NATIONAL UNDERWRITER®

Learn To Spot 'Phantom' Band Annuities

By Danny Fisher, CLU, ChFC

January 18, 1999

When selling annuities, it is of the utmost importance that the seller correctly explains to the buyer how an annuity is designed to work.

This is easy enough to do when the products are easy to understand. But with some fixed annuities, the interest crediting includes what I call a "phantom band" element, and if producers don't know they are selling such a product, they and their clients cold face difficulties down the line.

Before discussing this further, let's first review the basic designs in traditional fixed deferred annuities. There are four of them:

— *"Two Tier" type annuities* are the most difficult to explain and understand. Basically, these pay a large up front bonus on top of the normal interest rate. The bonus will be forfeited if the policy is not annuitized. Renewal rates are as declared by the company.

There seems to be no middle ground, agents either love or hate this type of annuity.

— *"CD" Type annuities* are the easiest to explain and understand. They work basically the same as a certificate of deposit at a bank. That is, the company will offer a rate, guaranteed for a given period of time. At the end of the guarantee period, the policyowner may surrender the annuity for it's full value, transfer the full value to a new annuity, or renew for a new period of time.

— *"Portfolio Rate" type annuities* generally offer a guaranteed interest rate for an initial period of time, such as one, three, or five-year periods. After the initial rate period, renewal rates are based upon the earnings of the underlying investment portfolio.

Companies will take their spread and pay out the rest to policyowners. The basic premise is that, after the initial period, everyone who owns that particular annuity will earn the same rate.

— *"Banded Rate" type annuities* generally fall into two categories, which I have dubbed; the "Promised" Band and the "Phantom" Band.

The difference, between the two distinctive bands, is causing some marketing problems.

About 20 years ago, virtually all annuities were "portfolio" types. In essence, an insurance company said "trust me" to be fair on renewal rates.

About 15 years ago, "CD" type annuities were introduced because clients wanted to know what they could expect to earn over the life of the annuity, rather than to trust a company, that in many cases they had never heard of before.

Then, about 10 years ago, the "promised" band type of annuities was developed. The idea behind that a company could offer a higher rate if it only "promised" to pay it, rather than guaranteed to pay it, as in a "CD" type annuity.

For example, in the sales literature, the wording reads something like this; "In the first contract year, your annuity will be credited with the current base interest rate plus an additional one percent. After the first year and through the fifth contract year, as current company practice, the company is committed to crediting an interest rate to your annuity that is equal to your base interest rate."

If the annuity had a penalty period of five years, the funds were invested accordingly. That way, the company knew what interest rate they could afford to pay over the five-year period.

The "Promised" band annuity works great. It makes sense to the client, agent, and company.

The problem is, about five years ago, some companies picked up on selling the base rate concept, but without the promise. Rather than expressing it as a "promised" rate, they simply refer to a base rate plus a first year bonus.

For example, the sales literature reads something like this: "The annuity has a base rate of 6 percent and will earn an additional 2 percent in the first year. Surrender penalties expire at the end of the fifth year. The minimum guaranteed interest rate is four percent."

Although the statement is technically correct, it implies that the base rate will remain at 6 percent in years two through five – when in fact, the base rate is a "phantom." The actual rate in years two through five will probably hover between four and five percent.

These annuities are what I call the "phantom band" annuities.

I have a lot of confidence in the honest nature of agents. The problem is that most agents simply don't understand the subtle differences between a "promised" band and a "phantom" band annuity.

Companies who offer "phantom" bands rarely go out of their way to explain what renewal rates are planned to be.

And therein lies the rub. If an agent sells a "phantom," thinking he is selling a "promise," his or her client is going to be real mad about two to three years from now.