Understanding Spread

What is the crediting rate in a guaranteed insurance account?

The crediting rate in a guaranteed insurance account product refers to the interest credited to the plan participants’ accounts. It is declared and guaranteed in the first contract year, in advance for up to one year and thereafter, in advance, for six months. Generally, the guaranteed insurance account guarantees a minimum rate of return ranging from 1%–3% regardless of the performance of general account assets. It is common for guaranteed insurance accounts to have a higher crediting rate than other capital preservation products because the underlying assets typically have a longer duration than, for example, the assets held in a money market fund. Simply put, crediting rate is the rate of return that a plan participant will receive on contributions and accrued interest and should be an important part of any plan sponsor’s evaluation before adding a guaranteed insurance account product to a plan’s investment lineup.

What is spread?

An insurance company is required to reserve capital to support the declared and guaranteed crediting rate on the guaranteed insurance accounts it offers. Spread revenue, or “spread”, refers to the difference between the actual earnings on investments made by the insurer and the crediting rate guaranteed to participants for that period. The crediting rate is subject to the minimum guaranteed rate stated in the insurance contract. Unlike fee products, spread is not pre-fixed or predictable. While the stated rate of return to plan participants is guaranteed, fluctuating investment returns, asset impairments, higher capital requirements, or other adverse situations may result in actual returns that are below the stated guaranteed rate. So, it is important to understand that spread does not always translate into profit for the insurer — it can just as easily translate into loss.

Must spread be disclosed under the Department of Labor (DOL) fee disclosure rules?

No. The DOL excluded guaranteed insurance account contracts and other fixed return investments from fee disclosure requirements, stating that these products must “provide a fixed or stated rate of return to the participant for a stated duration.” Guaranteed insurance account contracts are managed collectively in the insurer’s general account and are not earmarked for a specific liability. This differs from other stable value products that have a stated fee, usually expressed as a percentage of account value and deducted from the investment return.
Is it important to compare spreads across insurance companies?

Guaranteed insurance accounts are designed to deliver an insurance guarantee of principal and a declared interest rate, a concept similar to that of other fixed deferred annuities or certificates of deposit from a bank. Assume two providers with similar strong financial strength ratings both offer a guaranteed insurance account. Provider A guarantees a 4% rate but does not disclose spread, while Provider B offers a 2% rate and discloses some component of spread. In this example, it is easy to see that spread earned by the insurance company is not relevant and the focus should be on which product would be better suited to the plan.

Attempting to compare spreads across providers may lead to inaccurate conclusions because the factors compared may not be equivalent. Reserve requirements (such as the Risk Based Capital method of the National Association of Insurance Commissioners) will vary by company and often by the organization’s financial strength and ratings. Reserve requirements dictate the types of assets an insurer may hold in its general account portfolios and expected investment yields. Unlike fixed fees found in mutual fund structures, the determination of spread in a guaranteed insurance account structure may be variable and often unpredictable. Each insurer has a different portfolio mix, distinct contract terms, and capital requirements, any of which may cause spread earnings to vary — making comparisons difficult, and very often meaningless.

What should be compared when reviewing guaranteed insurance accounts?

When selecting a guaranteed insurance account product, participants are being offered a guaranteed return that is backed by the full faith and credit of the insurer, so guarantees matter. Focus on the creditworthiness of the insurer behind the guarantees, as opposed to any spread that the insurer may or may not earn. It is important to understand the guarantees being promised to the plan by the insurer, as well as the plan participants’ crediting rate.

First, review the insurer’s financial strength ratings from the four major rating agencies. These ratings agencies assign ratings annually and insurers disclose their capital surplus on at least an annual basis. There is no greater indicator of financial strength than ratings and capital surplus. Next, request a specimen contract from the insurer and thoroughly review the structure of the contract and the specific guarantees. The terms of the contract between the insurer and the plan should be consistent and not misleading. Also consider the quality and diversification of the insurer’s general account portfolio, their business lines and exposure to liabilities. Lastly, request a meeting with the insurer’s product and investment teams to help better understand their operations.

Plan fiduciaries have an obligation to implement a prudent process to evaluate, select and monitor investment plan lineups.
Contact your New York Life representative for more information about evaluation tools that can help your knowledge base and prepare for your clients' capital preservation reviews.

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