

Understanding Renewal Rate Caps

Why a renewal rate cap can go down when the index is rising.



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It's always difficult to meet everyone's expectations. But it's still trickier to meet those expectations when they aren't based on anything even remotely reasonable.

Take, for instance, sales quotas. Anyone who has ever reported to a sales manager knows what I'm talking about. Who knows what goes through the devious mind that makes up someone else's sales quota? I saw a statement hanging on the wall in a business office not long ago that summed it up pretty accurately, "Nothing is impossible for he who doesn't have to do it." There you have it — a perfect example of expectations being set by someone who doesn't have to do the work and may not have a clue about what it will take to get the job done.

As brokers, we often get ourselves in a pickle by doing something similar to our deferred annuity clients. We have a tendency to give a client just enough information to allow him to draw conclusions about future product performance that aren't realistic and are unlikely to be based on a complete understanding of the facts.

Most times the performance issues will revolve around interest crediting rates, which makes sense because there aren't many other moving parts in a fixed annuity. With multi-year guarantee annuities, or MYGAs, the challenge of explaining the product actually shakes out to be pretty simple. The rate is fixed for a specified period of time and rate speculation is simply not an issue until the end of the guarantee period.

But index annuities are a different matter.

Let me take a quick poll. Do you think that a renewal index rate cap on an annual, point-to-point index annuity (like the IGA from The Standard) should go up when the index has been

going up over the last few months? If you answered **no**, you'd be correct. Did you?

The fact that the index went up during the contract year (and is higher now than it was on the prior policy anniversary) is irrelevant to the setting of the renewal rate cap. If you have created an expectation that the renewal rate cap is directly linked to the index performance, you may have some explaining to do. It's quite possible that the renewal rate cap will go down even when the index is going up. On the flip side, your client may be happy to know that the same principle holds true when the index is going down — it's quite possible in that scenario that the renewal rate cap could go up.

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To keep your client's expectations reasonable at renewal time, you need to know how the renewal index rate cap is set each year. The reality is that renewal rate caps on annual, point-to-point annuities are set exactly the same way the initial rate caps are set.

In today's low-interest-rate environment, The Standard invests about 96% of the original deposit in bonds and mortgages (just like for our fixed-interest annuities). The blended return on those investments is what supports the minimum guarantee on the annuity. With the minimum guarantee now secured, the remaining 4% is used to purchase one-year options that allow the company to credit excess interest to the account if the index goes up in value during the index term.

Because all we can spend to purchase the option is 4% of the original premium, the price of the options determines how high The Standard can set the rate cap. At the end of the



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investment year the options expire, or are cashed in if they are in the money, and new options are purchased to hedge the index movement for the upcoming index term. It's easy to see, therefore, that your client should expect renewal rate caps will change (to some degree) every year, as the cost to purchase options changes daily.

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Option costs that support the Index Growth Annuity are determined in large part by the volatility (up and down movement) of the S&P 500 index. So, the fact that the S&P 500 is up over a certain period is not a factor in determining the option cost; volatility is the key. The Standard receives quotes for the options that we buy from multiple Wall Street providers, so we're always certain that we're paying a fair price. Once we know what our options costs are, we combine that information with the return we're receiving on the underlying investments (the bonds and mortgages) and set the index rate cap. Therefore, the most influential factor in determining the renewal rate cap on our IGA is the cost of the options that we buy to hedge the S&P 500 risk.

While option costs are the key driver, renewal rate caps also will be sensitive to changes in interest rates — just like fixed-interest annuities. Actually, renewal rate caps can be seen as twice as sensitive to these interest-rate changes.

For example, if an annuity carrier needs to adjust crediting rates on a traditional, fixed-rate annuity because the underlying portfolio has drifted 10 basis points either up or down (and we haven't had much up lately!), they will simply adjust the renewal crediting rates by exactly 10 basis points.

With the index-rate annuity, however, an adjustment of 10 basis points on what is available to purchase options will result in a 20–25 basis point change in the rate cap. So, if you are used to seeing small adjustments for interest fluctuations on

your MYGA renewals, expect those same adjustments to occur with renewal rate caps but in an amount that is at least twice what you see on the MYGA rates.

There are a number of factors that make this process somewhat less than an exact science. For instance, in order to give a policyowner adequate time at the end of the index term to decide whether or not to reallocate between accounts, we must set a renewal rate cap well in advance of the contract anniversary (and well before we purchase the options for the next index term). That means we must look at option costs in advance of the actual renewal date and make our best guess about what the cost will be when we actually purchase. If that decision is made 60 days before renewal, the option prices can change significantly before we're able to make the purchase — but we're still obligated to the renewal rate cap we published to the policyowner. That one, simple disconnect can end up being quite expensive for the company, but the policyowner is protected because we always honor the rate cap we announced.

The Standard is committed to providing the most we can for policyowners and we have always been committed to ethical business practices. We set rate caps as aggressively as the market will allow while still paying the broker fairly and keeping the lights on at the home office. That's why we feel comfortable in offering a renewal rate cap bailout provision that allows policyowners the right to take their money — without surrender charge — if we reduce the renewal rate caps too radically.

That being said, however, it's important that a broker understands there will be movement in renewal rate caps. The better a broker prepares a client for this reality, the less painful that discussion will be at renewal time. In most cases, it is all about knowing your product well enough to set reasonable expectations with your client.

My personal opinion is that our IGA contracts should stay on the books

until the policyowner needs the money for retirement or succession planning. Performance is linked directly to the performance of the S&P 500 and our rate caps (both initial and renewal) are among the most competitive in the market. If the market dictates that we must lower renewal rate caps more than two percent from the initial rate cap, the policyowner is free to bail out with no surrender charges.

Also, keep in mind that, unlike some annuity carriers, we publish our renewal rate caps every month. You can always see how well we have treated consumers. How can we provide any better assurances than that?

Because we partner with you in the solicitation and management of this business it's in our best interest — as well as yours — to provide candid and accurate information about how The Standard sets renewal rate caps. This will help you to manage your client's expectations and enable you to grow your business and be more successful.

“We believe any honest and forthright business partner should take the same approach.

We would love nothing more than to be able to raise rate caps both on new business and at renewal time. Unfortunately, when renewal interest rates decline or the stock market gets bumpy and volatility increases, we have no choice but to lower caps as the cost of options increases, sometimes dramatically. We believe any honest and forthright business partner should take the same approach. So, if you don't like the renewal rate caps you see offered — without explanation — by another carrier, maybe it's time to take a closer look at how The Standard chooses to operate.

If you have any questions, don't hesitate to contact me or any of our sales staff. We value your questions and are confident that when you know all the facts you will be proud to represent The Standard.

