The Slippery Slope of Subsidization

IS IT POSSIBLE TO ENHANCE YOUR CAP WITHOUT SACRIFICING RENEWAL RATE INTEGRITY?

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What is Cap Subsidization?

In an increasingly crowded Fixed Indexed Annuity (FIA) market, the S&P 500 Cap strategy has become the one consistent point of comparison. Products with high caps are perceived to be more competitive, but as many have experienced, not all caps are created equally.

When the S&P 500 Cap is offered alongside other strategies, life insurers can choose to set their cap rate higher than market yields suggest they could be profitable. They provide these increased caps by lowering the rates on their other strategies. Simply put, they spend less on other strategies and spend more on a higher S&P 500 Cap. We refer to this as cap subsidization.

Here's a hypothetical example of subsidization for a typical life insurer:

AFFORDABLE RATES		
1-YEAR ACCOUNTS	**RATE**	**COST**
S&P 500 with Cap	8.25%	4.50%
Engineered Index with Participation Rate	90%	4.50%
Fixed Account	4.50%	4.50%
EXPECTED TOTAL COST		**4.50%**

SUBSIDIZED RATES			
1-YEAR ACCOUNTS	**RATE**	**COST**	**EXPECTED ALLOCATION**
S&P 500 with Cap	9.25%	5.00%	50%
Engineered Index with Participation Rate	80%	4.00%	35%
Fixed Account	4.00%	4.00%	15%
EXPECTED TOTAL COST			**4.50%**

Cap Subsidization vs. Renewal Rate Integrity

While cap subsidization can make a product appear competitive and provides a high headline S&P 500 cap rate, it may be a risky proposition. If the subsidizing carrier experiences higher allocations to the S&P 500 cap strategy than initially assumed, it may be likely to lower renewal rates in the future.

Below is a hypothetical example of a subsidization model.

	AFFORDABLE RATES					
	AFFORDABLE ALLOCATION		HIGH ALLOCATION		EXTREME ALLOCATION	
1-YEAR ACCOUNTS	**COST**	**EXPECTED ALLOCATION**	**COST**	**ACTUAL ALLOCATION**	**COST**	**ACTUAL ALLOCATION**
S&P 500 with Cap	5.00%	50%	5.00%	70%	5.00%	90%
Engineered Index with Participation Rate	4.00%	35%	4.00%	20%	4.00%	5%
Fixed Account	4.00%	15%	4.00%	10%	4.00%	5%
	EXPECTED TOTAL COST	**4.50%**	**ACTUAL TOTAL COST**	**4.70%**	**ACTUAL TOTAL COST**	**4.90%**
			EXCESS	**0.20%**	**EXCESS**	**0.40%**

Allocations to the S&P 500 Cap strategy that are higher than expected can lead the insurer's total cost to rise above its aggregate budget. To get pricing back on track, the renewal rate for the S&P 500 Cap may be reduced in future years.

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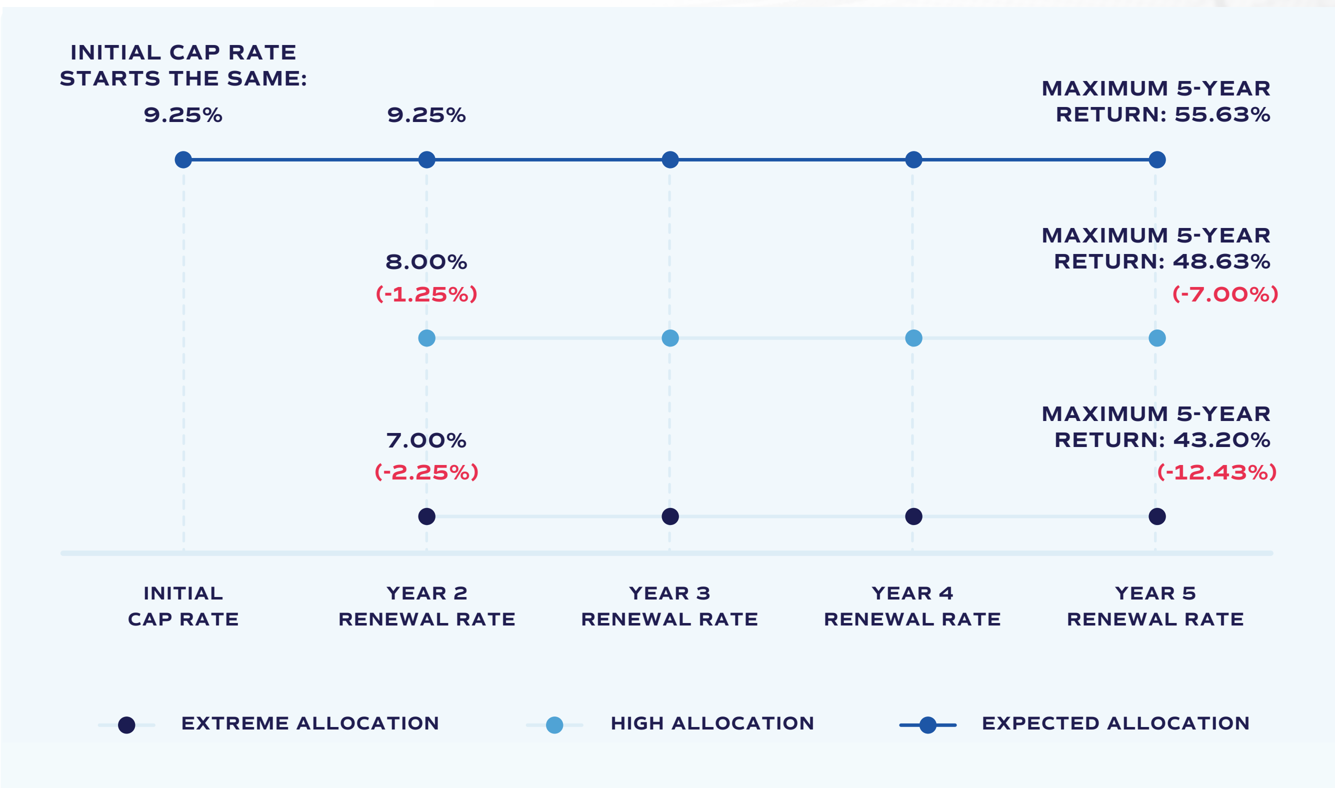
A Hypothetical Example

See the subsidization example below using a hypothetical 5-Year FIA, assuming other strategies maintain a consistent cost:

Initial cap rate set at rate → Renewal rates for higher S&P 500 cap allocations are reduced to recoup budget → Lower renewal rates reduce potential return over lifetime

S&P 500 CAP RATE FIA LIFETIME



Cap rate reductions in renewal years have a significant impact on potential returns over the lifetime of the annuity.

A Transparent Approach to Cap Subsidization

At Knighthead Life, we take a different approach to subsidization. For those wanting to allocate premium to the S&P 500 Cap strategy on our Chartline FIA, we provide two transparent options:

SUPPORTABLE BUDGET

For individual allocations to the strategy, we offer a Cap rate that's supportable by our budget rather than propped up by other strategies. The market environment may change and lead to fluctuations in renewal rates, but changes are intended to address the life of the contract.

CAP AMPLIFIER MODEL PORTFOLIO

For clients interested in maximizing their S&P 500 Cap rate, we offer the Cap Amplifier Model Portfolio. This model leverages transparent subsidization to increase the S&P 500 Cap above a standalone allocation.

This is supported by a pre-set allocation of funds among the strategies within the Model Portfolio. You can view the Cap Amplifier Model Portfolio one pager for more information.

Read more about the Cap Amplifier Model Portfolio.

See the historical performance of this Model Portfolio and other index options with our Index Visualizer.

View current available rates for Chartline & Chartline Bonus.

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Disclosures

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