The Realities Of Risk – CDs & Annuities 5/04

Pity the poor CD buyer. Four years ago they were earning close to 7% on their certificates of deposit, three years ago nearly 5% interest rates were paid, but for the last two years yields have hovered on the short side of 2%. Think about the magnitude of the drop. From May 2000 to May 2002 certificate of deposit rates fell 72%; they then dropped another 40% from the 2002 point over the next two years. If you were retired and attempting to live off your CD interest you've seen your income drop over 83% since the turn of the millennium. And yet, $800 billion of consumer money remains in CDs. *

Included in this mix is $166 billion sitting in bank IRAs. Let's see, if we use the ***Rule of 72*** to determine how fast money doubles, and our bank IRA is paying 1.25%, the $20,000 sitting in the bank IRA will double to $40,000 in ... 2060.

What possesses people to hold CDs in this environment? One reason is that CDs have guarantees.

Certificates of Deposit Offer Guarantees

Guaranteed Taxation

Guaranteed Lack of Minimum Return

Guaranteed Income You CAN Outlive

Guaranteed Recurring Surrender Charges

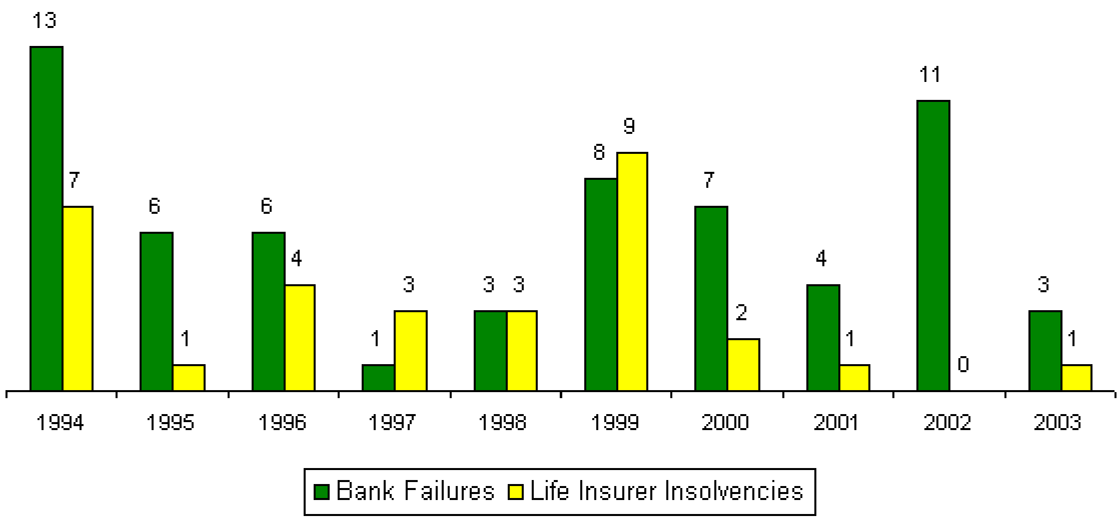
But you know the real reason people own CDs. It is because they are FDIC insured. Although you may not have received all your money back if your CD in a failed bank exceeded FDIC limits, bank balances of $100,000 or less were paid out promptly.

The credit risk of an FDIC insured account is for all practical purposes the same as that of a direct U.S. government obligation. Some producers try to sell annuities by bashing FDIC coverage. It doesn't work. In some of my consumer testing I've asked consumers if their agent ever brought up the risk of possible failure of FDIC. The response I get is the consumer believes their congressman will not let FDIC fail and they think the agent is just ranting to make a sale. I don't care if the agent knows they're right about FDIC, the consumer thinks they're wrong. An agent is not going to win on a safety issue involving a non-government insured instrument by saying the safety of the government insured instrument is suspect. A better way to handle the safety issue is to explain the realities of credit risk.

The financial books of insurance companies are examined by states on a regular basis. Independent companies assess the financial strength of carriers and assign ratings based on their assessment.

What if a company does go belly up? An annuity contract is an asset of the insurer, and another insurer usually buys the annuity contracts of the troubled company and life goes on. At worst, every state has a guarantee fund to dip into designed to protect annuity contract owners if a company tanks. The big picture is the consumer's car is insured, their house is insured, their pension is often insured, and their life is insured. If they're not losing any sleep over these insurance companies, why should they treat the annuity carrier any different?

Let's look at some hard numbers. From 1993 through 2003 there were 104 bank failures. Although CD deposits within federal deposit insurance limits were protected, the same did not hold true for account balances over the insurance limits. Bank account balances above FDIC limits were treated as creditors of the bank, and these customers stood in line to get paid just like other creditors. Savings customers were at the front of the line, but not every customer was made whole (someday I may publish a bank-by-bank list of the percentage of principal uninsured account balances actually received).



During the same period customers of 42 life & health carriers received cash from state guarantee funds. Every state guaranty fund covers up to $100,000 of cash value in the event of carrier insolvency, but here's the real deal. I have been digging though the records of insurance company failures for over eighteen months. Based on my research every annuity holder in a failed company during this period received up to $100,000 of the annuity value. In fact, during this period there was only one failed carrier that did not provide <u>all</u> of the annuity value – even for account balances in excess of $100,000 – for <u>all</u> of their annuity customers; owners of annuities issued by National American Life Insurance Company of PA did receive up to $100,000 but account amounts above $100,000 may never be fully paid.

Even when I go back twenty years I have only been able to find one other carrier that did not, at the very least, return 100% of the principal in the event of a failure. Annuity holders of Inter-American Companies, an Illinois insurer that went under in 1991, took a hit. Out of $648,747 that was still due from the annuities, the owners received a final payout of $97,653. There may be other carriers out there that have not returned a hundred cents on the annuity dollar, but I sure can't find them.

All of this is not meant to slam FDIC. FDIC insured accounts are very, very, safe, and consumers know this. Producers need to present fixed annuities as another safe money place. Will a consumer lose money due to bank failure with their CD? Almost certainly not. Will a consumer lose money in their fixed annuity due to an insurer failure? Almost certainly not, at least based on actual history.

Fixed rate and fixed index annuities offer a safe alternative to CDs with higher current rates and the potential to outperform CDs down the road. When consumers understand the realities of risk they often choose the annuity.

* All CD data is from Federal Reserve Board. Other sources include Federal Deposit Insurance Corp., National Organization of Life and Health Guaranty Associations, National Association of Insurance Commissioners, Illinois Department of Insurance, California Department of Insurance, Florida Department of Insurance.