

Income Riders

By James Lynch, Vice President and Chief Financial Officer of 1st American Pension Services, Inc.

It's clear, income riders are among the most popular marketing creations in our annuity industry today. Perhaps the timing of this popularity can be largely attributed to the current, low interest rate environment. After all, presenting a fixed annuity at 2.0% or a fixed indexed annuity with lower caps, is a tough offering for a less than capable annuity producer when income riders are "paying" 6% or 7%.

Let's take a look at a generic income rider and break it down.

Income riders bear a certain cost; usually around 75 basis points annually. This fee is charged from product inception, all the way through the payout phase or death of the annuitant. This cost can be mathematically translated to a reduced interest return. For example, if the annuity you are offering has a current interest rate of 2.25%, and the rider cost is 75bps, the net yield would actually be an annual return of approximately 1.50%. Bear in mind the charge is usually taken from the account's value at the end of the account anniversary after interest is credited, so the actual net yield will slightly vary.

So what is the income rider fee paying for? Once an income rider is selected (or sold) the annuity carrier establishes an imaginary account, usually called an "Income Calculation Base" or "Benefit Base", etc. This imaginary account is given an imaginary interest rate called a "Roll-Up Rate". In today's market, this rate is usually around 6% or 7% for the first 10 years, however I've recently seen a carrier advertise as high as 14%. In year 11, the Roll-Up Rate could drop as low as 3%.

It is imperative to recognize and disclose that these income accounts are not real and hold no value. Carriers that offer income riders go to great lengths disclosing this. Regrettably, unsuspecting annuity buyers are still left with the belief that they're "earning 7%, guaranteed for life". This is a completely erroneous, yet wide-spread misunderstanding of the rider.

So how does a 6% or 7% Roll-up Rate effect the annuity owner's income? It's really quite simple. When the owner is ready for distribution income, the "Income Calculation Base" or "Benefit Base" is used in the equation to determine the amount of the monthly payments. Sounds advantageous, right? The "Income Calculation Base" or "Benefit Base" should be much higher than the actual accumulation value (underlying real dollars) because it was calculated using a 6% or 7% Roll-Up Rate throughout the first 10 years of the accumulation phase and at least 3% starting in year 11. Shouldn't this produce a higher income? Negative. Why? How can a carrier legally advertise it if it's not true?

What makes the rider work is the other factor to the equation; an age-based table usually called a "Guaranteed Withdrawal Percentage Table" or something similar. This is a limit on how much money your client can take out annually in retirement. It is used to "off-set" the calculation of 6% or 7% to the "Income Calculation Base" or "Benefit Base".

On average, at age 60, the annuity owner is limited to approximately 4% to 4.5% of the "Income Calculation Base" or "Benefit Base" annually.

Let's take a look at how \$100,000 would compare over a 10 year period for a potential 50 year old annuity buyer:

ABC ANNUITY	INCOME RIDER	SYSTEMATIC WITHDRAWAL
INITIAL INVESTMENT	\$100,000	\$100,000
ACCUMULATION PHASE	10 Years	10 Years
ROLL-UP RATE / INTEREST RATE	7%	4%
DISTRIBUTION FACTOR	\$196,000 (ICB/BB)	\$148,000 (AV)
MONTHLY INCOME	\$675	\$740
INCOME DURATION	Life	3 Years Past Life Expectancy

Surprising? Remember, the income under an income rider is determined using both the "Income Calculation Base" or "Benefit Base" and the "Guaranteed Withdrawal Percentage Table". This table offsets the unrealistic "Roll-Up Rates" applied to the "Income Calculation Base" or "Benefit Base".

Under a generic systematic withdrawal provision available in most annuities, the annuity owner would be able to withdraw **\$740 per month** all the way to 3 years past his or her life expectancy, continue to earn a current, real rate of return throughout retirement and control the distribution of funds to fit their retirement needs. Assuming the client starts receiving income at age 60 and lives until age 87, that would be a total of **\$21,000 more income** utilizing the systematic withdrawal provision already available with no fee.

Now let's answer the question: What is the annuity owner who's purchased the income rider paying for? Anyone?

It's important to note that an income rider will continue to pay no matter how long you live beyond life expectancy. But let's keep in mind that life insurance companies are part of a multi-trillion dollar industry betting you won't live that long. Those are some pretty long odds.

GLIR vs. GSWP

Does a Guaranteed Lifetime Income Rider yield a higher income than a Guaranteed Systematic Withdrawal Provision?

HYPOTHETICAL EXAMPLE OF SINGLE SUM AND MONTHLY CONTRIBUTIONS

	<u>GLIR</u>	<u>GSWP</u>
Age of Policyowner:	40	40
Single Sum Deposit:	\$20,000	\$20,000
Monthly Contribution:	\$300 per month	\$300 per month
Number of Contribution Years:	20 Years	20 Years
Average Annual Interest Rate:		4.0%
GLIR Roll-Up Rate (Initial Prem.): (Guar. 7% yrs.1-10; 3% yrs. 11-20)	7%	N/A
GLIR Roll-Up Rate (Subsequent Prem.):	5.5%	N/A
GLIR Cost: (Paid from Inception Date through the last payment to Annuitant)	.65% (Years 1-20) .75% (Years 21+)	N/A
Income Calculation Base:	\$230,515.49	N/A
Policy Value:	N/A	\$153,332.32
Guaranteed Withdrawal %:	4.0% (Age 60)	N/A
Guaranteed W/D Payment:	\$655.24/mo.	N/A
Systematic W/D Payment:	N/A	\$765.99/mo. (to age 87)
Access to Capital During Retirement:	Yes (For a Reduced Income)	Yes (Annuitant controls payments and time)
Total Funds Paid to Annuitant:	\$212,297.76 (to age 87)	\$248,180.76 (to age 87)