by Bob Affronti

Age of the SPIA

Single Premium Immediate Annuities

I wrote two previous articles for *California Broker* on SPIAs. The first, in 2001, was to correct agent's perceptions about the SPIA product. The second, in 2003, discussed methods using fixed annuities to provide income. The myths I tried to dispel nine yeas ago still exist in the agent community. I attribute this to lack of training in the SPIA area, but things are changing.

I have been an advocate of SPIA products for many years. The growth of the market has been huge over the past few years. Based on my discussions with annuity agents, I still believe that education is the biggest obstacle to more SPIA sales.

"The immediate annuity product has been talked about for years as the next product boom in the industry. In the actuarial profession, payout annuities are finally starting to get more and more attention. Product development actuaries, like myself, are working to revamp and enhance the product to be even more consumer driven. "I have been pleased to work recently to develop some new and innovative product concepts for payout annuities," said Michael Kaster, FSA, MAAA, MBA, managing principal for Kaster Actuarial Resources.

The number one concern of seniors is the same today as it was in the past -- outliving their money. The SPIA is the only financial instrument that guarantees that you can't outlive your money. There are other ways to ensure you don't run out of money, but none can safely provide the amount of income the SPIA can. The reason is that an SPIA invades principal on each payment. Under an SPIA contract, the principal is reduced to zero upon reaching life expectancy. Any other investment would cease to pay any more. But, the SPIA continues as long as the annuitant lives since it is a form of longevity insurance.

Other investments, in which principal is invaded, require continually higher returns to make up for the fact that there is less principal each year upon which to earn interest. Suppose you had $100,000 and you needed $12,000 yearly income. In a 5% market, you would invade $7,000 in the first year. In year two, you would $93,000 at 5% or $4,650 interest so you would have to invade still more principal. You would have to reduce your income demands (not a great option), reduce your lifestyle or take on more risk for the required higher yield.

Why do retirees put themselves in this position? I firmly believe that it's because the SPIA option was not offered or explained to them. I hear about the "4% solution," which states that you shouldn't run out of money if you don't spend more than 4% of your principal each year. Lets see, you'll get 4% and probably not run out of money. The SPIA says (for a 75-year-old male) you will get 9% per year and you will get that for as long as you live. The SPIA also carries a money back guarantee if you die early. In this instance, the SPIA more than doubles the client's retiring income without him having to worry about outliving his money. In case he dies early, there is also a 100% money back guarantee to the heirs.

The SPIA product offerings have expanded recently to include features that were lacking in the past. In its purest form, an SPIA guarantees the annuitant a monthly income as long as they live. The payment stops when the annuitant dies. This is referred to as a life-only option. The most common use of a life-only SPIA is when the income is being used to fund a life insurance policy. If the annuitant dies, the annuity stops, but the life insurance pays off. Since the life-only option produces the highest level of income, it pays for the largest amount of life insurance.

SPIA Options

In addition to the life-only option, SPIAs offer many other payout options. I like to talk about SPIAs that have a money back guarantee with inflation protection. Basically, it's an SPIA with a refund option for early death with an annual, compounded increase of 3% to 10%. The following are some other options:

1. Period Certain Only – Payments are for a set time period only.
2. Life +5, 10, 15 – It pays for a minimum of 5 years, 10 years, 15 years, or life whichever is longer.
3. Joint & Survivor – It pays as long as either party is alive; you can add guarantees.
4. COLA/CPI – Annual increases in payments are based on COLA percentage or actual CPI.
5. Longevity – It delays the first payment beyond 13 months.
6. Split Annuity – It's part SPIA, part MYGA
7. Underwritten – A number of carriers will underwrite for health issues.

SPIA Pricing

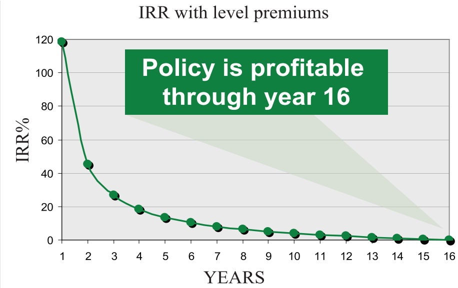
SPIA pricing is a moving target. The best price is found by running quotes from many companies. Some prices are better on males or females or older people or younger people. Some charge a lot more for guarantees then do some others. In reality, we run numerous quotes from numerous carriers.

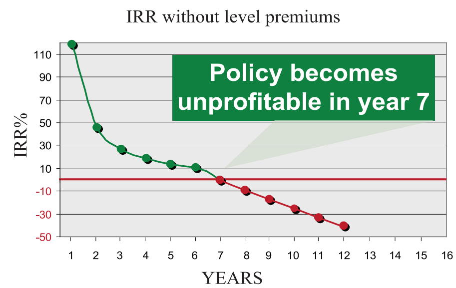
Sample Payouts

Males $100,000 Life with
Money back Guarantee
Age Monthly Payment Return
75 $722 8.66%
77 $759 9.12%
80 $822 9.87%
85 $937 11.25%

Exclusion Ratio

For non-qualified SPIA payments, the IRS recognizes that a portion of each





payment is a principal return. This part is tax-free. Typically, about 70% of each payment is tax-free as the older retiree ages. After reaching life expectancy, all future payments are fully taxable. Why? Because there is no principal remaining so payments consist of 100% interest. That is why they bought the SPIA -- so they still get monthly payments when the principal is exhausted. That is the insurance aspect; only an SPIA can continue an income stream with a zero principal balance.

Qualified monies are 100% taxable as received. Put an SPIA in a Roth and you'll get tax-free income guaranteed for life.

A Question of Yield

Occasionally I am asked, "What is the rate on that SPIA?" My standard answer is, "First tell me when the annuitant is going to die." An internal rate of return can be calculated on a SPIA, but I don't see the purpose because there is no principal if the annuitant lives beyond their life expectancy, yet payments continue. What is the rate on zero principal with a $500 payment? Infinite? It isn't fair to compare based on internal rate of returns because the SPIA is not a yield play. It is a longevity risk play. If your 80-year-old client can get a guaranteed return of almost 10% on his money for the rest of his life might there be some interest? A money back guarantee is included of course!

Liquidity

The good news here is that the carriers are finally allowing commutation of SPIAs. Lack of liquidity was a major concern. We now have several products with commutation provisions allowing liquidity in a meaningful way. Many methods are used to arrive at a value.

After 40 years in the guarantee business, I can honestly say that, in hindsight, the vast majority of retirees would have benefited from a guaranteed income product. I bought my mother an SPIA when she was 80. She is 92 now and still getting her checks and she doesn't care what the S&P does.

If a SPIA is not used in retirement one of the following will occur:

1. Underutilizing the retirement assets to cover longevity risk results in reduced lifestyle. You could have lived better, but you did not want to risk it.
2. Over utilizing of retirement assets to live in a certain style results in running out of money. Get a Wal-Mart job application card or call the kids!

A Word About Fees And Expenses

We have all faced the perception (misconception in my mind) that annuities are big commission, high expense products to be avoided. The reality is that an SPIA may pay a one-time commission of perhaps 3%. This is one-time only and there are no other fees for the rest of your life. If the investor chooses a mutual fund or variable annuity, they pay annual fees of 1% to 3.50% per year as long as they live – or run out of money. Even if the account loses value the fees are still charged which further dilutes the account.

In the long run, SPIA fees are far less than other investments, which put the risk on the investor. ❑

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