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It pays to keep things simple.®

How Insurance Companies Set Fixed-Indexed and Registered Index-Linked Annuity Rates

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 used to credit 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.

Setting rates on 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 in part 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 might use approximately 2% of the contract owner's premium to purchase a call option (e.g., a one-year, 3.50% cap on an S&P 500® strategy) in a highly competitive bidding process among approximately a dozen investment banks. The best call option price allows the insurance company to offer the highest cap.

When the market rises, the insurance company uses 100% of the return generated from the expiring 3.50% call option to credit the contract owner. For example, if the market rises 10%, the investment bank pays the insurance company a 3.50% return, and the entire amount is used to credit 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.

Setting rates on registered index-linked annuities

Registered index-linked annuities (RILAs) operate similarly to FIAs with one important difference. While interest credited to the contract owner is based on growth of an index or ETF (just like an FIA), the contract owner's principal is only partially protected against market declines – and in exchange for taking on additional risk, they receive greater growth potential in the form of a higher cap or upside participation rate.

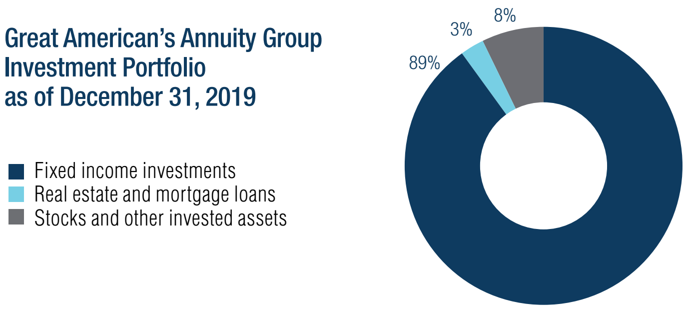
To provide for greater market-linked growth *and* partial downside protection, the insurance company uses both call and put options. The insurance company starts by selling the risk of a market decline in the form of a put option, for which they receive additional premium (usually between 2% and 6%). Then, the insurance company uses approximately 2% of the contract owner's premium (just like an FIA) *and* the additional premium received for the put option to purchase a more competitive call option (e.g., a one-year 18.00% cap on the S&P 500® 10% buffer strategy) – providing the contract owner with greater growth potential.

For both FIAs and RILAs, this process starts over at the beginning of each contract term, where investment banks competitively bid again and the highest cap wins.

Where the insurance company's profit comes in

At Great American, 89% of our assets are invested in corporate bonds and other fixed securities. Our fixed-indexed and registered index-linked annuity profit comes from the investment income generated from our portfolio, minus the 2% that is paid to the investment bank for the crediting strategy. By effectively managing our portfolio and associated risk - such as interest rate, liquidity and default risk - we are able to shield our contract owners' accounts against declines in equity prices.

Great American's Annuity Group Investment Portfolio as of December 31, 2019



A look at today's market

In December 2020, for 2% of the contract owner's premium, the best available S&P 500® point-to-point cap was 3.50% for an FIA and 18.00% for a RILA. At Great American, the 2% 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 vary.

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-$24 billion for 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.

With roots dating back to 1872, Great American Insurance Group has withstood the test of time through multiple financial crises – and while many insurance companies have seen their ratings fluctuate during difficult economic times, we received an upgrade to “A+” by Standard & Poor’s following the 2008 financial crisis and an upgrade to “A+” by AM Best during the 2020 pandemic. Throughout these periods of uncertainty, many investors saw their retirement savings devastated, but Great American contract owners were protected.

In conclusion, fixed-indexed and registered index-linked annuities allow contract owners to transfer all or some 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.

Standard & Poor’s rating affirmed March 5, 2020. AM Best rating effective October 28, 2020.

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.