How Rising Interest Rates Affect Annuities

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n March, the Federal Reserve is expected to raise interest rates for the first time in four years. For anyone considering buying an annuity or other income-oriented vehicles, that should be good news.

"Rising rates could have a very positive impact on annuities and the benefits they provide," says Tim Rembowski, a vice president at DPL Financial Partners in Louisville, Ky.

But which annuities, and exactly how they will be impacted, varies.

Fixed Annuities

Fixed annuities, which are insurance contracts that pay out a specific, guaranteed rate, are most directly affected by interest rates. As rates rise, "investors can get a better payout for the same premium," says Philip Chao, principal at Experiential Wealth in Cabin John, Md.

Fixed-indexed annuities (FIAs), though, pay out a rate based on the performance of a market index, such as the S&P 500. Holders of these contracts benefit when the index rises, and there is usually a limit on losses if the index falls.

But the amount of index gain that's credited to the FIA can fluctuate. If the insurance company's general account grows, the company can offer a higher cap rate, which is the percentage of index gains that are credited to the FIAs. And insurance companies' general accounts are expected to grow as interest rates rise. "Shoring up the balance sheet enables insurers to offer more attractive annuities," says Karl Wagner III, a partner at Biondo Investment Advisors in Milford, Pa.

That's true no matter what type of annuity you're talking about. Eric Henderson, president of Nationwide Annuity in Columbus, Ohio, puts it this way: "Rising interest rates allow us to offer increasingly competitive products."

At Lincoln Financial Group, the annuity provider headquartered in Radnor, Pa., chief investment officer Jayson Bronchetti adds, "The new money yields of our investment portfolio also increase, which is a positive contributor within the overall annuity rate-setting process."

Variable Annuities

Also expect these higher crediting rates on registered index-linked annuities (RILAs), an increasingly popular type of variable annuity (VA) that uses a stock index to determine gains and losses.

In general, variable annuities are more closely pinned to equity markets. Traditional VAs—not the RILA variety—hold contract assets in mutual-fund-like subaccounts. If equity markets slump with rising rates, their performance will suffer, too.

“If you absolutely knew that stocks would have a loss, I suppose a fixed annuity would be better [than a variable annuity],” says Wade Pfau, director of the Retirement Income Certified Professional designation program at the American College of Financial Services in King of Prussia, Pa. But, he adds, that’s only true for VAs without a guaranteed living benefit rider, which is an optional add-on that, for a fee, secures a separate income payout.

“Rising interest rates will give insurance companies more flexibility to increase payout rates on living benefits,” says Todd Giesing, an assistant vice president at the Secure Retirement Institute in Windsor, Conn.

Predicting which way equity markets will go is impossible, of course. “It sort of depends on whether the rise in bond yields is more or less than the anticipated rise in bond yields that’s already priced in,” says Joe Tomlinson, an actuary and financial planner currently based in West Yorkshire, England.

Annuities Versus Bonds

To be sure, a rise in interest rates will cause an increase in most newly issued bond yields (as well as savings accounts, money market accounts and CDs). Relatively speaking, how will annuities stack up?

This current increasing interest-rate cycle is still in its early innings. “The rising tide of higher rates lifts all interest-bearing boats,” says Frank O’Connor, a vice president at the Insured Retirement Institute in Washington, D.C.

But rising bond yields means bond prices will fall, hurting most bond funds, at least in the short run. “This could positively impact annuities,” says Pete Golden, chief sales and distribution officer at Equitable in New York City.

Moreover, annuities can provide benefits that bonds don’t, such as guaranteed income for life—“one of the main reasons financial professionals bring annuities to their clients,” says Bryan Pinsky, a president at AIG Life & Retirement in Woodland Hills, Calif.

"This ability to guarantee a lifetime stream of income, which bonds cannot do, is what makes annuities appealing to retirees worried about outliving their savings," adds Andrew Melnyk, chief economist at the American Council of Life Insurers in Washington, D.C.

Annuity Riders

Besides guaranteed lifetime income, some annuities offer other add-ons—such as long-term-care insurance and death benefits. "The different types of contracts offer different benefits that bonds cannot," says Michael Zmistowski at Financial Planning Advisors in Tampa, Fla.

In the new interest rate environment, annuity providers will no doubt keep innovating. "We need to see what new annuity products the insurance companies come up with," observes Brett Bernstein, CEO and co-founder of XML Financial Group in Rockville, Md.

Mortality Pooling

Annuities have another advantage over bonds: Their payout rates aren't based entirely on interest rates but also on mortality credits. Sometimes called mortality pooling, this is an actuarial calculation that weighs each annuitant's life expectancy at the time of purchase.

"Annuities offer an income advantage over the bond alone for anyone over 70, through mortality credits," says Jason Branning at Branning Wealth Management in Ridgeland, Miss.

It's All In The Timing

Whatever happens, existing fixed annuities won't change. Only newly issued contracts can reflect higher rates. "Because fixed annuities are contractual obligations with a life insurance company, their value doesn't fluctuate," says Kimberly Foss, president of Empyrion Wealth Management in Roseville, Calif.

Don't expect other types of annuities to change too soon either. "It might take some time for the adjustments in [interest] rates to make their way into payout rates," says James Regan, a partner at SharpePoint in Phoenix.

Annuity modifications will depend partly on how much and how quickly the Fed moves. "The pace of change is critical," says Russell Hill, chairman of Halbert Hargrove in Long Beach, Calif.

Everything Is Relative

As of this writing, the Fed has announced a gradual tapering of bond purchases in concert with rate increases. "So far, the rise in rates is slight, not impacting products

much yet and still way below what we have seen even in recent years," says Larry Rybka, president and CEO of Valmark Financial Group in Akron, Ohio.

His colleague, Jacob Soinski, senior financial planner at Valmark, adds, "An investor in bond funds will generally experience some return lag in a rising interest rate environment, because newly issued bonds with higher rates will be more expensive than the fund's existing bond holdings."

That's also good for annuities. "Annuities can often provide a greater benefit for long-term investors than buying bonds," says Mike Harris, a senior education advisor at the Washington, D.C.-based Alliance for Lifetime Income.

Impossible To Predict

But one can never be sure how far the Fed will move. "It's not all that clear how comfortable Federal Reserve chair Jerome Powell is with enacting less accommodative monetary policy," says Joan Alexandre, an analyst at Kestra Financial in Austin, Texas.

David Blanchett, Lexington, Ky.-based head of retirement research at PGIM, the investment management group of Prudential, is similarly cautious. "There's a very real possibility rates could fall again," he says, "if we have a big negative market event."