

# TReNDStrends in fixed rate annuities

## Which is Better for the Client?

### The Traditional Annual Declared Rate Annuity, or The Multi-Year Guarantee Annuity

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Insurers use different investment strategies for different types of annuities. Understanding those strategies will help you select the best contract design for your client.

### Understanding Insurers' Risks

The goal of the insurer is to minimize **interest rate risk** no matter what happens to future rates.

**Interest rate risk** occurs when interest rates move up or down. A downward movement in rates may result in the carrier's annuity investment portfolio not earning enough investment income to credit guaranteed interest to policyholder account balances. This is called a **negative spread**. Interest rate risk is highlighted when **rates are declining**. Companies call their bonds and individuals refinance their mortgages. The insurer is forced to **reinvest principal at lower yields** than their pricing models predicted.

In a **rising rate environment**, interest rate risk can occur in the form of disintermediation. Policyholders surrender contracts earlier than expected as they seek higher yields elsewhere. Bonds purchased to fund the liabilities haven't matured. As rates rise, bond values decline. The insurer

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is forced to **sell the bonds at a loss** to fund redemptions.

### How insurers manage interest rate risk

**Fixed rate annuities.** The insurer allocates the entire premium to fixed income investments and credits annual compound interest to the policyholder account. However, **different investment strategies** are required for each type of fixed rate annuity.

- **Multi-Year Guarantee Annuity (MYGA).** The insurer guarantees an interest rate for the term of the guarantee period. The guaranteed rate is typically higher than the rate that is required by each state's non-forfeiture regulations.

Because the rate is guaranteed for the entire guarantee period, typically 5-10 years, MYGA reserves are typically invested in non-callable corporate bonds and more conservative fixed income securities. This strategy positions the insurer to earn enough investment income during the guarantee period to credit interest to the policy owner.

- **Annual Declared Rate Annuity (ADRA).** The insurer can reset interest rates each contract year in response to the change in the overall level of interest rates. ADRA typically guarantee the minimum rate required by the non-forfeiture regulations. This not only reduces interest rate risk for the insurer, it also provides the opportunity to invest in higher yielding securities. The ADRA product design allows the insurer to purchase callable bonds, mortgage backed securities, and other fixed income investments that possess higher yields than non-callable bonds and more conservative fixed income investments.

### What the Differences Mean

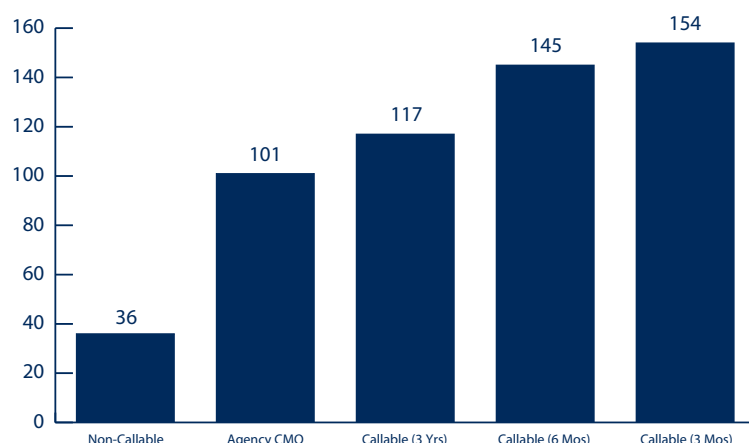
The **investment strategy for a MYGA will be more conservative** than for an ADRA. The investment portfolio for the ADRA product design has a higher initial yield, so the insurer can afford to profitably offer **higher initial interest rates for an ADRA** than for a MYGA.

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## How Significant is the Investment Advantage

The Investment Yield Advantage of the ADRA product design is significant. A ten year non-callable bond yields just 36 basis points above the ten year treasury yield, whereas, ten year collateralized mortgage obligation yields 101 basis points over the ten year treasury, an advantage of 65 basis points. Furthermore, a ten year bond callable after three years and a ten year bond callable after six months yield 117 and 145 basis points respectively, an advantage of 81 and 109 basis points. On average, a fixed income portfolio for the ADRA product design can generate returns 65 – 100 basis points higher than a MYG portfolio.

## Yield Over 10 Year Treasury (10-21-05)



## How Each Performs in Different Interest Rate Environments

Understanding what will happen to the underlying insurer's investments will help you to make better recommendations to your clients.

Interest Rate Environment	What Happens	MYGA	ADRA	Better Choice for Your Clients
Declining	Callable investments and mortgage backed securities experience significant prepayments  Insurer must reinvest prepayments at lower rates	Fewer prepays because of more conservative investment strategy  Insurer is contractually obligated to credit the guaranteed interest rate	Insurer would reduce future interest rates to reflect lower investment returns and the current interest rate environment	MYGA
Flat	Far less prepays of callable instruments and mortgage backed securities	Guaranteed rate paid, but insurer's portfolio earns lower yield than an ADRA portfolio	Earns higher yields than MYGA portfolio  Insurer would not be forced to lower interest rates	ADRA
Rising	Lowest amount of prepays of callable instruments and mortgage backed securities	Guaranteed rate paid, but insurer's portfolio earns lower yields than an ADRA portfolio	Earns higher yields than MYGA portfolio  Insurer would not be forced to lower interest rates	ADRA

## Check Past Renewal Rates!

Because of past experience, some producers might have a valid concern that ADRA's permit the insurer to reduce interest rates even in a flat or rising rate environment. Some producers prefer MYGAs because of the long-term rate guarantees and are willing to sacrifice potential gains. Before you recommend a specific ADRA over a MYGA, be sure to review the insurer's ADRA renewal rate history to make sure they have treated

policyholders fairly in the past. If the insurer is unwilling to publish their renewal rate history, beware!

## Conclusion

When you have done your due diligence, understand the investment strategies that drive the annuity interest rates, and understand their likely performance under different interest rate scenarios, you should feel confident in your ability to explain

your recommendation to your clients. In a flat or rising rate environment, that recommendation should be an Annually Declared Rate Annuity contract.

For a sales kit and your agent code, contact Reliance Standard Life's Annuity Sales Desk:  
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