How Does An Insurance Company Make Money?

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Have you ever wondered how an insurance company makes money through the sale of annuities? Simply put, an insurance company makes money on the spread between its investment yield and the interest it credits to contract owners. But there's more to it than you realize.

For traditional fixed annuities, 100% of the money the company receives from a contract owner is invested in traditional investments like corporate bonds, mortgage backed securities and similar securities. The largest portion of the investment yield generated is credited to the contract owner. The remainder covers acquisition and maintenance expenses, provides a profit for the risks undertaken, and produces a reasonable return on capital for the insurance company.

A closer look at fixed-indexed annuities

Fixed-indexed annuities operate similarly to traditional fixed annuities, with two important differences. First, interest credited to the contract owner is based on growth of an index or ETF. Second, the contract owner's principal is protected against market declines.

To provide for market-linked growth and principal protection, the insurance company uses approximately 3% of the contract owner's premium to purchase a call option (e.g., a one-year, 5.50% cap on the S&P 500®) in a highly competitive bidding process among approximately a dozen investment banks. The best call option price is the one that gives the contract owner the highest cap for the fee the insurance company pays.

When the market rises, the insurance company passes 100% of the return generated from the expiring 5.50% call option to the contract owner. For example, if the market rises 10%, the investment bank pays the insurance company a 5.50% return, and the entire amount is passed to the contract owner. The insurance company does not deduct any fees for the cost of the option, nor the competitive bidding process.

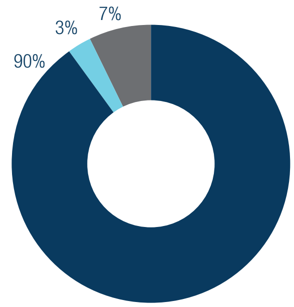
When the market declines, the call option expires worthless, so there is nothing to pass along to the contract owner. The insurance company still absorbs 100% of the cost of the option.

The process happens at the start of each one-year term for the contract, where investment banks competitively bid again and the highest cap wins.

Where the insurance company's profit comes in

At Great American, 90% of our assets are invested in corporate bonds and other fixed securities, which allows us to shield our contract owners' accounts against declines in equity prices. Our fixed-indexed annuity profit comes from the investment income generated from our portfolio, minus the 3% fee that is paid to the investment bank for the call option on the index.

Great American's Annuity Group Investment Portfolio as of December 31, 2017



- Fixed income investments
- Real estate and mortgage loans
- Stocks and other invested assets

A look at today's market

In May 2018, for a 3% fee, the best available S&P 500® point-to-point cap was 5.50%. At Great American, the 3% fee is expected to remain constant, as long as the company's future expectations are realized. To the extent the future deviates from this expectation, future caps may be more or less than 5.50%.

Other factors that may affect future caps include market volatility, bond spreads, interest rates and changing regulatory requirements.

Strength in numbers

Great American competitively bids approximately $20 billion for call options every year. Most individuals and organizations do not have this buying power, so they would not receive as high a cap as Great American can offer.

During the 2008 financial crisis, Great American remained profitable, honored every obligation and maintained its strong capital position without borrowing. In the process, we received a ratings upgrade from Standard & Poor's, while other companies were downgraded. Many investors saw their retirement savings devastated, but Great American contract owners were protected.

In conclusion, fixed-indexed annuities allow contract owners to transfer the risk of equity loss to the insurance company, while receiving competitive pricing and earning potential they could not obtain on their own. An insurance company does not take any of a contract owner's return. Rather, the profit comes from its investment portfolio.

An early withdrawal charge and a market value adjustment may apply if a contract owner surrenders or takes a withdrawal from the fixed-indexed annuity during the early withdrawal charge period. An early withdrawal charge will reduce contract values. A market value adjustment may increase or reduce contract values depending on changes in interest rates.