but for this to happen, we need a clear understanding of what the retirement phase is about.

Retirement is not simply an extension of the accumulation phase, with a few changes. It is more like the accumulation phase set on its head. Serving this market well (and profitably) means understanding why this is true, and applying these insights in new ways.

FROM THE RETIREE'S POINT OF VIEW

To understand retirement, we first have to look at it from the retiree's point of view. There are important life changes that occur at retirement, there are important financial changes, and there are usually attitudinal changes as well. The attitudinal changes are both caused by and, in turn affect, the life and financial changes.

ATTITUDES AND INCREASED RISK

Risk capacity. Most people's "risk tolerance" decreases at retirement. Furthermore, "risk capacity" declines, too. Even for natural risk-takers, the *price* of risk goes up at retirement because one's human capital (the future ability to earn money) plummets on retirement day. The big paycheck is gone forever, and with it the ability to recover gracefully from risks gone bad.

Confusion and urgency. When people retire, they may have a dozen or more financial issues to resolve. Some decisions are immediate, some are irrevocable. The questions are difficult individually, and mind-boggling in combination. At no other time are people so receptive to professional input.

Longevity risks. With retirement often lasting 30 years or more, many retirees now realize that the bigger financial risk is living too long, not dying too soon.

Health. Most retirees experience an extended period of ill health before they die, and about one in three will need some kind of long-term care not covered by Medicare.

Market volatility. Retirees who withdraw regular amounts from savings suffer from "reverse dollar cost averaging"—when markets drop, more shares or units get liquidated and, having been withdrawn, they can never rebound.

DECREASED RISKS

Fortunately, there are some risks that actually decrease for most retirees. These are usually far outweighed by the risks that increase, but they offer some respite.

Financial market returns. Although market volatility is bad for retirees, the impact of inferior returns is much lower in retirement. This seems counter-intuitive, but most retirees have flat or declining balances so earnings do not compound. Investment return is still relevant, of course, but its importance is much reduced.

Inflation. Expenses tend to increase significantly during the retirement years only in three main areas: medical, housing, and energy costs. Most other items usually stay fairly flat and, for people who become truly elderly, actually decrease or even disappear.

OPPORTUNITIES FOR STRETCHING FINANCIAL RESOURCES

Most retirees instinctively, and correctly, do not see their retirement predicament as an investment management problem. Rather, they see it as a cash flow problem with two main aspects: whether they have enough money to pay their annual expenses, and whether they will eventually run out of cash. This means that *all* areas of personal financial management must be examined.

Expenses. This is overwhelmingly the most important area where retirees can control their fate. Few could increase overall income by 10%-20%, but most could cut expenses more than that and still live good lives. Furthermore, expense savings are usually after-tax.

Income. Investing appropriately fends off unaffordable losses while providing for suitable returns, liquidity, and cash flow. Immediate annuities can often stretch cash flow better than a program of spending down one's own savings (self-annuitizing).

Assets. In addition to asset allocation and the occasional IRA rollover or Roth conversion, financial professionals should be helping to determine the disposition of non-liquid assets (homes, investment real estate, collectibles, family businesses). This can generate cash flow for the retiree, and opportunity for the financial provider.

Debt. At typical baby boomer levels of indebtedness, smart debt management can be as important as smart investment management.

Insurance and benefits. Optimizing government benefits, benefits from former employers, and insurance coverages can have a big impact on improving household cash flow.

THE NEED FOR FINANCIAL SUPPORT

If retirees are going to be able to make the best of whatever financial situation they are in, they will need the support of the financial services industry.

ANALYSIS

Above all, they need timely advice based on sound analysis. But this is risky. Younger clients can afford to act on incomplete analyses because they have time to recoup losses. Retirees rarely have equivalent flexibility. They may, depending on health, have none at all. Providing inappropriate advice, therefore, is a devastating disservice to retirees, and ultimately to the provider as well. Only those willing to invest what it takes to do it right should attempt this service. Unfortunately, there is no industry consensus yet about how to move beyond the old and clearly inadequate strategy of planning around "average" assumptions. The main alternatives so far are:

Monte Carlo ("stochastic") investment-based models. Such models expand classic asset allocation models by taking into account longevity risks and sometimes other factors. They evaluate certain decisions (especially investment and annuity purchase decisions, but sometimes others, too) under many randomly generated scenarios, and allow the customer to determine what probability of success is acceptable. These models shine by taking mathematically rigorous account of certain risks, and by showing that risk is manageable only up to a point. Their main drawbacks are that their mathematics require a simplified model of reality that omits many important elements (thereby mitigating the validity of the risk analysis), and they do not answer most of the specific questions that confound retirees.

Financial planning models. These models reflect the notion that retirement is fundamentally a cash flow management problem. The best such models take into account all the important aspects of a person's situation: assets, income, debts, expenses, benefits, and insurance, as well as health and family situations, and goals and priorities—and can then analyze these aspects under alternative scenarios that make sense to people (e.g., what happens if you live an extra long life). Furthermore, such models can answer, in principle, virtually any financial question that concerns retirees. The main drawbacks are that these models require extensive data collection and, as they are fairly new, they may not be as solid as the older Monte Carlo models.

PRODUCTS

Financial companies offer an array of products suitable to retirees and are developing new ones at a rapid pace. Not all of these ideas will succeed in a big way, but the new dynamism we are witnessing in product development bodes well for the industry and, more importantly, for retirees.

MONITORING

It is one thing to be ready for retirement, it is another to continue to thrive during one's retirement years. When we speak of the higher risks that retirees face, we implicitly set up the demand for regular monitoring so that when a risk turns into a reality, the retiree and his or her financial provider are capable of responding quickly and appropriately. It is not enough to reposition assets or sell a product, then assume that everything is fine. In most cases, whatever analysis is done for retirees should be updated annually.

FINANCIAL MANAGEMENT

Creating a plan is important, but a plan that is not implemented and managed will quickly become worthless. Most retirees need help with this. Investment strategies in particular usually require periodic review and adjustment. Some retirees can handle this on their own, or even enjoy it. A majority need help.

ADVICE

We have already seen that retirees need many kinds of financial advice.

Analytical models can meet some of this need, and traditional investment and financial advice cover part of it as well. But retirees have specialized problems, many of which require specialized help. NAVA, in conjunction with InFRE (the International Foundation for Retirement Education) has developed a certification course to help professionals in this market meet their clients' many needs.

The future may take us even further. Increasingly, financial professionals are coming to understand the links between financial issues and issues that traditionally have not been considered to be financial. Health, lifestyle, and even a retiree's general outlook can have a big impact on longevity, medical costs, and expenses such as travel, hobbies, and other activities. A truly "holistic" approach to advising retirees is neither far out nor far off.

THE ROLE OF ANNUITIES

Social Security is an annuity. A defined pension benefit is an annuity. Consumers are all in favor of such benefits. Yet when it comes to annuitizing their own assets, they often hold back. Why?

First, retirees feel for many reasons that they are losing control over their lives. This makes them reluctant to part with a substantial chunk of assets, even in return for a highly advantageous stream of income. It may be a poor financial decision but psychologically it makes them feel more secure.

Second, they fear "losing the bet." People who buy immediate annuities are wagering that they will outlive most of their peers. If they die sooner than average and payments end, then they have "lost."

There are three approaches to overcoming these obstacles:

Education. To understand what an annuity does is to experience at least an initial attraction to the concept. A well-designed product tuned to a particular party's need is even more attractive. Explaining this well is sometimes enough.

Product design. New product designs that provide access to at least a portion of the annuitized balance help with the "loss of control" objection. Older solutions (joint annuitization, certain and continuous options) help with the "losing the bet" problem. Unfortunately, these features dilute the overall advantage of annuitizing and therefore need to be applied carefully.

Phased annuitization. In this arrangement, the client makes smaller annuity purchases several years apart, rather than one large one. This has several advantages. First, the plan illustrates even better than a straight annuity because purchases made in later years pay out at higher rates. Second, by requesting a smaller commitment up-front, you do not ask for a big reduction in the client's control over assets. Third, the annuitant will take only a small loss if death comes early, and will look smart by having limited this loss. Finally, after a few years of receiving monthly checks, most annuitants will be completely sold on the idea, especially when they realize that a second contribution equal to the original amount *more* than doubles their monthly income.

MORE QUESTIONS THAN ANSWERS

As comforting as it might be to have all the answers, when it comes to managing retirement, questions still predominate. That makes 2006 an exciting time to serve this market and to jump out in front of a wave that will continue to grow in the coming decades. ■

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CHAIRMAN's Letter

AS I BEGIN MY TENURE AS NAVA's chairman, I would like to share with you my goals for the upcoming year. Attaining these objectives will make NAVA a more vibrant organization for our members and a more effective voice for the industry.

1. Objective assessment. It is vital that our industry step back and objectively assess our business and product line as well as how we are viewed by the public.

2. Input. In order to get a broad cross section of opinions and insights, we need input from all our members.

3. Involvement. The variable annuity business needs a focused approach which can only be achieved through a dedicated association such as NAVA. For NAVA to properly represent the industry as we face our current challenges, members at all levels must contribute and get involved.

NAVA's recently formed Insurers and Distributors Leadership committees will play an important role in fulfilling these goals. In addition, the board of directors has just approved another committee to provide valuable input from a key area of our organization—money managers. These members are a critical part of our industry and have much to contribute. The new Fund Managers Advisory Committee will be provided an opportunity to advise the NAVA board and membership on issues that are important to this sector. Selection and member participation details will be announced before the Marketing Conference in February.

I look forward to seeing you all in California!

Michael J. Gilotti,
Chairman, NAVA

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periods. Where today's VAs generally have surrender charges lasting four to seven years, most FIAs have surrender charges lasting seven to twelve years. Some FIA contracts have surrender charges lasting fifteen or more years.

Some current FIAs have a market value adjustment (MVA) that further modifies the value available upon contract surrender (subject to the guaranteed floor value). The MVA provides a means for altering the available surrender value to account for changes in interest rates since policy issue. This is similar to the operation of MVAs on the fixed accounts of some VA contracts.

From the producer compensation standpoint, the FIA market provides higher compensation to the producer than has been the tradition in the VA market. This is typical of fixed annuities, although FIA compensation is a bit higher than on other fixed annuities. It should be noted that higher-compensation FIAs come with higher starting surrender charges, lower caps, lower participation rates, or higher spreads than lower-commission products.

From a consumer standpoint, a variable annuity will feel more like a standard investment than an FIA. VA deposits go into the account, fees (mortality and expense charges) are deducted, and separate account returns directly decrease or increase the account value. The FIA, on the other hand, is a standard spread contract whereby interest credits are determined and credited by the insurance company. Almost all of the expenses/fees of the FIA contract are implicit rather than explicit.

Perhaps the best way to compare a VA and an FIA on similar terms is to look at an FIA compared to a VA with a return of premium guaranteed minimum accumulation benefit (GMAB). The FIA will march through time, crediting index-based interest credits to the contract according to the design of the contract and index choice(s) of the policyholder. At any point in time, the surrender value of the contract will be the greater of the account value, less surrender charges, adjusted for any MVA and the guaranteed floor value. On the other hand, the VA will march through time, subtracting out the base contract and GMAB mortality and expense charges and increasing/decreasing the account value according to the performance of the underlying subaccounts chosen by the policyholder. Once the waiting period for the GMAB has passed (usually seven to ten years), any benefit paid by the company on the GMAB rider will be deposited into the account value. The surrender value of the VA contract is the account value (sum of the subaccount values, adjusted for any applicable MVA on fixed subaccounts) less the surrender charge. Unlike the FIA, which generally credits and locks in interest periodically and has a guaranteed floor value that applies for surrender at any contract duration, the VA with GMAB rider normally has no floor value on surrender prior to the end of the GMAB waiting period.

On the upside, the VA is limited only by the expense levels built into the contract, the investment choices of the policyholder, and the investment results of those choices. The FIA index-based interest credits are limited by any participation rate, cap, spread, or index averaging in the contract.

The risk/reward tradeoffs of the two contracts underscore the investment risk taken on by the consumer versus the insurance company in each case. The FIA limits the downside and upside for the consumer, while the insurance company takes on the investment risk underlying the contract. The VA with GMAB passes through most of the investment risk to the consumer, the exception being any benefit provided by the GMAB.

In some ways, the difference between FIAs and VAs simply comes down to this: in the FIA, financial market movements are a measuring stick for interest credits that are less than the change in the index itself; in a VA those market changes directly affect the account value. Other bells and whistles may further distinguish one product type from the other, but this one key difference stands at the core.

It will be interesting to see, as industry discussions continue on the suitability and marketing of annuity products, whether the debate surrounding FIAs and VAs centers on the products themselves or how they are understood by customers. As is so often the case, effective consumer education will be key. When it comes to these two annuity types, similar sounding names can belie the true underlying differences.

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