Annuitizing Old Contracts to Generate Income

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When advisors come across an old annuity contract, their first instinct, typically, is to replace it with a newer, more feature-rich, and possibly cheaper one. After all, newer is better, right? Not always.

Old annuity contracts have one very important advantage: They were designed with vastly different assumptions about mortality and interest rates. If the contract is old enough – 15 to 20 years old – these assumptions can be beneficial to the policyholder because the older the contract, the more potentially valuable it is.

For example, despite recent Federal Reserve interest rate policies, rates remain below where they were at the turn of the century. In May 2000, 10-year U.S. Treasury notes were yielding 6.51% compared with "just" 3.6% today.[1] This means that insurance companies were basing their annuitization rates for these contracts at that time on the assumption they could earn much more interest than contracts issued over the last 15 years. This, in turn, means that these contracts likely have much more generous payout rates than offered in the market today.[2]

Adding to the potential advantage is the fact that older policies are based on older mortality tables. Since life expectancy has increased over time, the older the mortality table that is used, the lower the assumed life expectancy, which in turn generally means a higher rate of annuity income.[3]

While insurance companies update their mortality tables over time, it can often be many years after the National Association of Insurance Commissioners (NAIC) establishes the latest tables. For example, the 2001 Commissioners Standard Ordinary (CSO) tables weren't required to be used until 2009.[4] This means that annuities issued prior to 2009 could have issued with mortality tables created in 1980.[5]

Stop and think about that for a second. Life expectancy in 1980 was just 73.7 years, compared with 76.1 years today.[6,7] But more importantly, think about interest rates in 1980. U.S. 10-year Treasury notes hit 12.86% in March of 1980, before peaking at over 15.5% just 18 months later.[1]

The point is that the older the annuity contract, the greater the amount of income the policyholder can likely receive by doing something that very few policyholders actually do – annuitize the contract. Financial professionals should consider contacting the insurance company and asking for an annuitization quote for clients with annuities contracts that are at least 15 years old. I expect you will be surprised at how much income that annuity can generate.

But are there a lot of contracts that old? Haven't most of them been either cashed out or moved to a newer contract? You'd be surprised at just how many there are. After filtering through the 1 million+ annuities sitting in SIMON from iCapital's Annuities Platform for contracts issued prior to February of 2008, there were over 240,000, or just under 25%, that are at least 15 years old. Almost 10% are 20 years old or older.

I don't know about you, but I would have never guessed that there were that many old policies. But, if I stopped to think about it, I shouldn't have been surprised. A lot of annuities are funded with money the policyholder never really needs; therefore, they just leave the money in the contract to avoid the taxes. They simply don't realize how valuable the policy could be as a retirement income generation tool. I would suggest you educate them.

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