How do Index Annuities Actually Work?

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Have you ever wondered how it's possible to have a product that offers upside potential while also protects all of the principal? Clients and financial advisors alike often wonder how it is actually done and I'm going to tell you how.

How is this even possible?

The interest credited to the contract is based on the performance of a market index, but the money is not directly invested in the market.

How does the insurance company actually do that?

This is a very simplified explanation, but here is the general concept around how an index annuity is built. Premiums paid to an insurance company to purchase a fixed index annuity are pooled with all other client premiums. This pool of money is meant to do two things: First, the majority of the premium is used to purchase bonds, which make up the insurance company's general account portfolio. Since the insurance company pools all client premiums together, it allows them to have greater buying power and thus higher bond yields than those available to individuals. Second, a smaller portion of the premium is taken to an investment bank where they determine how much upside they will give of an index. The investment bank will tell the insurance company the cost of a call option of which they will provide all of the return of the index for the next year, up to a certain cap. The insurance company will buy the call option and this will establish the fixed index annuities cap rate for the year.

One year later, if the index has experienced an increase, the insurance company will exercise that option and will yield a gain up to the predetermined cap. This gain will then be passed on to the contract owner. If the index experienced a decline, the insurance company will allow the call option to expire and the only loss will be the amount paid for the call option, known as the premium. This same process will occur each contract year with the annual premium for the options coming from the annual return on the bonds that were originally purchased. The insurance carrier will calculate the overhead expense to administer the plan, pay for the contract guarantees, and compensate the advisor. A portion of the bond interest will be used to meet these obligations with the remaining amount used to purchase new call options. As prices change each year, so do the renewal rates of the fixed index annuity contract.

In summary, by investing all the client premiums into bonds, and not directly into the stock market, insurance carriers are able to protect the client's principal. After factoring out all company and contract guarantees, the excess bond yields provide the required premium to purchase call options for the upside potential and this is how a fixed index annuity is built.