Do Fixed Indexed Annuities Cost More Than Other Fixed Income Annuities?

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February 28, 2019

I. The Issue

There is a common belief that fixed indexed annuities (FIA) cost more than other fixed income annuities such as the vanilla deferred income annuities (DIA) and the immediate annuities (SPIA). The basis for such belief is that FIAs are more complex in product design, which leads to higher fees such as surrender charges and certain benefit riders. They also pay higher commissions to agents as part of their marketing efforts. Accordingly, many advisors would recommend DIA and SPIA over FIA to clients because these annuities have low or no sales commissions and no surrender charges.

If DIAs and SPIAs are better products due to their low costs, it should follow that the benefits that flow from these products would be better than those offered by FIAs for the same amount of investment.

This paper seeks to show that the perceived low costs of DIAs and SPIAs do not necessarily translate into better benefits than FIAs by comparing the income benefit offered by each type of annuity.

II. The Facts - Compare the income benefit from a DIA with the income benefit from a FIA (Benefit Comparison A).

Benefit Comparison A entails comparing the payout benefits from a DIA and a FIA. Both annuities are deferred annuities. The data for the DIA are obtained from www.immediateannuities.com, and the data for the FIA are based on an illustration for a policy from Lincoln Financial. The policy perimeters for each annuity are listed below. All data are based on a single life female annuitant.

a. Policy perimeters for the DIA.

1. The total premium is $123,000 single premium.
2. The annuity policy begins at age 55.
3. Benefit payout is deferred 10 years to age 65.
4. As the FIA has a guaranteed death benefit that essentially refunds the unused portion of the policy value, the benefit payout of this DIA is based on the "life with cash refund" payout schedule to match the death benefit provision of the FIA.
5. There are no surrender charges as the policy cannot be surrendered once it is in force.

b. Policy perimeters for the FIA.

1. The total premium is $123,000, single pay as the DIA.
2. The annuity policy begins at age 55.
3. Benefit payout is deferred 10 years to age 65.
4. The benefit payout is guaranteed for life.
5. There is an 8-year surrender charge, which becomes 0 in the 9th policy year if the annuitant does not cancel the policy before benefit begins.
6. The policy has a 5 percent compound interest bonus for 10 years.

c. Data for Benefit Comparison A.

Table 1 outlines the fixed annual and cumulative benefits for the DIA and the FIA.

Table 1
Benefit Comparison A

	DIA	**FIA**
Single premium at Age 55	$123000	$123000
Annual payout beginning At age 65:	$10980	$12500
Cumulative payout:		
Age 70	$54900	$62500
75	109800	125000
80	164700	187500
85	219600	250000
90	274500	312500
95	329400	375000
100	384300	437500

d. Findings for Benefit Comparison A.

1. The annual payout from the FIA is higher than the DIA by $1520 when both annuities begin at the same time and with the same premium.
2. The difference in benefit amounts to 14 percent and should be considered significant.
3. Over the 35 benefit year from 65 to 100, the FIA yields $53,000 more in benefit than the DIA.
4. It would take the DIA 11.20 years to recover the investment, as compared to 9.84 years for the FIA.
5. The compound rate of return over 35 benefit years is 3.69 percent for the FIA, and 3.31 percent for the DIA.

6. The finding that FIA yields better benefits than the DIA for the same investment suggests that the premise that DIAs are cheaper than FIAs is not valid. The data show that the FIA offers better benefits, despite the common perception of high fees and high commissions. To put it in another way, high commissions and high fees have NO impact on the benefits from a FIA.

III. More Facts - Compare the income benefits from a SPIA with the income benefits from a FIA. (Benefit Comparison B)

If the low costs of a DIA does not lead to better benefits than a FIA, how about a low cost SPIA in comparison with a FIA?

As FIAs are deferred income annuities, while SPIAs are immediate annuities, it would appear that comparing the two types of annuities is like comparing apples and oranges.

However, for retirement income planning, if clients should need certain amount of income at a particular time, such as age 65, the income goal can be accomplished through the use of either a SPIA or a FIA. What we would compare is the benefits from a FIA and a SPIA at age 65.

The policy perimeters for the SPIA and the FIA for Benefit Comparison B are as follows.

a. <u>Policy Perimeters for the FIA</u>

1. The same FIA in Benefit Comparison A.
2. The benefit base becomes $200,000 at age 65, as it has grown from $123,000 at age 55 as a result of the interest bonus of 5 percent compound over 10 years.
3. The payout schedule is the same as in Benefit Comparison A.

b. <u>Policy Perimeters for the SPIA.</u>

1, The policy begins at age 65 and the payout also begins at 65.
2. The total premium is $200000. The higher premium matches the income base value of the FIA.
3. The payout schedule is based on the ”life with cash refund” option that matches the FIA’s death benefit provision.

c. <u>Data for Benefit Comparison B.</u>

Table 2 outlines the data for the income benefits of the SPIA and the FIA.

Table 2
Benefit Comparison B

	SPIA	**FIA**
Income Benefit Base at age 65	$200000	$200000
Annual payout beginning At age 65:	$11952	$12500
Cumulative payout:		
Age 70	$59760	$62500
75	119520	125000
80	179281	187500
85	239040	250000
90	298800	312500
95	358560	375000
100	418320	437500

d. <u>Findings for Benefit Comparison B.</u>

1. The annual payout from the FIA is $548 higher than the immediate annuity.
2. The capital layout for the FIA is much lower than the immediate annuity, which is $123,000 compared to $200,000.
3. Accordingly, for the 35 year payout duration of the immediate annuity, the compound rate of return is 2.13 percent with a $200,000 initial investment.
4. For the FIA, the return for the same 35 benefit years is 3.69 percent with an initial investment of $123,000.
5. It would take the immediate annuity policy 16.73 years to recover the capital outlay, while it would take only 9.84 years for the FIA to recover the entire capital outlay, which is a difference of 6.89 years. This is a significant difference as the payout from an annuity is only a return of investment in the early years.
6. These findings show that immediate annuities may actually cost more with lower benefits in comparison with FIAs.

IV. Discussion.

1. It is commonly believed that FIAs entail higher cost in the form of surrender charges and high sales commissions as compared with DIAs and SPIAs which have low commissions and no surrender charges. In a recent article by Michael Edesess and Robert Huebscher, the authors indicate that the sales and the marketing costs of a FIA that clients have to pay for may range from 8.5 percent to 9 percent, and may be as high as 12 percent for the annuities in their study. *A Close Look at Ibbotson's Research on FIA, Advisor Perspectives, January 28, 2019.*

2. The implication of high costs is that annuities that have high costs benefit the insurers and the sales force more than the consumers. Yet the data on actual policy cases in our study do not bear that out. In fact, our sample FIA consistently yields higher benefits than either the DIA or the SPIA.

3. Cost is often used as a measure of whether an investment is desirable. For annuities, surrender charges and sales commissions associated with FIAs are often used to indicate the high cost of FIAs, which are then considered less desirable for clients.

4. Based on our benefit comparisons, it is clear that neither surrender charges nor high sales commissions lead to higher costs for FIAs that would impact the benefits of FIAs. The reason is probably that the true costs for annuities are unknown. Except for charges and fees that insurers are willing to disclose or are required by law to disclose, advisors really do not have good information on the costs of annuities, which are essentially embedded in the design of a product. Since surrender charges and sales commissions are about the only cost items known to advisors, they have been used as proxy to determine the costs of annuities. As the findings of our study show, the focus on these cost items is essentially misplaced, and is also misleading.

5. Moreover, surrender charges may be irrelevant for FIA where the annuity is intended to generate lifetime income. Surrender charges operate like the back load for mutual funds. They are inconsequential if the owner/annuitant does not intent to cancel the policy.

6. If surrender charges are irrelevant for FIA, it serves to match the absence of surrender charges for DIA and SPIA as these income annuities do not allow policy cancellation once they are in force.

7. Though many FIAs have additional policy components that increase the complexity of the product, such as nursing home care benefit, and the potential growth of account value according to certain investment index options, these components do not serve to affect the lifetime income benefit that is fixed at the outset of the policy and is guaranteed, as long as the lifetime income provision is included in the policy as the prototype FIA in this paper.

8. Since annuity costs are difficult to ascertain, looking to the benefits offered seems to be a better way for assessing the value of an annuity because they are readily ascertainable.

9. The data in this paper also suggest that it is beneficial to plan for retirement income earlier rather than later, as the cost for secure, guaranteed income may be lower than it would be otherwise.

V. Conclusion

The common belief that FIAs are more costly than DIAs and SPIAs has not borne out in a comparative study of the income benefits of these annuities. While DIAs and SPIAs have low sales commissions and no surrender charges, they are not necessarily cheaper products as they in fact offer lower benefits, given the same investment. Conversely, FIAs offer higher benefits despite the fact that they may entail surrender charges and high sales costs.

It is therefore critical for advisors to understand the true benefit of each type of annuity by going beyond the issue of cost. Relying on common beliefs in dealing with the income needs of clients may be detrimental to their interests if such common beliefs turn out to be invalid.