

WHERE TO GET IMMEDIATE FIXED LIFETIME INCOME AT RETIREMENT TODAY

BY DAVID BLANCHETT

The rapid increase in interest rates beginning in 2022 has led to some relatively staggering changes in the annuity market: annuities are now available that provide immediate, fixed guaranteed lifetime income with payout rates that *exceed* those of single premium immediate annuities (SPIAs), where the annuitant has full access to the account value (i.e., they are revocable).

These annuities are generally referred to as a fixed annuity (FA) with a Guaranteed Lifetime Withdrawal Benefit (GLWB). With this structure, the account grows at a fixed rate (e.g., 3% per year) and for an annual fee (e.g., 1% per year) the annuitant is guaranteed income for life. As noted in this research here the expected income from a FA+GLWB is significantly greater than other annuities that also include GLWBs, such as variable annuities (VAs).

This article explains why advisors should become familiar with FA+GLWBs, in addition to considering them for retirees who want fixed lifetime income in retirement.

IMMEDIATE LIFETIME INCOME

Immediate annuities are one of the simplest and oldest strategies for creating a guaranteed lifetime income. Contracts known as “annua” promising a payment stream for a fixed term, or possibly for life, in return for an up-front payment, were issued in ancient Rome. Single-premium life annuities were available in the Middle Ages.

With today’s single premium immediate annuities (SPIAs), a lump sum is generally irrevocably transferred to an insurance company which then promises to pay the annuitant (or annuitants if the payment schedule is based on the lives of more than one individual) some income benefit for life.

While SPIAs have been the predominant focus of early research on the potential benefit of an-

nuities that provide lifetime income, they remain relatively unpopular. (Only approximately \$6 billion of the \$255 billion total annuity sales in 2021 were in SPIAs according to an analysis by LIMRA).¹ One reason SPIAs are unpopular is the irrevocable nature of the contract.

Introduced in the 2000s, a “Guaranteed Lifetime Withdrawal Benefit” (GLWB) feature, sometimes referred to as a “Guaranteed Minimum Withdrawal Benefit” (GMWB), allow access to the contract value (i.e., are revocable) and guarantee some minimum level of lifetime income (which could potentially increase) even if the underlying account value goes to zero for an annual fee, typically around 100 bps per year.

GLWBs were originally very popular in the variable annuity (VA) space, but VA+GLWBs have fallen out of favor due to several insurers exiting the business (or dramatically reduc-

1. <https://www.limra.com/en/newsroom/news-releases/2022/secure-retirement-institute-total-annuity-sales-jump-16-in-2021--marking-highest-sales-since-2008/>

ing benefits) and the rising costs of issuing them. For example, in early 2022 changes in VA+GLWB marketplace resulted in the creation of products I characterize as “GLWB Lite”² which offered significantly lower expected benefits than previous product iterations.³

One recent pivot is the use GLWBs with fixed annuities (FA). In this structure the FA+GLWB will have a fixed fee (e.g., 100 bps accessed against the contract value) as well as a minimum fixed rate return, such as 3% per year.

These new FA+GLWBs effectively offer a fixed benefit for life, which is unlike many VA+GLWBs which offer the potential for higher income if the markets do well. The focus is on maximizing initial income, while providing the annuitant access to the initial premium. It’s a significantly simpler story than VA+GLWBs.

The exhibit below illustrates how the expected income from a VA+GLWB could be expected to differ from a FA+GLWB, assuming an initial premium of \$100,000 where the annuity purchased at age 65 for a single individual and income starts immediately. The analysis includes the results of a 1,000 run Monte Carlo simulation over 30 years assuming the VA+GLWB has an expected return of 7%, with a standard deviation of 9% (effectively a 60% equity portfolio using current capital market assumptions), a 5% initial payout rate, and an annual fee of 1.5% applied to the contract value. The FA+GLWB assumes an initial payout rate of 7.1% (more on this next).

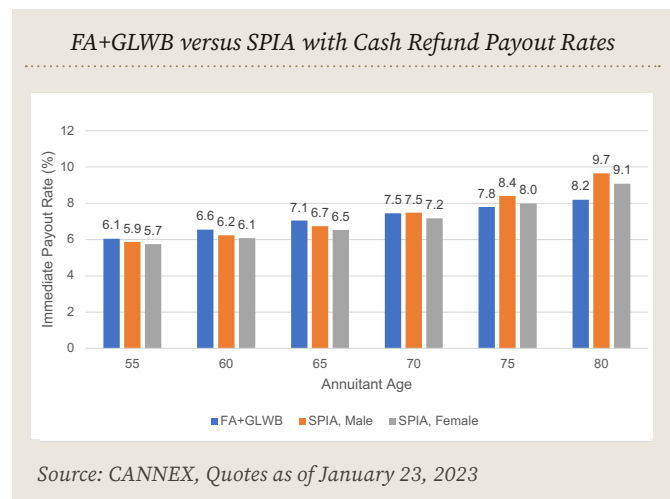
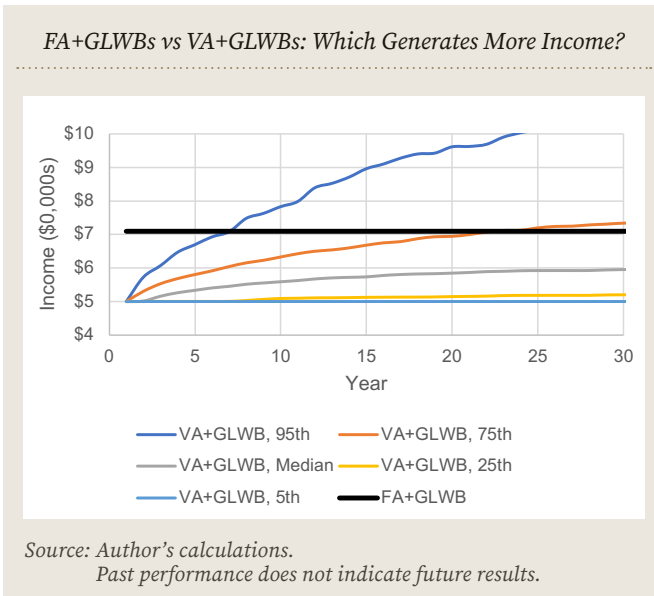
For example, the FA+GLWB generated a higher net present value income in approximately 85% of scenarios.

An important note: the VA+GLWB performs best when it adds the least value (versus self-annuitization). That’s because the runs where the income increases are those when returns are the highest where the non-annuitized portfolio assets would also be expected to do relatively well (notably reducing the value of the explicit longevity protection).

FA+GLWB VS SPIAS

The income generated from a FA+GLWB is perhaps most consistent with a SPIA, since both provide fixed, guaranteed amount of lifetime income. Theoretically, the payouts for SPIAs would be higher than FA+GLWBs because SPIAs generally require an irrevocable transfer of the premium while the premium for FA+GLWBs is effectively revocable (i.e., the annuitant can get his or her money back).

In reality, though, the income levels for FA+GLWBs are currently *higher* than SPIAs. This effect is illustrated in the exhibit below, which includes the information on the payout rate (annual income divided by premium) for the highest five SPIAs for single individuals (male or female) obtained from CANNEX on January 23, 2023. The SPI quotes include a cash refund provision, since this is the most common refund provision used today and only about 10% of quotes are life only (based on CANNEX Annual reports). The FA+GLWB payout rates are the average of two companies currently offering the strategy.



The exhibit clearly demonstrates that the FA+GLWB generated more income than the VA+GLWB, on average.

2. <https://www.advisorperspectives.com/articles/2022/04/18/glwb-lite-lower-costs-but-much-worse-benefits>
3. LIMRA sales data, December 2022.

The payout rates for the FA+GLWB are currently higher than the SPIA rates, especially for females, up until around age 70, after which the SPIA tends to generate more income. While not included in this piece, the differences in joint payouts were also reviewed and follow a nearly identical pattern, where payouts for the FA+GLWB are higher up until about age 70, where the SPIAs generate more income.

IT'S NOT NECESSARILY A FREE LUNCH

The fact FA+GLWBs have higher payouts than SPIAs (under the age of ~70) and offer access to the initial premium may seem like a free lunch, but that's not entirely true. There are a few important considerations that someone should be aware of before purchasing a FA+GLWB.

First, access to the premium for the FA+GLWB is to some extent a double edge sword. While access to the initial premium can be valuable to the annuitant, it can also result in lapsation, where the annuitant would have paid the annual rider fee and not effectively realized a benefit from the longevity protection. However, it is worth noting that since the annual credited fee exceeds the rider fee (generally 3% and 1%, respectively), the internal rate of return from owning a FA+GLWB would not be expected to be negative regardless of holding period. In other words, while the annuitant could almost definitely make money if the FA+GLWB is not held for life on a relative basis, it's not really possible to lose money on an absolute basis.

Second, GLWBs do not typically qualify for exclusion ratio taxation like with SPIAs. With exclusion ratio taxation any gains are effectively amortized over the life expectancy of the annuitant, while GLWBs are typically subject to "worst in, first out" (WIFO) taxation, in which all gains are taxed first.

Third, as noted previously, while payouts for FA+GLWBs are currently higher than SPIAs at younger ages, the higher income levels effectively disappear after age 70, so when the income is expected to commence will have a significant impact on the potential benefits.

Fourth, it's not clear how long this effect will persist. Changes in interest rates, regulations, competitive positioning are all reasons this could change in the future, so the potential benefits are by no means permanent.

CONCLUSIONS

The recent rise in rates has created exciting changes in the annuity product landscape. In this piece, I explored an annuity that can provide fixed guaranteed lifetime income with payout rates that are currently *higher* than single premium immediate annuities (SPIAs), where the annuitant has full access to the account value (i.e., they are revocable). FA+GLWBs are a relatively exciting development and would generally be considered to economically dominant SPIAs, given the combination of higher income and premium access, and are therefore worth consideration among retirees, especially those interested in fixed guaranteed lifetime income.