

Check Point: Income Rider Litmus Test

The Marketers of income riders available on the market today all hype their guaranteed roll up. The history goes something like this, one company releases a 5% guarantee rollup, and then the next one throws out 6%, then 7%, and then 8%. Can I get 10%? The guaranteed roll up is added to a fantasy number. It is a number that cannot be withdrawn in a lump sum because that sum of money really doesn't exist. It is merely a number used to calculate guaranteed income for life, and if you die the beneficiaries do not inherit this fortune. They get what ever is left in the account value. This looks a lot like a lifetime annuity with a A) commutation value benefit and B) a cash refund at death. Does anyone else see the similarities?

That being said, have you ever wondered if your client would be better off in a Fixed or Fixed Index deferred annuity and then annuitizing their spoils at a later date? Ask yourself "what is the actual internal rate of interest credit being assumed by the insurer when they are pricing this income benefit?" These are a few of the questions I wanted answers to. I'll show you how to get these answers as well.

With a few simple financial "house hold" items you can answer these questions.

Here is what you'll need

1. Your Favorite Income Rider/Product
2. A Specific Prospect: age, expected income date, premium
3. A reliable Immediate Annuity: with a commutation feature and a refund feature at death
4. A Future Value Calculator (Try This One)
 - a. (<http://tcalc.com/tvwww.dll?User?Tmplt=fv.htm&Cstm=financialwisdom>)

Here's Where To Start

Consider your next prospect, specifically one that you had identified as a candidate for an income rider. Knowing what your prospect's time horizon for deferral is(essential to even considering an income rider), determine what their income account value will be, "guaranteed." For example, multiply the premium by the roll up percentage and compound the interest (I use this term "interest" loosely to describe growth on the income account value). Do this for the specific number of years before guaranteed lifetime withdrawal will be taken. This will be your income account value (fantasy account number).

Next, multiply the income account value by the guaranteed lifetime withdrawal percentage. This is the age based percentage that determines how much of the income account value may be accessed for the clients lifetime. For example, many carriers have a 5% guaranteed annual withdrawal rate at age 60. Doing this will give you the guaranteed annual lifetime withdrawal. This withdrawal may be taken for the lifetime of the owner, and will stop when the owner dies (unless a joint payout option has been elected).

May I suggest using the company sponsored calculators rather than hand calculating these numbers? It will save you time, and headaches. Remember, these are all simple numbers and basic math. If company A) has the same roll up, and the same age based withdrawal rate as company B) the outcome will be the same for both income riders. No amount of flashy marketing will change that. So pick a calculator that is easiest for you to work with.

Uncovering The Real Cost

Now that you know what the guaranteed annual lifetime withdrawal is you can move on to the next step: Uncovering the cost of the annual payout in an immediate annuity. You will do this by choosing an immediate

annuity from and A rated carrier. However, choose your immediate annuity wisely. To be fair, you need one that will let clients ask for their remaining balance of the premium back while they are alive, and one that pays a death benefit of the unused premium to a beneficiary if the owner dies. You may find that the same company offering the income rider also offers an immediate annuity with these features too. This will give you a clearer look into the pricing of their rider. However, if they do not offer such an immediate annuity then you will have to look to a different company for this tool. If you cannot find an immediate annuity with these features AMZ Financial Services can help you locate one.

Utilize the company provided illustration software to find the premium needed to generate the income equal to what your prospect would receive annually from the income rider. Most of the illustration software programs have a “solve for” function that will allow you to do this. Make sure that the modal payment (frequency) of the immediate annuity is the same as the modal payment of the income rider. For example, if the income from the rider is calculated annually (most likely will be the case) be certain that the income from the immediate annuity has been calculated in the same manner. The premium needed to generate the income from the SPIA is much less than the income account value on your income rider. Go figure, oh wait, we just did!

Can you do better?

Now it is time to see if you can do better. The shorter the deferral period, the more likely it is that you can do better. The longer the deferral period, the more likely you cannot. Here is how I got there.

Dust off your trusty Future Value Calculator. Input the rate that you think your client would need to earn in order to grow the original deposit earmarked for the product/income rider combo. Now run that against the original deposit amount. Presto! Is the outcome more or less than the premium needed for the immediate annuity? If your guess is not spot on then adjust the interest rate on the future value calculator until you get within a few dollars of the needed premium for the immediate annuity. If the rate is 3%-5% you have to be wondering if there is a better solution to your clients future income needs. Perhaps a deferred product with a guaranteed rate of 5%-6% might do the trick. Maybe an index annuity with a cap rate of 10%-11% (Annual Point to Point) might be better.

The Account Value Can Grow Too!

I hear this one from time to time after explaining this simple calculation to a producer. Not surprising that I receive the staunchest resistance from producers who have been swooned by the allure of the income rider marketing and therefore have been selling them with fervor. There is some truth to this. If the index product has excellent crediting rates you could end up with a very attractive account value. In fact, you could have an account value that is worth more than what the premium cost would be for our immediate annuity above.

I have two points to make with regard to this argument. First, your client would have been annually charged the cost of the income rider against their account value. So if product X has the same crediting rates as Product Y and no rider, and product Y has a rider costing 0.50% per year, if you assume 5 years of deferral on both products Y will have at least 2.5% less interest than product X (not to mention the effects of negative compounding).

Secondly, the products that are most often paired with income riders are Big Bonus contracts. I will agree that these contracts make the most sense for this pairing because they boost the income account value from day one. This is assuming that the account value and the income account value are the same at issue. This may vary by product. If an income rider has already passed the “is this suitable” test then I would give you thumbs up to proceed. (To Learn more about the “is this suitability” test read “Guaranteed Income or Guaranteed Lawsuits” from the October issue of Producers Web)

However, the bonus contracts by nature have much lower crediting rates than products without bonuses. This is due to the internal pricing structure of an index annuity. A bonus reduces the budget allocated to hedging the index gain. This results in lower cap rates, higher margins, and lower participation rates. That being said, the bonus contracts overall interest credit (beyond the bonus) will be less, and the account value will grow more slowly.

Rate Will Rise

We are in a record low interest rate environment. Rates will rise in the future. This is important for you to recognize for two reasons. The income generated from an income rider purchased today will be the same today as it will be later when the interest rate environment has risen. In other words, when interest rates rise the cost of income goes down, but an income rider does not adjust for this. The income rider calculation does not take into account rate increases in the future. On the other hand, the cost of an immediate annuity income of \$2,000 per month today will be greater than the cost of a \$2,000 per month income in the future if you are assuming interest rates a likely to rise in the future. The cost of an immediate annuity falls when interest rates rise.

If you can beat the internal crediting rate on an income rider today with traditional fixed annuity products or index annuity products with high crediting rates then you would have the flexibility to purchase income for your customer in the future. The same income you propose on your favorite income rider today could most likely be purchased at a reduced cost in the future. This takes some more planning, and you will have to see you customers more often, but isn't that why we do what we do? Helping others achieve the best situation we can possibly provide. By the way, when you see your clients often no one else will be allowed to. You may just get a few more referrals too!

There is No Size Fits All Solution

There is no one size fits all solution to every Americans income needs. Each individuals situation will be unique to them, and the solutions that you provide as a financial professional should be specific to the individual you are trying to help. Income riders were created to solve "some" of the income needs of today's retirees and pre-retirees. Knowing how to use them effectively is important. They are tools to be used for specific situation.

If close is not good enough for you when working out a client's lifetime retirement income plan, then take to heart what I am saying to you. If you could create an income stream that is 20%-30% more efficient through a little planning wouldn't that be worth it? If you could provide a greater income for you customers, or leave a legacy to their heirs would that make sense?

Don't throw the baby out with the bath water either. An income rider could play an important role in an income planning strategy if the numbers work out in favor of the client. My challenge to you is to look objectively at these income riders as they pertain to your customers' unique situation. The solutions you provide to your customers are a reflection of you, and your commitment to their well being. Rather than blindly follow the lead of some flashy marketing, formulate your own educated position on income riders. Understand when they make sense for your customers and when they do not.