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for

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4-HOUR NAIC ANNUITY SUITABILITY TRAINING

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CHAPTER 1: ANNUITY BASICSPRIMARY USES OF ANNUITIES

An annuity is a long-term contractual arrangement in which an investor gives money to an insurance company and is expected to get it back in either a lump sum or a series of regularly scheduled payments. In most cases, the purpose of an annuity is to provide the investor with a permanent stream of income that cannot be outlived. That income stream might be needed immediately if personal savings and Social Security checks don't adequately cover a retired individual's expenses. Alternatively, it might be a deferred tool that can help working people develop a retirement strategy far in advance.

Annuities initially became popular in the United States during the Great Depression. Serious losses in the stock market were pushing millions of people into poverty, and those who still had money were losing faith in the era's frighteningly unstable banks. Some retirees couldn't count on significant financial support from their children, so they started putting more of their trust in insurance companies.

Particularly since the 1980s, changes in employer-sponsored retirement plans have caused annuity sales to surge. Members of previous generations often worked for only one or two businesses over the course of their career and were rewarded with guaranteed pension benefits. But over the past few decades, those guarantees have become much harder to find. If a business has a retirement plan today, it's usually one that demands a more active role from its participants. Without at least a basic understanding of the financial markets, workers aren't likely to see the desired level of growth in their retirement accounts.

Although annuities don't remove all the uncertainty and personal responsibility from retirement planning, they can ensure that seniors receive at least some dependable income that can be layered on top of Social Security benefits. This may explain why many people consider an annuity to be the reverse of a life insurance policy. Whereas life insurance financially supports beneficiaries if someone dies too soon to support their family, an annuity can financially support someone if he or she lives too long and runs out of savings.

There are annuities to attract conservative investors and annuities for people who are willing to take more risks. Products called "fixed annuities" guarantee a return of the money that investors put into them and will often promise higher interest rates than certificates of deposit (CDs). Products called "variable annuities" are less likely to guarantee a full return of a person's initial investment, but they have the power to produce higher returns.

Long-term investors and long-term savers are also sometimes won over by the annuity's tax features. Most annuities go through an "accumulation period." Throughout the accumulation period, interest or investment gains earned on an annuity grow on a tax-deferred basis, and the interest may be compounded. So, in simplistic terms, no one pays taxes on the money until it comes out of the account, and interest can be credited to *both* the amount invested (known as the "principal") and any previously earned interest. Consumers receive these positive benefits in exchange for less liquidity than they might find in CDs or mutual funds.

Consumers' increased interest in annuities has coincided with and been nurtured by a rise in the number of people who sell them. Despite being insurance contracts underwritten by insurance companies, annuities eventually found favor among stockbrokers who could use personal investment experience to explain the contracts' complexities to common shoppers. Banks have also become major players in the annuity game over the past 15 years, sometimes selling the contracts for insurance companies and sometimes going one step further and managing customers' annuity accounts on their own.

The general public, though, has always been a bit confused by annuities, and the addition of more options and more salespersons hasn't exactly fixed that problem. Since each annuity might have its own set of guarantees or its own way of crediting interest, the average person can have a hard time evaluating all the choices. With so much competition, some salespeople may be tempted to misrepresent the positives and negatives of annuities and put people's retirement security at great risk.

Whether the media's overgeneralizations, an occasionally misinformed sales force or overly aggressive sales pitches are to blame, regulators worry that annuities are sold too frequently to people who don't benefit from them. According to a report by the Los Angeles Times, the National Association of Securities Dealers filed a record 88 enforcement actions related to annuities from November 2004 through November 2005.

In the years that followed that report, several states and insurance companies have taken steps to bring down the number of dissatisfied annuity owners. Most insurance producers are now required to consider factors such as a person's financial status, tax status and investment objectives before a prospect can purchase an annuity from them. Many producers are also required to complete specific courses before becoming involved in annuity transactions.

Throughout this course, you will review annuity basics and engage in an in-depth study of how fixed, variable and equity-indexed annuities are structured. Due to constant changes in the financial world, this material can't touch on every detail that might exist in a specific annuity contract. But the presented information should help you broaden your perspective and make it easier to determine what consumers need to know.

BASIC KINDS OF ANNUITIES

Almost every annuity can be categorized in three different ways depending on how the corresponding funds are invested, how the owner pays for the annuity and when the owner expects to dip into the annuity for payments. An annuity may be either fixed or variable, deferred or immediate, and bought with either a lump sum or in multiple installments.

We will now briefly review these three basic groupings and examine how they relate to consumers' risk tolerances and financial goals.

Fixed and Variable Annuities

People who care more about saving money than engaging in high-risk, high-return ventures tend to prefer fixed annuities over variable annuities because fixed contracts contain more guarantees. The traditional fixed annuity guarantees a return of all money given to the insurance company plus a guaranteed amount of interest.

Guaranteed interest rates for fixed annuities have generally been near 3 percent or 4 percent in recent times, but they're often higher during the first few years of a contract's term.

The risk to the fixed annuity purchaser is minimal because the insurance company invests the client's premiums in conservative bonds and government securities. The consumer is responsible for picking the right contract and insurer, while the insurer is responsible for investing the principal in a manner that will satisfy the contract's guarantees.

Variable annuities increase in popularity when the financial markets are noticeably strong. They appeal to investors who are willing to put some of their principal at risk in exchange for potentially higher returns. The owner typically shoulders the responsibility of investing his or her money in one or several mutual fund-like accounts, and the annuity's account balance will go up or down depending on how those funds perform. In addition to absorbing market risks, owners of variable annuities will usually be charged account management fees on an annual basis.

Deferred and Immediate Annuities

The annuity shopper's choice between an immediate annuity and a deferred annuity will depend on when the person wants to start receiving payments from the insurance company. Let's go over the options.

Deferred Annuities

A "deferred annuity" is often favored by clients who don't need consistent, additional income at the time of purchase but envision needing it in the future. When people buy a deferred annuity, their goal at that moment is to watch their principal expand for several years. Presumably at a much later date, they'll cash in their deferred annuity for a lump-sum payout or for divided payouts that will be disbursed throughout their remaining lifetime.

Between the time it's purchased and the time payments begin, a deferred annuity goes through an accumulation period. During the accumulation period, the owner's account is expected to grow without negatively affecting the person's tax situation.

Immediate Annuities

An "immediate annuity" creates an income stream for the owner soon after the sale date. In general, the owner starts receiving payouts within one year of entering into the contract.

People who buy immediate annuities might care less about growing their principal and more about maintaining their current income level for as long as possible. An immediate annuity can help them achieve their goals by giving them payouts on a monthly, annual or other set schedule rather than in a lump sum.

Immediate annuities don't go through a traditional accumulation period because money is being taken out of them at the same time that the account would otherwise be growing in value. Also, opportunities for tax deferral with an immediate annuity are relatively minimal because taxation on an annuity begins when money is taken out of the owner's account.

The amount of money a client receives regularly from an immediate annuity will be determined by the principal, the person's life expectancy and the fixed or variable status of the annuity. With all other factors being equal, a larger principal will translate to bigger immediate payouts because the insurance company will have more money to give out in the first place. But because annuities are designed as supplementary sources of income that last a lifetime, immediate payouts offered to a younger person can be lower than those offered to an older person. This can be true even if the younger individual invests more principal.

Since the insurance company begins paying money to the immediate annuity owner so soon, the buyer may have a hard time getting out of the contract with much principal intact. Immediate annuities that grant the owner greater access to principal in the event of a financial emergency or a mere change of heart force the customer to receive considerably lower payouts. Also, because the standard annuity death benefit calls for heirs to receive either a return of any remaining principal or the value of the deceased's account, death benefits in an immediate annuity (if they are available at all) are likely to decline more quickly than death benefits in a deferred annuity.

Most immediate annuities are fixed and give budget-conscious owners the security of knowing that their scheduled payouts will not dip below a guaranteed minimum dollar amount. However, because immediate fixed annuities lock the owner into a room where the ceiling on interest rates is only so high, some people worry that these products will not keep up with inflation. In efforts to confront that concern, insurance companies have designed some riders (add-on features in insurance contracts) that can either automatically increase annuity payouts every year or at least ensure that payouts will temporarily keep pace with consumer price indexes.

A minority of annuity owners choose to receive variable immediate payouts, which can combat inflation without the help of a rider. Variable immediate annuities will not help someone craft a budget because, without riders, they offer no minimum guarantees. The insurance company calculates an initial payout for a variable immediate annuity, based on life expectancy and economic conditions, but subsequent payouts can rise or fall with the financial markets.

Split Annuities

Another possible but rarely mentioned option for the annuity prospect is the "split annuity." Through a split annuity, some of the owner's principal is used to create an immediate income stream, and the rest is put in a tax-deferred account for long-term accumulation.

SINGLE PREMIUMS AND MULTIPLE PREMIUMS

Before the market became flooded with incredibly diverse and intricate products, many annuities were purchased in pieces. The buyer would periodically make level payments to an insurance company and hope that the accumulating funds would ultimately add up to a decent amount when the time came for retirement. Policies set up in this way still exist, but the common level-premium contracts of the past have been joined by annuities that consumers can fund through one lump sum or through unequal periodic payments.

Individuals who purchase annuities outside of an IRA or employer-sponsored retirement plan are probably buying these products with a single premium. In fact, finding an immediate annuity that does not require a lump-sum payment can seem impossible in some markets.

Annuity contracts that allow for multiple, flexible premium payments are usually deferred and are often funded through payroll deductions as part of an employer-sponsored retirement plan. Flexible-premium annuity contracts can stipulate a specific pay schedule as chosen by the buyer or the insurer, or the insurance company might give customers the freedom to make contributions to their accounts at times that are not pre-determined. The contract might also state that the buyer can make unlimited contributions to the account but that all premiums must meet or exceed a minimum value.

PREMIUM REQUIREMENTS

In most cases, the federal government doesn't put a cap on the amount of money someone may invest in an annuity. This freedom distinguishes the annuity from other retirement vehicles, including 401(k) plans and IRAs, which limit annual contributions to a few thousand dollars or so.

Occasionally, investing a larger principal will help improve the terms of an annuity contract. For example, insurers might offer higher interest-rate guarantees for people with larger accounts. But even though laws might not prevent big annuity investments, individual insurers can set their own maximum limits.

An annuity contract that allows owners to invest very little money might appeal to people in search of a deferred annuity because the small initial investment can grow substantially over time if it goes untouched. However, some financial experts question the benefits of putting only a small amount of money into an annuity that's immediate. After all, that small amount will need to be divided right away, before it can grow much, and the size of the payouts might not end up satisfying a client's financial needs.

ISSUE AGES

Like life insurance policies, annuities usually have maximum issue ages. The "issue age" is the age of the annuitant (usually the recipient of payouts) when the contract goes into effect. In the past, it was customary for insurance companies to not sell annuities to people who were at least 70 or 75 years old. But because people are living longer, many of today's insurers have increased their maximum issue ages to 80, 85 or even 90.

PARTIES IN AN ANNUITY CONTRACT

No matter who sells the product or how the seller has organized it, an annuity is a legal agreement that bestows rewards and responsibilities upon multiple parties. These parties include the insurance company, the annuity owner, the annuitant and the beneficiary.

The Insurance Company

The insurance company behind the annuity has a contractual obligation to eventually pay money to a person or other entity. In return, the insurer collects fees from investors or is allowed to invest clients' money and keep a portion of any positive yields.

The Annuity Owner

The "annuity owner" is the person who puts money into the annuity. He or she chooses how much to invest and, in the case of variable annuities, how that investment amount should be allocated among various funds. The owner is usually (but not always) the party who will be held responsible for paying taxes on the annuity.

The annuity owner has many of the same rights as the owner of a life insurance policy. The owner can surrender the contract, choose a beneficiary and, in some cases, borrow money from the annuity's cash value. The owner hangs onto these rights until the contract expires or is terminated. An annuity may be owned by one person, several people, a trust or a corporation.

The Annuitant

An annuity owner also gets to designate an "annuitant." The annuitant is the person whose life expectancy influences the size of payouts from the insurance company. In most (but not all) cases, the annuitant is also the person who receives the income created through the annuity. Because annuity payouts are determined, in part, by life expectancy, an annuitant must be a person, rather than a trust or corporation.

In most cases, the annuity owner and the annuitant will be the same person. In other words, people will invest their own money with a goal of creating an income stream for themselves. But it's also possible to have one person as the owner and another person as the annuitant. For example, one spouse might own an annuity that pays income to the other spouse, or a company might own an annuity that pays income to a former employee. However, designating different people as the owner and annuitant can create unexpected tax problems and may even cause death benefits to go to beneficiaries at an inappropriate time. (Beneficiary and tax issues will be explained in more detail later in this chapter.)

The annuitant lacks the right to borrow money from the annuity, alter investments within the annuity, or partake in any of the previously mentioned privileges that are granted to the annuity owner. In fact, some contracts let the owner eliminate an annuitant from the original contract and choose a new one.

The Beneficiary

The "beneficiary" is a person, corporation or trust that receives death benefits if someone passes away before income payouts have begun. Depending on the annuity, a beneficiary might also be entitled to benefits even if the insurance company has already started making payments from the owner's account.

The annuity owner chooses the beneficiary and can alter that choice after the annuity has been issued. As is the case with a life insurance policy, owners can designate multiple beneficiaries, divide death benefits equally or unequally among those multiple beneficiaries, list contingent beneficiaries or pick themselves as beneficiaries. If the owner and the beneficiary are different people, the beneficiary cannot borrow from the annuity, alter investments within the annuity, or partake in any of the other previously mentioned privileges that are granted to the annuity owner.

The role of the beneficiary may seem simple, but it can be complicated if the annuitant and the owner aren't the same person. Some annuities require that any applicable death benefits be paid to beneficiaries when the annuitant dies. Others will only pay death benefits when the owner dies. Annuities that will pay death benefits only when the owner dies are considered "owner-driven." Annuities that will pay any applicable death benefits if the annuitant dies before the owner are considered "annuitant-driven." (For tax reasons, an annuitant-driven annuity might also need to provide death benefits to a beneficiary if the owner dies before the annuitant.)

Because of the different rules for owner-driven and annuitant-driven contracts, the owner's choice of a beneficiary should be made with great care. Imagine, for example, a husband and wife who are involved in an annuity transaction. The couple's intention is for the surviving spouse to eventually be able to benefit from the annuity and for their children to receive death benefits when both spouses die.

Now assume that the couple decided to purchase an annuitant-driven annuity with the husband as the owner, the wife as the annuitant and their children as beneficiaries. If the wife dies before the husband, the money from the annuity might flow immediately to the children rather than to the husband. To avoid this problem, the husband could have listed himself as the main beneficiary and listed his children as contingent beneficiaries.

Now imagine that the same couple is involved but that the husband dies first. Again, any death benefits from the annuity might go to the children as beneficiaries instead of to the surviving spouse. If the husband had intended for his wife to benefit from the annuity after his death, he could have listed her as the main beneficiary and listed his children as contingent beneficiaries.

There are even scenarios in which a co-owner forfeits a financial interest in an annuity upon the other owner's death. To ensure that the intended beneficiaries only receive death benefits at the intended time, annuity contracts should be examined thoroughly by all parties and drafted with care.

ANNUITIZATION

If an annuity owner is ready for the insurance company to start paying an income stream, the "annuitization" process will begin. During traditional annuitization, the insurance company usually pays out the same amount in installments on a set schedule to an annuitant.

An assortment of newer annuity contracts allows the owner to opt for payouts that are scheduled to go up or down after a certain date. This option can be helpful if the owner foresees a significant change in the annuitant's need for income. For example, the scheduled conclusion of a mortgage agreement might be reason enough for the owner to want payouts that start large but get smaller after a certain date. Some variable contracts allow the owner to choose between receiving level payouts upon annuitization or payouts that will go up or down depending on market performance.

In most annuitization situations, payouts are fixed at an equal amount and are scheduled to continue throughout the annuitant's lifetime. When the owner chooses this option, the amount of each individual payout owed to the annuitant will depend on the account balance and a figure called the "benefit rate." The benefit rate is the dollar amount the insurer will pay in each installment (usually on a monthly basis) for every $1,000 in the owner's account.

The benefit rates offered by different insurance companies will vary, but all benefit rates will be based, to a large extent, on the annuitant's life expectancy. Payouts from most immediate annuities will reflect the benefit rate that was offered by the insurer when the annuity contract was signed. Payouts for most deferred annuities will be based on either the benefit rate offered by the insurer at the time of annuitization or the guaranteed minimum benefit rate that was offered by the insurer when the contract was signed.

With life expectancy serving as such an important factor in the calculation of benefit rates, it ought to come as no surprise to the reader that older people receive higher benefit rates than younger people and that men receive higher benefit rates than women of the same age. Some insurers will also increase their benefit rates for annuitants with serious health problems.

Once annuitization has begun, the insurer generally may not reduce the benefit rate or the size of the scheduled payments. Suppose, for example, that a client bought an annuity and annuitized the account for life when it was worth $100,000 at a benefit rate of $10 per thousand. The client would then be entitled to $1,000 each month for life. This would be the case even if the annuitant ends up living longer than the insurance company originally expected. In this regard, the risk to companies selling annuities differs from the risk to companies that only sell life insurance. For the life insurer, the risk is that the person will die too soon to make the company profitable. For the annuity issuer, the risk is that a person will die too late.

Very often, people use the term "annuitization" as if it was synonymous solely with lifetime, monthly income. In fact, modern annuitization involves several other options for the owner. Instead of occurring monthly, lifetime payouts can go to the annuitant every year, every season, twice each year or on a different schedule.

In rarer cases, the payout schedule might not be linked to the annuitant's lifetime at all. For example, payouts might be set to continue regularly until the insurer has given a specific, cumulative dollar amount to the annuitant. A "period certain annuity" (which should not be confused with a "life with period certain annuity") pays money to the annuitant only until a predetermined date, even if the person is still alive after that date.

The choice of when and how to annuitize one's money rests with the annuity owner. The owner can annuitize before leaving the workforce, upon reaching retirement age or much later in life. Unlike money in an IRA or employer-sponsored 401(k) plan, money from an annuity generally does not need to be withdrawn at all when the owner turns 70 ½. (There are exceptions for annuities purchased within 401(k) plans and IRAs.) Despite the absence of a federal requirement, most annuity contracts call for some level of annuitization by the time the annuitant turns 85.

Why Wait to Annuitize?

Although having a consistent income stream for life can be an attractive option, there are several reasons why someone might delay annuitization. Obviously, an investor who does not yet need additional income might be best served by leaving funds alone and allowing them to grow on a tax-deferred basis. But the risks involved with annuitization are sometimes more complex than that and may relate to liquidity, inflation protection and death benefits.

Some people don't annuitize because they like the flexibility that comes with receiving a lump-sum settlement from an insurer after a period of surrender charges has expired. Whereas an annuity that is still in the accumulation period can be surrendered for the full principal amount (minus any applicable surrender charges), a contract that has reached the annuitization period is sometimes nearly unbreakable. Many annuitized products can only be surrendered in pieces, with withdrawals perhaps needing to meet maximum and minimum requirements.

Inflation is a concern in regard to annuitization because once the owner annuitizes, the amount of each payout is generally locked in place for the rest of the annuitant's life. If inflation or other factors cause an eventual rise in the annuitant's living expenses, the person will need to look beyond the annuity income to make up the difference. Some insurers offer inflation riders that might boost payouts under certain circumstances, but the riders typically lower the benefit rate that the insurer would normally offer at the beginning of annuitization. They can also seem unjustifiably expensive if the annuitant has a low life expectancy.

Finally, people who annuitize for life should plan to have mortality on their side because, once annuitization begins, the beneficiary's opportunity to collect death benefits often disappears. The standard annuity death benefit gives beneficiaries the greater of the principal or the account balance when the annuitant (or owner) passes away. However, the death benefit sometimes applies only if the death occurs during the accumulation period. If someone annuitizes an account worth $200,000 for a lifetime monthly income of $2,000 and dies two months later, the insurer might be able to pocket the remaining $196,000. The owner can solve part of this potential problem by requesting enhanced death benefits, but this extra security for the beneficiary will reduce payouts for the annuitant.

INCOME TAX CONCERNS

Tax breaks represent one of the most significant reasons why annuity sales have been so fruitful over the past few decades. At this point, we will look at the relationship between the federal tax code and annuities and cover some of the tax consequences that prospective buyers should know about. The reader should understand that the material presented here is intended only to *summarize* an annuity's potential tax features. Specific questions about how the Internal Revenue Service might interpret an individual's tax situation should always be referred to a professional with substantial knowledge of tax law.

Tax Deferral

Like an IRA, an annuity is one of the few financial options available today that allows investors to accumulate money and temporarily avoid paying taxes on investment gains. This opportunity for tax deferral doesn't make an annuity tax-free or tax-deductible. The owner merely has the choice to wait awhile before paying certain taxes to the government.

On a federal level, an annuity generates no tax bills until the owner or the annuitant receives a payout from the insurer. If a deferred annuity goes untouched, the owner will encounter no tax penalties during the accumulation period. If the owner makes a partial withdrawal from a deferred annuity but doesn't annuitize the funds, he or she will only pay taxes on the withdrawal, and the money left over will continue to grow on a tax-deferred basis. Fixed immediate annuities are poor vehicles for tax deferral because payouts begin right away and some of that money is automatically treated as taxable income.

Although annuity payouts are subjected to income taxes, retirees often find themselves in a lower tax bracket than when they were working. Therefore, if the owner delays annuitization until after retirement, there might be more money available from the annuity for personal use.

Bear in mind, though, that the positive aspects of tax deferral will not always be as significant as the owner expects. It is possible, if not likely, that a person will retire and remain in a relatively high tax bracket. And even if a wealthy person retires and falls into a slightly lower bracket, the insurer's additional fees (particularly those for variable products) might eat away at the annuity's value and marginalize the benefits of tax deferral.

Qualified vs. Non-Qualified Annuities

The federal tax treatment of an annuity payout will depend on how the owner paid for the contract. "Qualified annuities" are paid for with pre-tax dollars, which means the principal in these accounts was not previously counted as part of the owner's taxable income. Since the principal was never taxed, taxes must be paid on the entirety of any money received from the insurance company.

Qualified annuities are often purchased within employer-sponsored 401(k) plans and IRAs. Like those common retirement vehicles, qualified annuity contracts limit the initial amount of money investors can contribute to their accounts. They also require that payouts begin by a specific date, usually by the time the accountholder is 70 ½.

"Non-qualified annuities" are funded with after-tax dollars, which means the principal was already counted in one form or another as part of the owner's taxable income. Since the principal was already taxed, only a portion of a person's annuity income will be taxable.

Unlike qualified annuities and many kinds of employer-sponsored retirement plans, non-qualified annuity contracts usually do not limit the amount of money investors may put into their accounts, and they don't need to be annuitized by the time the accountholder reaches age 70 ½. (The reader should note that the tax-related information in this course [unless stated otherwise] applies solely to non-qualified annuities.)

How Much Is Taxed?

People who utilize non-qualified annuities are ultimately taxed only on the interest or gains in their accounts. Still, the mathematical methods used by the IRS to tax annuity payouts are far from simple.

Until the 1980s, annuitants received the principal portion of the annuity before they received any interest payments. This meant there were often no taxes paid on the annuity for many years even if the annuitant was receiving payments. For example, if a person received $100 a month from an annuity that was purchased for $12,000, that person paid no income taxes on the annuity for 10 years. Then, because the annuitant had received a full return of the principal, any remaining payouts were counted entirely as taxable income.

All of that changed thanks to the Tax Equity and Fiscal Responsibility Act of 1982, which mandated that at least some interest from annuities be included in payouts as soon as annuitization begins. If the owner cancels the contract and receives a lump-sum settlement that exceeds the principal, all income taxes on the annuity are likely to be due in a lump sum. If the owner annuitizes the contract for life, income taxes on the annuity must be paid every year until the account has been closed.

To determine how much of each annuity payout will be subjected to federal income taxes, we need to know the principal sum and the total expected return on the annuity. The total expected return on an annuity that pays a fixed monthly income for life can be calculated by multiplying the monthly payout by the annuitant's remaining life expectancy at the beginning of annuitization.

Suppose, for example, that someone annuitizes with a remaining life expectancy of 15 years (180 months) and is set to receive $500 each month for life. By multiplying the remaining life expectancy (180 months) by the monthly payout ($500), we learn that the total expected return on the annuity is $90,000.

We can now calculate the taxable and non-taxable portion of each monthly payout by dividing the principal sum by the total expected return. Suppose the annuity was purchased with a lump sum of $80,000. By dividing the principal ($80,000) by the total expected return ($90,000), we're left with an answer of roughly 0.89 or 89 percent. This means roughly 89 percent of each monthly payout (or roughly $445) will not be counted as taxable income and that the remaining 11 percent of each monthly payout (or roughly $55) will be considered taxable income. This will hold true until the cumulative non-taxable income from the annuity equals the principal investment. Beyond that point, 100 percent of each monthly payout will be considered taxable income.

Different calculations are used in the rare cases when a person opts for variable payouts from a variable annuity. Payouts will go up and down with the markets in this scenario, so the insurer can't accurately calculate a total expected return. Instead, for tax purposes, the insurer can tell the owner the annual dollar amount that will *not* be taxed. This is accomplished by dividing the principal sum by the annuitant's remaining life expectancy at the beginning of annuitization.

Once again, imagine that a person annuitizes a contract bought for $80,000 and is expected to live an additional 15 years. By dividing the principal ($80,000) by the remaining life expectancy (15 years), we learn that roughly $5,333 will be exempt from income taxes each year. Anything beyond that annual amount may be taxed. Then, once the annuitant has received a full return of the principal, all money from the annuity will be taxable.

Taxation of Annuity Death Benefits

When beneficiaries receive money from the insurance company, they will usually need to pay taxes on the difference between the account's value and the owner's principal investment. Although applicable death benefits from a deferred annuity will generally need to be paid out when the owner dies, the annuity can continue to grow on a tax-deferred basis if the beneficiary is the owner's spouse.

Depending on the annuity, money left in a deceased owner's account may be subject to estate taxes. In general, the entire value of the annuity can be considered part of the owner's estate for tax purposes if the person's death occurs before annuitization. If death occurs after annuitization, the value of payments that will continue after the person's death can be considered part of the estate. If no one will receive payments or death benefits after the owner's death, the annuity will have no remaining value and won't be part of the estate. Most estates, though, are exempt from federal estate taxes. In 2012, only estates valued at more than $5 million after a person's death were taxed. (Gift taxes can still be a factor when a surviving co-owner of an annuity is not listed as a beneficiary.)

Taxes on Capital Gains

Some financial experts believe consumers should only buy an annuity if they want the security of a lifetime income. As far as taxes are concerned, these advisers say there may be better places for people's money.

One reason for this is that interest and other gains from an annuity are taxed at the same rate as regular income. This rate will usually be higher than the one used to tax capital gains that are earned in the stock market. For savers, the annuity's guarantees might be enough to cancel out this tax disadvantage. For investors, the differences in tax rates might make other aspects of financial planning more attractive than annuities. As always, specific tax advice should only be dispensed by knowledgeable professionals who are aware of a client's financial situation.

ANNUITY FEES AND SURRENDER CHARGES

Annuities have come under fire in recent years because consumers have entered into them without being adequately aware of significant charges and fees. Annuity owners might face these charges and fees when they purchase the contract, when they make withdrawals or on an annual basis. The various annuity fees might include a one-time or annual contract fee, a transaction fee that reduces the account balance by a set percentage when the owner deposits or withdraws money, or an annual fee that compensates a financial institution for managing the owner's account.

Insurers will itemize these fees for people who purchase variable annuities, but fixed annuity owners rarely know how much they pay in fees. Instead, the fees they pay are usually bundled together and factored into the interest rates and benefit rates offered by the insurance company. Annuity fees typically either stay the same throughout the term of the contract or go down annually, but they can sometimes rise.

The various fees represent another reason why some financial experts dislike annuities in some situations. Annual fees can consistently lower investment progress in variable annuities, and withdrawal fees can make fixed annuities seem less attractive than products that promise lower rates but more liquidity. Some critics say a person would probably need to hang onto an annuity for at least a decade or more for the product to become more valuable than many other popular investment vehicles.

Surrender Charges

“Surrender charges” are often the biggest drawback to annuities and help show why the products do not suit every consumer’s financial situation. These charges result in a percentage-based deduction from the owner’s account if the owner withdraws money or opts out of the contract before a specific date.

The owner’s inability to access money from an annuity can create problems big and small. A relatively small problem concerns the interest rates that are applied to fixed annuities. Imagine, for example, that a person buys a fixed deferred annuity that will credit 5 percent interest to the person’s account annually for seven years and also features a surrender charge that will remain in force for seven years. Three years pass, and an improved economy creates a financial climate in which many insurers now offer fixed deferred annuities with short-term interest guarantees of 7 percent. The person in our example knows about these better deals but would not be able to get out of the existing contract for another four years without having to pay a significant surrender charge.

Now, suppose the circumstances are more serious and that the owner needs money to handle a financial emergency. Even in these urgent cases, the account balance could still suffer a big blow thanks to surrender charges

Federal Surrender Charges

IRS-mandated surrender charges suggest that the federal government approves of annuities when they are used for retirement purposes but frowns upon them when they are bought and sold with other motives in mind. Owners who make early withdrawals will need to pay regular income taxes on the money they receive and will also surrender an additional 10 percent to taxes if a withdrawal occurs before they turn 59 ½. The regular income taxes and the additional 10 percent penalty will be applied to any portion of a withdrawal that is not considered a return of the owner’s principal.

Even if an owner is willing to accept an additional 10 percent penalty, an early withdrawal can create a bigger tax bill than expected. Under a concept known as “last in, first out,” an early withdrawal will first be treated as a gain and then as a partial return of principal. In other words, if an owner purchases an annuity for $10,000 and makes a $5,000 withdrawal after the account has grown to $15,000, the entire withdrawal will be fully taxable. Similarly, if the owner were to make a $6,000 early withdrawal from that account, $5,000 of it would be fully taxable, and only the remaining $1,000 (the amount in excess of the account’s gains) would be treated as a non-taxable return of principal.

For obvious reasons, tax penalties for early withdrawals might make an annuity an uncomfortable fit for young consumers. In 2003, the National Association of Securities Dealers and the national media reported that a financial institution sold a $30,000 annuity to an 18-year old. Based on current tax law, a person of that age would probably not be able to access the $30,000 to buy a home, purchase an automobile, fund a college education or pay off debt until more than 40 years had passed.

There are some exceptions that can nullify the 10 percent tax penalty (but not the requirement to pay regular income taxes). The 10 percent penalty generally does not apply if any of the following statements are true:

- The owner is at least 59 ½.
- The owner is disabled.
- The owner has died, and payments are going to a beneficiary.
- The annuity involved is immediate, and payouts are being received on a regular basis in substantially equal amounts.
- The owner has decided to annuitize and will be receiving substantially equal payments based on his or her life expectancy for at least five years or at least until the owner turns 59 ½ (whichever is scheduled to happen later).

Keep in mind that there may be additional exceptions (or exceptions to the exceptions) that can impact taxpayers. In addition, like issues related to beneficiaries, the rules regarding early withdrawals and taxation can be very complicated if the annuitant and the owner are not the same person. For more specifics regarding federal withdrawal penalties, contact the IRS or speak to a tax professional.

Company-Mandated Surrender Charges

Even if an owner has passed age 59 ½ and can avoid federal surrender charges, the owner might still need to pay a company-mandated surrender charge when money comes out of an annuity prematurely. Insurance companies tend to lose money on an annuity during its early years, and surrender charges help make up for losses if the owner cancels the contract before the issuing company can make a profit on it.

At first, it may seem improbable that a financial institution would lose money in the early years after a sales transaction, particularly since buyers are often paying six-figure lump sums for immediate and deferred annuities. But, as is the case with a lot of life insurance transactions, a significant portion of an initial premium for an annuity helps pay producers’ commissions. An annuity’s high or lengthy surrender charge might be the result of a high commission for the agent or broker. Conversely, low surrender charges might be the result of a low commission for the agent or broker.

Sometimes, a prospective buyer can purchase an annuity directly from the insurance company, thereby avoiding commission costs and probably getting lower surrender charges. Of course, a direct purchaser might lack the expertise that trained professionals can provide. Consumers must also realize that direct purchases probably won’t eliminate surrender fees altogether because the fees also cover various administrative costs and contribute to an overall pool of money that allows the insurer to satisfy contractual guarantees.

Sizes of Company-Level Surrender Charges

Surrender charges can differ greatly depending on the type of annuity and market conditions. In some cases, the surrender charge will come out of the annuity's total cash value. At other times, an insurer might only take surrender fees out of the principal and leave accumulated interest alone. On occasion, principal will remain intact, and the insurer will deduct the interest earned over a set period of time from the owner's account.

If consumers research annuities via the mainstream media, they will probably come to the conclusion that there is a standard surrender charge for annuities that starts at 7 percent or so and lasts roughly seven years, with each passing year resulting in a 1 percent reduction in the fee. In reality, the size and duration of a surrender charge can be better or worse than that. In terms of length, research conducted during the development of this course uncovered annuities with surrender fees that were as brief as three months and as long as the annuitant's lifetime. In terms of size, one annuity came with a surrender charge that began at a rate of 25 percent. Another product combined long duration with large size by reportedly featuring a surrender charge that started at nearly 18 percent and lasted 17 years.

People with an interest in flexible-premium annuities (in which principal can be added to an annuity on a periodic basis) ought to be aware of "rolling surrender charges." A rolling surrender charge is tied to all money invested at a particular time. If, for example, someone buys a flexible-premium annuity with a $10,000 initial investment, the insurer might allow the owner to withdraw the $10,000 without penalty after seven years or so. But if the owner puts an additional $5,000 into the annuity at a later date, a new surrender charge might apply, and the owner might need to wait an additional seven years before being able to access the additional $5,000.

Insurance companies understand that these fees can cause customers to pause before coming to a long-term financial agreement, and they have responded with some degrees of compromise. In exchange for paying higher annual fees, shoppers might be able to buy rare annuities that lack a surrender charge. Sometimes fixed annuities with long-lasting surrender charges will feature higher introductory interest guarantees because the insurer will likely have more time to invest the premiums. In efforts to hang onto existing customers who might be itching to cancel their annuity contracts, some insurers will offer bonus interest to owners who agree to keep their contracts in force after surrender fees expire.

FREE WITHDRAWALS

Insurers soften their sometimes rough surrender penalties by usually giving owners a chance to withdraw small amounts of money from their annuities without losing any additional principal or interest. Most contracts allow annual withdrawals that may not exceed 10 percent of principal at one time

Before they prepare to withdraw from an annuity, owners should understand there might be a waiting period (perhaps one year) before the penalty-free withdrawals can begin. Owners should also know that these withdrawals might not be permitted forever. The insurer can limit withdrawals by disallowing them after a pre-determined number of years or by putting an end to them once cumulative withdrawals reach a set percentage of the principal.

The free 10 percent withdrawals keep surrender charges at bay for people who need a little extra cash now and then. They do not, however, exempt the owner from tax laws. People must still pay income taxes on these partial withdrawals, and the government can still knock payouts down by 10 percent if they occur before the owner turns 59 ½.

CRISIS WAIVERS AND RIDERS

Annuity owners can use the money from an annual penalty-free withdrawal for anything they choose. Crisis riders and crisis waivers, on the other hand, can only be used to support the owner or annuitant during specific financial emergencies, such as those involving a disability, a chronic health problem or unemployment. A rider or waiver may entitle someone to more than 10 percent of the principal each year.

While some "crisis waivers" only waive surrender charges for withdrawals below a certain dollar amount, others let the owner make a clean break with the insurer without penalization. A "crisis rider" can do more than just eliminate a surrender charge. These contract add-ons might either increase payouts if the annuitant experiences a crisis after annuitization or may incorporate an insurance policy into the contract. In the latter case, the owner would basically be getting a discount for buying two insurance products at once.

Insurers offering annuities with riders or waivers for long-term care (LTC) have adjusted their products to reflect changes in care options. In the old days, LTC riders provided financial protection against long stays in nursing homes or hospitals. Modern add-ons can still serve that purpose, but they can also help people cope with the cost of at-home care.

In order for the owner or annuitant to receive LTC benefits through a waiver, rider or insurance policy, someone must demonstrate a contractually defined need for care. In general, LTC benefits are given to people who either live with a cognitive impairment (such as Alzheimer's disease) or cannot perform common tasks called "activities of daily living" (ADLs). For LTC benefits to be triggered by an inability to perform ADLs, a person usually must require assistance when doing at least two of the following tasks:

- **Bathing:** The ability to move in or out of a shower or tub, clean oneself, and dry oneself
- **Dressing:** The ability to put on clothing and any medical accessories, such as leg braces
- **Eating:** The ability to chew and swallow food and use utensils
- **Transferring:** The ability to move in and out of beds, cars and chairs

- **Toileting:** The ability to get to a restroom and perform related, basic personal hygiene.
- **Continence:** The ability to control the bladder and bowels and perform related, basic personal hygiene.

After demonstrating a need for LTC, the owner or annuitant must wait for an "elimination period" to pass. During the elimination period, the person receives no privileges or benefits through the LTC waiver or rider and will need to pay out of pocket for care unless he or she has adequate health insurance. The length of the elimination period will depend on the contract and might be left up to the owner at the time of purchase. Elimination periods for LTC crisis waivers or riders can range anywhere from 30 days to several months.

Eligibility for LTC benefits within an annuity is far from guaranteed, particularly due to the link between people's age and their susceptibility to long-term health problems. Some insurance companies only offer LTC waivers and other health-related add-ons to owners or annuitants who have not had major health issues. In these cases, the opportunity to withdraw funds specifically for health reasons might expire as the owner or annuitant grows older.

Financial products that contain LTC benefits must be evaluated and purchased with some caution. Although state governments have adopted minimum benefit triggers and forced LTC insurers to include various other contract provisions within their policies, the laws associated with LTC insurance policies might not apply to LTC crisis waivers or LTC riders within annuities. Unlike long-term care insurance, these waivers and riders generally do not force the insurer to pay directly for anyone's care. Instead, they merely give owners the chance to access or receive more money when long-term care is needed.

Similar crisis waivers include those for disability or terminal illnesses. Triggers for disability benefits may also be tied to one's ability to perform ADLs, but the owner or annuitant will want to check to be sure. According to National Underwriter, elimination periods for disability waivers can be as brief as 0 days or as long as six months. Terminal illness waivers will usually exempt the annuity owner from surrender charges if the person's remaining life expectancy has dropped to one year or less. Non-retirees can also take advantage of unemployment waivers, which in many instances eliminate surrender charges if the owner has been out of work for at least six months.

Despite their positives, riders that increase payouts in a crisis or give the owner or annuitant insurance-level protection rarely ever come without a cost. The benefit rates for these enhanced annuities might be lower than usual, and the owner might need to pay higher fees. Money withdrawn due to an LTC, disability or unemployment crisis will still count as taxable income, although a disabled owner can escape the 10 percent tax penalty on withdrawals made prior to age 59 ½.

DEATH BENEFITS

The typical annuity offers a death benefit that's equal to at least the principal investment, minus any withdrawals of principal that were made by the owner. If an annuity experiences positive investment gains and is worth more than the principal sum when someone dies, beneficiaries can collect this larger amount instead and will be required to pay income taxes on the extra money.

At first, this might sound fair or even favorable to beneficiaries, but there's a big catch. The standard death benefit sometimes only applies if someone dies while the annuity is in the accumulation period. If an owner has an immediate annuity or has annuitized a deferred annuity, the insurer might pocket the remaining balance in the account and use the money to make payouts to its other clients.

An annuity that only pays a death benefit if the annuitant dies during the accumulation period is sometimes called a "straight life annuity" or a "single life annuity" because the money given to the insurance company is meant to last for the rest of one person's life and is not invested with dependants in mind. The insurance company bases the size of payouts from this kind of annuity on the annuitant's remaining life expectancy at annuitization and is not contractually obligated to pay out any money after the annuitant dies, unless annuitization never began. Because straight life annuities provide money to an annuitant or a beneficiary but not to both parties, the insurance company can afford to give straight life annuitants its highest benefit rates.

People who want to be a little less risky and allow for some death benefits after annuitization can opt for a single life annuity with "period certain." When the period certain option is added to a single life annuity, the annuitant still receives lifelong payouts from the insurance company, but the period certain helps guard against the annuitant dying suddenly after annuitization and leaving nothing for heirs.

The period certain option guarantees that payouts will at least continue for a contractually mandated time period, usually in the neighborhood of 10 to 20 years. If, for example, the annuitant starts receiving payouts from a single life annuity with a period certain provision of 10 years and dies after five years, a beneficiary could then step into the annuitant's place and receive payouts for the remaining five years of the contract. If that same annuitant bought that same contract and received payouts for at least 10 years, the insurance company would not need to pay any money to a beneficiary upon the annuitant's death. When the period certain ends, so does the beneficiary's right to any death benefit.

Because life with period certain annuities involve limited guarantees to more than one person after annuitization, the individual payouts will be slightly smaller than those available through straight life contracts. The degree to which benefit rates are reduced will depend on the length of the period certain. A short period might not affect payouts or rates much at all, while a long period could translate to a substantial financial sacrifice for the annuitant during his or her lifetime.

A third settlement option can give heirs a death benefit no matter when someone passes away. In this setup, beneficiaries receive a refund of any principal that remains in a deceased person's account. Beneficiaries receive none of the interest that might have accumulated in the account, and they get nothing if the person lived long enough to receive a full return of principal. The refund of principal can go to beneficiaries in one of two ways. In a "cash refund" annuity, the beneficiary receives the death benefit in a lump sum. An "installment refund" breaks up the death benefit and awards money to the beneficiary periodically until all of the principal has been paid back.

Some insurance companies have enhanced their annuities' death benefits by pairing them with life insurance riders that cover accidental death. These riders might appeal to consumers because they can significantly enlarge the death benefit if the annuitant or owner dies in an accident and are sometimes cheaper than stand-alone life insurance policies. However, like most other riders, their cost can have a detrimental effect on an owner's account balance. If buyers already have life insurance or can provide for beneficiaries through other means, their need for this coverage might be minimal at best, particularly if the insurer's asking price is high.

Keep in mind that some annuities will only pay death benefits when the owner dies and some will pay if the annuitant dies first. In most cases, the distinction will be a non-issue because the owner and the annuitant will be the same person. However, in cases where the owner and annuitant are different people, death benefits may be provided in ways and amounts that are different from what we have described here. If the annuitant and owner aren't the same person, the contract's death benefit provisions should be examined with care so that all parties know what to expect.

ANNUITY EXCHANGES

The federal government allows people to exchange insurance policies for annuities and to exchange one annuity contract for another annuity contract via a "1035 exchange." The ability to move money from an old annuity contract to a new one can be beneficial to investors when their current contract is not accumulating much interest compared to other products in the market.

Insurance companies sometimes make a potential exchange even more enticing to the consumer by offering special bonus interest to people who agree to move old money into a new annuity. In some cases, these bonus rates will help lessen the sting of any surrender charges that are applied by the old insurer when the transfer is executed.

One potential problem with annuity exchanges is that old money invested in a new annuity will automatically introduce a fresh set of surrender charges. Money that finally became accessible after many years under the old contract may suddenly lose its liquidity under the new agreement.

Regulation of Annuity Exchanges

Alleged unethical conduct in the exchanging of annuities has caught the eye of regulators in recent years. Some observers believe that the opportunity for decent commissions on annuity transfers has successfully tempted insurance producers to avoid telling consumers about fresh surrender charges. A few financial institutions, including some insurance companies, have conducted self-policing and have even eliminated or restructured commissions for employees who handle annuity transfers and exchanges.

In Illinois, insurance producers need to provide disclosures and obtain certain signatures before they can replace someone's annuity. At the time this course was being written, the relevant rules for producers were found in Section 917.60 of the state's administrative code:

<u>Section 917.60 Duties of Insurance Producers</u>

a) Each insurance producer shall submit to the replacing insurer with or as part of each application for life insurance or annuity:

1) *A statement signed by the applicant, as to whether or not such insurance will replace existing life insurance or annuity; and*
2) *A signed statement as to whether the insurance producer knows replacement is, or may be, involved in the transaction.*

b) Where a replacement is involved, the insurance producer shall:

1) *Present to the applicant, not later than at the time of taking the application, a Notice Regarding Replacement of Life Insurance or Annuity in the form as described in Exhibit A of this Part; with or as part of such notice, the insurance producer shall list the contract number or numbers which are to be replaced. The insurance producer's signature must be affixed to the notice. A copy of the notice presented to the applicant, together with the Notice Regarding Proposed Replacement of Life Insurance or Annuity, as described in Exhibit B of this Part, signed by the insurance producer, shall be submitted to the replacing insurer with the application;*
2) *Submit to the replacing insurer with the application: a copy of the Notice Regarding Replacement of Life Insurance or Annuity, as described in Exhibit A, signed by the insurance producer.*

Exhibit A, mentioned in the preceding section of the code, appears below:

<u>Section 917.EXHIBIT A Notice Regarding Replacement of Life Insurance or Annuity</u>

REPLACING YOUR LIFE INSURANCE OR ANNUITY?

Are you thinking about buying a new life insurance policy or annuity and discontinuing or changing an existing one? If you are, your decision could be a good one – or a mistake. You will not know for sure unless you make a careful comparison of your existing benefits and the proposed benefits.

Make sure you understand the facts. You should ask the insurance producer or company that sold you your existing policy to give you information about it.

Hear both sides before you decide. This way you can be sure you are making a decision that is in your best interest.

We are required by law to notify your existing company that you may be replacing their policy.

List below the identification of policies which are involved in the replacement transaction

Contract Number	*Insurance Producer's Signature*
Contract Number	*Date*
Contract Number	
Contract Number	

FREE-LOOK PERIODS

If the annuity owner is at all displeased with an aspect of an annuity contract, he or she might be able to take advantage of the contract's "free-look period." The free-look period grants the owner several days to cancel the annuity and receive a full or partial refund of the principal. In most cases, the refund of principal will be in full. On occasion, a variable annuity that invests premiums immediately in variable funds may only call for a return of the annuity's value at the time of cancellation.

Different states mandate different free-look periods for annuities. The opportunity for penalty-free cancellations might last anywhere from 10 days to 30 days. In some jurisdictions, free-look periods are longer for senior citizens.

CHAPTER 2: FIXED ANNUITIES

AN INTRODUCTION TO FIXED ANNUITIES

If consumers like the basic idea of accumulating money for a lifelong income stream but don't want to risk taking a beating in financial markets, a fixed annuity might be the right product for them. Like everything else involving a financial investment, a fixed annuity has attractive and unattractive features. However we will begin our study of these contracts by focusing on their positive side and learn why these annuities (particularly when compared to variable annuities) are attractive to many savers and some growth-minded investors.

Unlike variable annuities, fixed annuities put nearly all the risks involved with investing money on the insurance company's shoulders and offer multiple guarantees. Arguably the most significant of these guarantees is a full return of the principal. Only premature withdrawals, premature surrender of the contract or an insurer's insolvency can endanger this guarantee. Otherwise, even in terrible market conditions, the owner's money will remain intact.

Fixed annuity contracts will also guarantee set amounts of interest that will be credited to the principal until annuitization. Generally, the insurer will designate a specific interest rate, known as the "initial rate," that will be applied to the principal for a contractually mandated period of time. After anywhere between a few months and a few years, the insurer pulls back the initial rate and credits a new interest rate to the annuity. This new rate is usually modest and can change frequently during the accumulation period, but the contract for the fixed annuity guarantees that the new rate will never fall below a set percentage.

These guarantees help simplify the fixed annuity from both a producer's and a prospective buyer's point of view. The minimum guarantees keep fixed contracts from being deemed securities under federal rules and allow licensed insurance producers to sell these annuities without needing to be licensed as securities dealers. Sellers and marketers of variable annuities, on the other hand, generally cannot avoid this licensure requirement.

For the consumer, the guarantees mean that, barring premature withdrawals or surrender charges, a minimum return on a fixed annuity may be calculated down to the last penny and can greatly assist those annuitants who need to create a fixed budget for themselves. The fact that the insurance company remains responsible for investing the principal in its general account eliminates the need for clients to wade through confusing account prospectuses and to make extremely complex investment decisions.

Also, because all clients' money goes into a general account, a fixed annuity will not feature the kinds of fees that can reduce the value of a variable annuity. The buyer is still compensating the insurer for administrative services, but costs for these services will rarely count as a direct charge that reduces one's account balance. Instead, the various costs associated with fixed annuities will be reflected in the interest rates that insurers credit to accounts.

INITIAL RATES

The interest rates that insurance companies offer to owners of fixed annuities will depend on the company's business goals and financial health, the amount of money invested and the duration of the initial guarantee.

Due to a lack of annual fees, fixed annuities will always have their credited interest rates affected by the insurer's ideal "spread." In an annuity context, a spread is the difference between the amount of interest the insurer earns through its investments and the amount of interest the company applies to clients' principal.

Years ago, when economic prosperity nurtured extremely healthy market returns for insurers, owners of fixed annuities could sometimes receive double-digit interest rates during their annuities' early years. Today's initial interest rates are usually in the single digits. Some insurers will offer higher interest rates when buyers pay a minimum premium up front for the annuity. The customer can also receive a higher initial rate by agreeing to a lengthier or steeper surrender charge.

The insurance company guarantees the initial rate for only a brief period of time, which is usually shorter than the duration of surrender charges. In general, the guarantee will last a year, although a few contracts have limited the guarantee to six months.

RENEWAL RATES

After the guaranteed, initial interest rate on a deferred fixed annuity expires, the insurance company will begin crediting a new rate, sometimes known as a "renewal rate," to the owner's account. Like the initial rate, each renewal rate usually remains in effect for one year, but the insurer may alter the rate more or less frequently. It's possible, for instance, for an insurer to introduce a new renewal rate each quarter.

Renewal rates present some elements of risk to owners of fixed annuities because the insurance company generally has the right to set renewal rates as it sees fit. Clients have almost no way of knowing how the company will credit their accounts in the future.

Many factors can contribute to unfavorable renewal rates for fixed annuities. In fairness to insurance companies, many reduced renewal rates arise because the bonds that insurers must purchase in order to guarantee a return of principal to their clients have been governmentally set at rates that don't allow companies to cover expenses and keep a reasonable profit. In other words, the insurers' investments no longer allow them to maintain an adequate spread.

Sometimes, major changes at the company, such as a corporate merger, will lower renewal rates. At other unfortunate times, the issuing company will have planned to reduce rates significantly all along, and buyers eventually realize that the initial interest rate was merely a teaser to get unsuspecting customers in the door.

No matter the insurance company's level of good faith, unexpectedly low renewal rates put annuity owners in a disgruntled state of mind. Those who have owned a fixed annuity long enough to avoid surrender charges are likely to cancel their contract if renewal rates become ridiculously small. Those who can't break free from their contracts might start thinking about whether their investment will even keep pace with inflation and wonder if buying an annuity was ultimately a wise decision.

Businesses and some state governments have taken steps toward relieving consumers' nervousness regarding renewal rates. A few insurance companies sell annuity contracts that are actually guaranteed to earn more interest at renewal time. As the reader might have guessed, these products may credit initial interest rates that are lower than usual in order to compensate for the guaranteed increases.

The contract for a fixed deferred annuity will also list a "floor rate," which adds some consumer protection to the renewal process. Even if the insurance company suffers through a tremendously tough year, it cannot lower interest rates for its fixed deferred annuities below the floor rate.

CREDITING METHODS FOR FIXED DEFERRED ANNUITIES

Insurance companies credit interest in seemingly innumerable ways. For simplicity's sake, we'll break down their various methods and focus on two general practices.

In portfolio rating, all money invested in an annuity earns the same amount of interest regardless of when or if the owner paid multiple premiums to the insurance company. Suppose, for example, that the owner bought an annuity with an initial premium of $10,000 and invests another $5,000 in the annuity five years later. If the insurance company imposes a renewal rate of 5 percent and practices basic portfolio rating, it will credit 5 percent interest to the entire $15,000 investment until a new renewal rate goes into effect. Annuities bought with a single premium will be subjected to portfolio rating, and some annuities that require or allow for multiple premiums will be subjected to it, too.

Some annuity contracts call for the use of a crediting method called "banding." When the banding method is used, different interest rates are applied to money in an annuity depending on when the owner made the investments. Imagine, once again, that an annuity owner buys the contract with an initial premium of $10,000 and invests an additional $5,000 in the annuity five years later. If the issuing company practices banding, the $10,000 initial premium will be credited with one interest rate, and the additional $5,000 will be credited with a different interest rate. If the owner makes another $5,000 payment to the insurance company, the contract might then call for a third rate to be applied to that latest portion of the principal. Usually, banding will result in higher interest rates being applied to the owner's most recent contributions to the annuity and lower interest rates being applied to the owner's earlier contributions.

Bear in mind, however, that, in the cases of both portfolio rating and banding, we have looked at intentionally simplified examples. In reality, these crediting methods can be much more complex. Many annuity contracts call for a hybrid form of portfolio rating and banding. In these situations, the insurance company might offer one interest rate for "new money" that the owner gives to the insurer within a year or so and another interest rate for "old money" that was paid to the insurer at any earlier date. Following a year or two, the new money may be lumped in with the old money, and all of those dollars will be credited via the portfolio method from that point forward.

BONUS RATES

When economic conditions don't lend themselves well to attractive interest rates, or when one insurer merely wants to increase its profits or market share, a company might offer "bonus rates." A bonus typically ups the initial, guaranteed interest rate by a point or two, and, as reported by market analysts, some "super-bonuses" enhance the initial rate by at least four percentage points. Once the initial guarantee expires, a renewal rate will go into effect and will not include the bonus.

A true bonus rate can be a great deal, even if it only means the difference of earning 1 percent extra on the principal. Many of the bonus rates that are offered in good faith exist because insurance agents accept lower commissions than usual from sales of the corresponding contracts or at least agree to receive a larger portion of their usual commission down the road rather than shortly after a sale. But in various other forms, an annuity with a bonus rate is sometimes too good to be true and can lure even a careful buyer into purchasing an inappropriate annuity.

One common complaint about bonus rates is that the issuing company can earn its money back at renewal time by applying lower rates to bonus annuities than to regular annuities. Suppose a man and a woman each buy a fixed deferred annuity at the same time but from competing insurance companies. The woman buys her annuity without a bonus rate and is promised an 8 percent interest rate on her investment for one year. The man, meanwhile, jumps at the opportunity to get a 2 percent bonus that will help him earn a guaranteed 10 percent on his investment in the first year. After 12 months go by, the insurance companies introduce renewal rates for their clients. The woman's insurer drops her interest rate to 7 percent, but the man's insurer knocks rates down to 5 percent. Another year passes, after which both insurers decide against changing their interest rates, and the man begins to wonder if he should have ever bothered with the bonus rate in the first place.

Sometimes the bonus rate has no noticeable effect on renewal rates but limits annuity owners' satisfaction in other ways. An interested buyer might discover that the surrender charges for an annuity with a bonus rate are steeper and remain in effect longer than surrender charges for other annuities.

Someone who takes advantage of a bonus rate might also find that the enhanced rate will not be credited to the principal under all circumstances. The insurer may reserve the right to rescind the bonus if the owner withdraws funds prematurely from the annuity. Some contracts place similar limits on beneficiaries by forcing them to receive death benefits in periodic installments if they want to receive interest created through the bonus rate.

PROHIBITED BAIT AND SWITCH TACTICS

All these warnings about initial rates, renewal rates and bonus rates relate, in some way, to an all-too-common sales technique known as "baiting and switching." In a bait and switch, the issuing company lures customers into its doors by promising high interest rates that will be credited to an annuity in the contract's early years. Then the company turns its back on clients by crediting renewal rates that are shockingly low.

When researching the current rates being offered by the issuing company, the consumer should consider how long those rates are likely to remain relatively stable. In some cases, the individual can make a reasonable prediction about future rates by taking a good, hard look at a company's past rates. Illustrations used for sales purposes might suggest that renewal rates for a company's fixed deferred annuity will hardly budge. But the company's history of renewal rates, which will be based on facts rather than a salesperson's projections, might suggest otherwise.

Insurance producers who engage in annuity sales transactions need to be careful when they advertise a company's guaranteed interest rates. In Illinois, advertisements for annuities will be considered illegal if they are likely to confuse the average person. An ad that doesn't adequately disclose the nature and duration of a guaranteed rate of return might be viewed as an unacceptable bait-and-switch tactic.

Specific products and contract provisions that can guard against unpredictable renewal rates for fixed deferred annuities are addressed in the next few sections of this material.

BAILOUT PROVISIONS

If annuity shoppers are worried about renewal rates sinking to unpredictable levels, they can shop for an annuity contract that includes a "bailout provision." A bailout provision lets the owner cancel the annuity contract without having to deal with surrender charges if renewal rates ever drop to a certain percentage. This provision is very similar to a guaranteed floor rate but promises liquidity instead of a rate of return.

Some bailout provisions allow owners to surrender their annuities if renewal rates ever fall below 1 percent of the initial guarantee. Others will permit a penalty-free, total withdrawal if the renewal rate is more than 1 percent less than the preceding renewal rate. The owner may have 30 days following the imposition of the renewal rate to bail out of the contract and receive at least a return of principal. If the renewal rate is lower than the rate floor in the bailout provision and the owner does not act, the contract will renew at the new rate.

JUMP RATES

Some insurers sell riders that allow money accumulating in an annuity to earn interest at a "jump rate" if the rates offered to prospective customers are greater than the rates offered to existing customers. A jump rate basically turns back the clock on the annuity contract and replaces the renewal rate with whatever initial, guaranteed rate the company is marketing at the time. So if the renewal rate on an old annuity is 5 percent and the initial rate on a similar, new annuity bought from the company is 7 percent, the rider would give the owner of the old annuity a one-time opportunity to earn 7 percent interest.

Like the initial rate in a regular annuity contract, the jump rate will only last temporarily, and a renewal rate will eventually kick in. Jump rates will usually introduce a new period during which the owner must pay surrender fees for any early withdrawals. If owners buy a contract that allows for a jump rate, they might need to wait a few years before taking the jump. Also, the chance to take the one-time jump might be limited to the early years of a contract.

CD ANNUITIES

Because the fixed annuity features a guaranteed return of principal as well as assorted guarantees pertaining to interest, the product often draws comparisons to certificates of deposit. Still, the CD and the fixed annuity are by no means identical. The typical annuity offers far less liquid than the typical CD. In return for making a long-term commitment with the issuing financial institution, owners of fixed annuities can usually expect to earn more interest than they would normally receive through a CD.

The comparisons made between fixed annuities and CDs undoubtedly led insurers to begin promoting products in the 1990s that combined the annuity's best features with some of the liquidity and guarantees found in CDs. The "CD annuity" is still a fixed, deferred product that can produce a lifelong income stream, but like a certificate of deposit, its interest rate is guaranteed for a length of time that is equal to or longer than the surrender period. As a result, the buyer doesn't need to worry about being locked into a contract and having no choice but to accept unpredictable renewal rates.

When opting for a CD annuity, the buyer chooses a desired pairing of years and interest rates from those offered by the insurance company and can end up with a contract that pays a guaranteed interest rate for anywhere between six months and 10 years. At the end of that chosen time period, the owner might have 30 days to decide what to do next. The owner can terminate the relationship with the issuing company and pay taxes on a total withdrawal or enter into a new contract with the insurance company that once again guarantees a specific interest rate but also imposes a fresh surrender period on all funds. Trade articles published in the past few years indicate that some CD annuity contracts allow owners to avoid additional surrender periods if they accept renewal rates chosen by the insurance company.

TOTAL RETURN ANNUITIES AND MORE

The past 15 years have introduced a new set of fixed annuities that scrap the traditional renewal process. These annuities come in several forms and go by several names, including "direct recognition annuities," "pass-through annuities," "bond-indexed annuities" and "total return annuities." All of these products still fall under the category of fixed annuities because they guarantee a return of principal and a minimum interest rate.

The significant difference between most of these products and the usual fixed annuity is that the interest rate applied annually to the owner's account will not be chosen by the insurance company. Instead, the insurance company invests money, is allowed to earn a contractually defined amount of interest on its investments (usually at least 3 percent) and credits excess interest to the owner's account. The owner might have the opportunity to invest the principal in specific kinds of bonds as long as investments associated with these specific bonds equal a minimum dollar amount.

In many ways, these annuities are similar to variable annuities that feature fixed account options and to another kind of fixed product called the "equity-indexed annuity." Later sections of this course describe variable and equity-indexed annuities in greater detail.

MARKET VALUE ADJUSTMENTS

Owners should be aware of the insurer's ability to make a "market value adjustment" (MVA). An MVA generally lets the insurance company reduce the value of a fixed deferred annuity if money comes out of the account at a time when interest rates for fixed annuities are higher than they were when the owner entered into the contract. The MVA helps discourage annuity owners from surrendering their contracts and transferring their funds to a competing company that might be offering better guarantees. Perhaps most importantly, the MVA helps the insurance company cope with situations in which it must cash in long-term bonds prematurely in order to meet the demand for account withdrawals.

Formulas for MVAs boil down to the difference between the current interest rate at the time of withdrawal and the rate applied to the annuity when the contract began. In a simplified example, suppose a client bought an annuity when fixed rates stood at 6 percent and surrenders the annuity when fixed rates in the market stand at 9 percent. With the MVA in effect, the insurer would reduce the annuity's value by at least 3 percent before handing the funds back to the owner.

Depending on the contract, the MVA may reduce the value of the entire account balance, just the principal investment, or just the owner's accumulated interest. Some state governments have tried to find a balance between MVAs and contractual guarantees by instituting caps on the adjustments so that annuity owners can earn minimum interest and avoid losing some of their principal if they make a withdrawal at the wrong time.

Prospective buyers also deserve to know what sort of event will trigger an MVA. In general, the insurer will perform an MVA whenever the owner makes a full or partial withdrawal while the surrender period is in effect. The insurer then applies the appropriate surrender charge to the remaining funds. The MVA provision may disappear at the same time as the surrender charge if the owner keeps the contract in force for several years, but this isn't a uniform practice across the industry. Some contracts give the insurer the right to perform an MVA on death benefits, and some make an MVA possible even if other surrender fees have expired and the owner has decided to annuitize the funds.

The preceding paragraphs probably make MVAs seem a little scary. It's important to note that not every fixed deferred annuity will feature an MVA and that some buyers might actually prefer contracts with an MVA provision. For instance, if an owner withdraws funds at a time when interest rates for fixed annuities are lower than when the person purchased his or her contract, the MVA can result in a credit to the owner's account. Also, because the client who opts for a contract with an MVA is accepting more risk than someone who opts for a contract without this feature, an annuity that allows for an MVA will more often include comparatively high and long-lasting guarantees of interest.

PICKING A SOLID INSURER

If we set liquidity issues aside, we can generally say that fixed annuities are safe investments. After all, they guarantee a return of principal as well as some interest on that principal. At the very least, fixed annuities dwarf variable annuities in regard to the amount of investment risk they present to buyers. A variable annuity will rarely produce favorable returns unless the owner knows a thing or two about mutual funds and the stock market, but a fixed product can produce favorable results for less-experienced investors because the insurance company is the one putting money to work in the financial markets.

Still, this doesn't mean all insurance companies deserve the same amount of trust from the public. Man-made or natural catastrophes—not to mention poor financial planning—have created occasional situations in which life insurance companies could no longer live up to the contractual promises they made to clients. Beneficiaries on life insurance policies have sometimes been denied full death benefits following a company's collapse. Some annuity owners have lost parts of their investments in similar situations.

A life insurance company's stability ought to be important to owners of fixed annuities because money given to an insurance company for a fixed contract becomes part of what is known as the insurer's "general account." In contrast to other accounts held by the company, the general account may be accessed by creditors if the insurer becomes insolvent.

As if that wasn't a big enough problem for investors, no federal entity insures the dollars that consumers put into annuities. Even when a person buys a fixed annuity from a bank, the product is not backed up by the Federal Deposit Insurance Corporation. Individual states have their own guaranty funds that impose taxes on solvent insurers in order to return some of the money owed to insolvent companies' clients. But the guaranty funds put a cap on the amount of money that each unlucky annuity owner would receive in the event a company's collapse. This cap usually falls somewhere in the ballpark of $100,000. A failed insurer also leaves behind a considerable amount of legal and bureaucratic red tape, and the owner could end up waiting years for a refund.

A little research on the prospective buyer's part can go a long way toward ensuring that thousands of dollars don't go to an unstable company. An examination of a company's rate history for fixed annuities might hint at the insurer's stability or lack thereof. Nervous consumers might feel more comfortable giving their money to a long-time insurer with an extensive history of modest yet consistent interest rates than to a new company that offers very high interest rates.

If consumers don't feel comfortable comparing and analyzing various statistics on their own, they can turn to reputable rating organizations, such as A.M. Best, Standard & Poor's and Weiss Ratings, which give companies grades based on their financial health. In general, advisers suggest that their clients only do business with insurers who receive at least an A+ rating from A.M. Best, an AA rating from Standard & Poor's or a B rating from Weiss Ratings. Of course, these are mere guidelines. A client can have a favorable experience with an annuity issued by a low-rated or unrated insurer, and a client can have a bad experience with an annuity from a highly esteemed, well-rated institution.

CHAPTER 3: VARIABLE ANNUITIES

AN INTRODUCTION TO VARIABLE ANNUITIES

In 1952, the Teachers Insurance and Annuity Association, College Retirement Equities Fund (TIAA-CREF), introduced the first variable annuity in the United States, thereby complicating the options for shoppers but also adding flexibility to the market.

Like the annuities we have already covered, variable annuities may be immediate or deferred, can create a lifelong income stream for an annuitant, may feature a death benefit and will involve surrender charges for early withdrawals. Nevertheless, these products are significantly different from fixed annuities.

Variable annuities can lead to investment gains that tower over those created through fixed annuities or CDs, but they can also result in some losses. Unlike the fixed annuity, a variable annuity contract doesn't need to guarantee a full return of principal or a particular amount of interest. The annuity's value at any given time may depend on the state of the economy and the soundness of the owner's investment decisions. The abundance of market risk and responsibility that can be assumed by the owner explains why some variable annuities are known as "self-directed" annuities.

Variable annuities might satisfy clients who are interested in a long-term investment that might keep up with or exceed inflation and who feel reasonably comfortable putting their money in mutual funds. People who have had success with variable life insurance policies might also find variable annuities to their liking. However, it might be hard or even inappropriate to sell a variable annuity to someone who prefers security over growth.

FIXED AND VARIABLE ACCOUNTS IN VARIABLE ANNUITIES

The number of investment options for the owner of a variable annuity can usually be counted on at least two hands, and some issuing companies let clients invest their premiums in any of several dozen different vehicles similar to mutual funds. The annuity owner generally has the right to allocate the principal investment as he or she sees fit. Nearly all of the owner's investment can go into a single fund, or the principal may be disbursed relatively evenly among funds that involve foreign and domestic stocks and foreign and domestic bonds. Other options might include funds that go up or down in value depending on various indexes, such as the S&P 500.

Much of the money invested in variable annuities becomes part of "variable accounts," which offer no guarantees of principal or interest. Insurers also allow owners to invest a portion of their premiums in one or several "fixed accounts." A fixed account acts like a fixed annuity within the variable annuity. Investors receive a guaranteed return of principal on all money put into fixed accounts and also earn a minimum interest rate on that money.

The option to put some principal in a fixed account can appeal to owners of variable annuities who have lost money in higher-risk funds or who are experienced enough to recognize when a booming financial market is close to becoming a sluggish one. These accounts also allow insurance companies to occasionally guarantee a full return of principal or various minimum benefits if the owner adheres to certain investment guidelines for at least a few years after purchasing the variable annuity.

Like a variable life insurance policy, a variable annuity contract will give owners the opportunity to transfer invested funds from one fund to another within contractually mandated limits. The owner might have an opportunity every month to move money from a domestic stock fund into an international stock fund, for example, and the insurer might require that all transfers involve a minimum number of dollars. Transfers within a variable annuity will avoid taxation, but the contract may allow the insurance company to charge surrender-type fees if transfers occur too frequently or involve movement between a fixed account and a variable account.

VARIABLE ANNUITY FEES

The mechanics of the variable annuity tend to make it a seemingly costlier product than the fixed annuity. As the reader might recall, owners of fixed annuities often have no idea exactly how much money an insurance company is making from a sale. Since the insurer is the party doing all the investing in a fixed setup, it merely calculates a spread for itself and credits the excess interest to owners' accounts. The insurer may credit less interest from one year to the next, but it generally doesn't subtract fees directly from the owner's account balance.

Owners of variable annuities pay flat fees as well as percentage-based "asset charges" that will be linked to the amount of money in an account. In most cases, these fees will remain the same as long as the contract is in force. Annuitants who opt for variable payouts, which we will study in the next section of this course, will continue to be charged these fees during annuitization. The various fees can lessen investment gains during good times and possibly contribute to a financial loss during rough times.

An “account maintenance fee” is perhaps the most common flat fee found in variable contracts. The charge generally covers the cost of paperwork. In terms of asset charges, owners can at least expect to pay a “mortality and expense risk charge,” which will typically amount to somewhere near 1.25 percent of the annuity’s value each year. This annual fee is like a life insurance premium and helps pay for any applicable death benefits. The typical variable annuity contract calls for beneficiaries to receive the greater of the principal investment, minus any previous withdrawals and the annuity’s value at the time of death. For an additional fee, the insurer might guarantee a larger death benefit.

Beyond those two common fees, the owner might also need to reimburse the issuing company and its affiliates for investment-related services, such as fund management, and might need to pay yet another fee for any desired financial advice.

VARIABLE ANNUITIZATION

When owners of variable deferred annuities determine that the time is right to start receiving periodic or lifetime income from the insurance company, they may put a stop to market risk and request fixed payouts that will be based on the insurer’s benefit rate and the accumulated funds. In a sense, their variable annuity can transform into a fixed annuity during annuitization.

Other people will not be intimidated by continued market risk and will want their money to retain its growth potential even as they receive an income for life. Variable annuities make this latter option possible through the process of “variable annuitization.”

At first, this concept might seem illogical. If the owner’s investment remains in variable accounts that fluctuate with the markets, how can an insurer offer periodic payouts that are supposed to continue over the course of a person’s lifetime?

For both deferred and immediate variable annuities, the answer to that question involves the “assumed interest rate” (AIR). Along with such important factors as the account balance and the annuitant’s life expectancy, the AIR helps the insurer arrive at a statistically fair, initial payout. The company will then base subsequent payouts on the invested funds’ performance in relation to the AIR. When investments in the annuity outperform the AIR, income received from the insurance company will be larger than the initial payout. When investments in the annuity under-perform, income received from the insurance company will be smaller than the initial payout.

Variable annuitization is a complex settlement option that will result in a regularly timed but inconsistently sized income for the annuitant. This can make budgeting a bit of a guessing game for annuitants. A sudden market downturn can cause someone who received a perfectly adequate income for one month to receive a largely inadequate income for the following month.

Variable annuitization can even create budgeting problems for people whose accounts grow in value. Even if the invested funds always outperform the AIR, they will almost certainly not outperform it by the same margin at every interval. The payments in this case will always be above the AIR, but they won’t necessarily be the same from month to month or year to year.

Financial advisers and insurance professionals have come up with at least two suggestions for people who want the inflation-beating potential of variable annuitization but who shudder at the thought of unpredictable payouts. One option is to accept a low AIR from the insurance company, which means initial payouts will be small but subsequent ones will be more likely to equal or exceed the initial payouts.

Concerned consumers might also be interested in riders that can temporarily guarantee that income will not drop below a certain amount. This kind of guarantee (and most other promises within variable annuity contracts) will still affect the account balance by way of annual fees.

OPTIONAL GUARANTEES

In spite of the risks involved with variable annuities, consumers can secure various guarantees from the insurance company if they’re willing to pay annual fees, sacrifice more liquidity or follow a strict investment plan. These optional guarantees may cater to the owner’s desire to provide additional funds for beneficiaries or can create a relatively reliable income stream for the annuitant.

Because we are already familiar with the general concept of an annuity’s death benefit, we’ll quickly focus first on those optional guarantees related specifically to beneficiaries and then turn our full attention to different kinds of contract provisions called “living benefits.”

Variable Annuity Death Benefits

The standard annuity death benefit grants beneficiaries the greater of the principal and the annuity’s value at the time of the death, minus any previous withdrawals. This may seem like a reasonable benefit as far as fixed annuities are concerned because the fixed annuity’s value won’t decrease unless the owner makes premature withdrawals. But with a variable annuity, there’s always a chance that a portion of the owner’s investment gains will vanish during a market downturn.

Pretend, for a moment, that a man bought a variable annuity for $100,000 and opted for a standard death benefit. After 15 years, investment gains pushed the man’s account value up to $130,000. After five more years, some of the man’s investments went poorly, and his account value dropped to $125,000. The man died, and the standard death benefit entitled his beneficiaries to $125,000. On the positive side of things, his heirs received $25,000 more than his principal investment. But the drop in the annuity’s value from $130,000 to $125,000 meant that $5,000 was lost along the way.

If the fellow in our example wanted to maximize death benefits for dependants or other loved ones, he could have purchased a rider that allowed for a “stepped-up” death benefit. This contract feature, which usually involves an annual fee, allows the owner to lock in the minimum death benefit once or every few years during the accumulation period if the variable annuity increases in value. When the annuitant dies, beneficiaries receive the greater of the stepped-up amount and the account value at the time of death. So, if the owner buys an annuity for $100,000 and invokes a stepped-up provision when the annuity is worth

$130,000, beneficiaries are guaranteed to receive at least $130,000 if death occurs prior to annuitization and prior to any premature withdrawals.

If the owner is worried about losing money in a variable annuity and leaving nothing but the principal amount for beneficiaries, he or she can purchase a modestly enhanced death benefit. For an annual fee, the insurer will guarantee that beneficiaries will at least receive a return of the principal plus a pre-set rate of interest if death occurs prior to annuitization.

Living Benefits

Living benefits help preserve a potential lifelong income for the annuitant regardless of poor market conditions. Essentially, when insurers attach living benefits to their variable annuities, they are adding fixed elements to the contracts and selling minimum guarantees.

Perhaps the most common living benefit is the “guaranteed minimum income benefit” (GMIB), which, in some ways, entitles the annuitant to a modest immediate fixed annuity if investments in the variable sub-accounts prove to be disastrous. In exchange for keeping the variable annuity with the issuing company for several years (usually 10), the annuitant will receive no less than the GMIB upon annuitization. In exchange for that extra security, the owner must invest premiums temporarily in a manner chosen by the insurance company. When owners surrender their variable annuities, they also surrender this non-transferable living benefit.

The fact that the GMIB only applies during annuitization distinguishes it from the “guaranteed minimum accumulation benefit” (GMAB), which, in some ways, entitles the owner to a minimum rate of return. In exchange for keeping the variable annuity with the issuing company for several years, the owner will end up with an annuity that can be worth no less than the GMAB, which is usually equivalent to the principal investment.

Like the GMIB, the inclusion of a GMAB might force the owner to invest premiums temporarily in a manner chosen by the insurer. However, the owner might have the right to take advantage of the GMAB without needing to annuitize with the issuing company. In other words, unlike some other living benefits, the GMAB might still be applicable if the owner decides to surrender the annuity after a number of years and receive a lump sum instead of regular, equal payouts.

Another optional pre-annuitization feature is the “guaranteed minimum withdrawal benefit” (GMWB), which guarantees that the owner may take out a set percentage of the principal each year even when the initial funds become battered in the financial markets. A basic GMWB allows for withdrawals up to a certain percentage until the owner has withdrawn a cumulative amount equal to the principal investment.

Another kind of GMWB may extend the benefit beyond the principal investment and through the annuitant’s lifetime. Suppose a woman buys an annuity for $100,000 along with a GMWB that allows for 4 percent withdrawals for life. She could then receive $4,000 annually without annuitizing. If her annuity’s value ever dips below $4,000, she could still receive annual checks, equal to the GMWB, from the insurance company.

All of these guarantees are usually associated with potentially significant annual fees. An owner who chooses these benefits should expect to pay an asset charge of at least 0.5 percent or so to the insurance company each year.

The asset charge for each benefit might not seem like much at first, and the benefits might end up paying for themselves in a threatening financial environment. But prospective buyers should be made to understand that, just like the annuity itself, a living benefit represents a long-term commitment between the insurer and the contract owner. If buyers have second thoughts after purchasing a living benefit, they may find it hard or even impossible to cancel the add-on provision.

REGULATION OF VARIABLE ANNUITIES

Variable annuities present considerable market risk to buyers and don’t always balance that risk with free guarantees. This imbalance explains why the federal government and state regulators treat variable annuities like securities.

Security-level status puts the variable annuity market under the rule of the Securities and Exchange Commission (SEC)—which aims to protect consumers at a national level—and private regulatory organizations that oversee market conduct. The most prominent of these private regulatory organizations is the Financial Industry Regulatory Authority (FINRA).

These various regulatory bodies make rules that affect annuity salespersons and the products they promote. Anyone interested in selling variable annuities should keep in mind that he or she must be licensed to sell variable products. A basic license to sell life insurance policies will not, on its own, satisfy all security-related licensing requirements.

Regulations require that all variable annuity contracts come with a prospectus, which discloses all fees associated with the annuity and summarizes the investment history of all the mutual funds associated with the annuity. The prospectus should be simple yet informative enough to help people make educated decisions regarding their investments.

CHAPTER 4: EQUITY-INDEXED ANNUITIES

AN INTRODUCTION TO EQUITY-INDEXED ANNUITIES

For many consumers, the choice between a traditional fixed annuity and a variable annuity is too limited to bring them into the market. From their perspective, the typical fixed annuity doesn’t allow for enough growth to settle a person’s long-term concerns about inflation. Yet, at the same time, the variable annuity seems like an overly risky product that puts people’s life savings at the mercy of an unpredictable investment environment.

To meet the needs of those prospects who are intrigued by the potential for growth but uninterested in dealing with market uncertainty, insurance companies and other financial institutions have developed hybrid products called “equity-indexed annuities” (EIAs). These annuities tend to combine some of the various strengths and weaknesses of basic fixed and variable contracts.

Since its debut in the early 1990s, the EIA has remained in third place in the annuity industry. However, the billions of dollars spent on equity-indexed annuities over the years and the willingness of consumers to exchange their CDs and regular fixed annuities for these relatively new products suggest that the EIA is a popular gateway item that has eased many conservative investors into the financial markets.

GROWTH POTENTIAL AND GUARANTEES

An EIA is typically a deferred investment product with contract terms that can last anywhere from one year to 15 years and sometimes more. When owners give money to insurance companies for an EIA, most of the premiums are invested in low-risk bonds and other items associated with fixed annuities, but the insurer also spends some of the principal on call options within a stock index, such as the S&P 500 or the Dow Jones Industrial Average. Some EIAs allow premiums to go toward call options in multiple bond and stock indexes or into an index created by the insurance company.

Despite not owning these stock options, the EIA owner is contractually entitled to share in the wealth that those options create. The interest rate credited to the buyer's principal will be based on the amount of growth in the stock index over the contract term. For the sake of a simple example, pretend that a stock index associated with an EIA grows by 9 percent during a one-year term. As result of that growth, the owner might earn 9 percent interest on the EIA, minus various deductions by the insurer. The owner typically does not receive any dividends.

Like a variable annuity, an EIA lacks a fixed initial interest rate and does not subject the owner to insurer-mandated renewal rates. Much of the risk involved with an EIA lies in the performance of the stock market rather than in the insurer's sense of fairness. A market boom at the right time can make an EIA more profitable than a traditional fixed annuity, while a market downturn at the wrong time can create disappointment among owners and make the traditional fixed contract a potentially better deal.

A lot of the differences between EIAs and variable annuities relate to guarantees. While the guarantees in a variable annuity are often only available to consumers who are willing to pay additional fees, minimum guarantees for equity-indexed annuities are generally required by law. The insurance company often guarantees that an equity-indexed annuity can never be worth less than 87.5 percent of the owner's contributions plus annual interest of 1 percent to 3 percent. In practice, this minimum guarantee applies even in cases where an owner wants to surrender the annuity prematurely. In the event of an early surrender, the insurer will often calculate this amount (87.5 percent of contributions plus interest) without applying a surrender charge, calculate the annuity's most recent value minus a surrender charge and then give the owner the greater of those two amounts.

Based on these guarantees and other factors, insurance regulators have traditionally treated most EIAs like fixed annuities. Such treatment has allowed insurance companies to sell some EIAs without a prospectus and given insurance agents and other financial workers the chance to sell the products without needing a securities license. But since 2008, an assortment of federal and state rules and court cases has created a lot of uncertainty regarding how these products should be treated under the law. An SEC ruling that classified equity-indexed annuities as securities was followed by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which allowed most equity-indexed annuities in this country to remain state-regulated insurance products under certain conditions.

CALCULATING EIA INTEREST RATES

Considering their attractive combination of growth potential and minimum guarantees, it may seem strange that EIAs have not yet become the dominant products in the annuity market. But upon closer inspection of EIA contracts, we can see how some potential buyers might be turned off by the limits insurers put on owners' investment gains and by the complex manner in which issuing companies calculate and apply interest to these annuities.

Like other fixed annuities, the EIA usually does not involve fees that are deducted directly from the owner's account balance. The insurance company earns profits and recoups its administrative expenses from EIAs by taking a percentage of investment gains for itself before crediting interest to the annuity. As a result of this financial arrangement between client and insurer, the buyer cannot monitor a stock index, such as the S&P 500, and expect to earn interest that is equal to the jump in the index during the contract term. A 10 percent bump in the S&P from one year to the next, for example, is merely a starting point for calculating interest on the annuity. In the end, the percentage credited to the owner's account will inevitably drop due to contractually defined participation rates, caps and spreads.

Participation Rates

The EIA's "participation rate" is the percentage of the increase in the stock index that the insurer will credit to the owner's annuity. Suppose a person bought an EIA when the corresponding index was at 800 points. At the end of the contract term, the same index is at 880 points. The 80-point increase in the index translates to a 10 percent gain between the start and the conclusion of the term. So, does that mean the owner's annuity will be credited with 10 percent interest for each year of the term? With the participation rate in effect, the answer to that question is "no." If the participation rate on that EIA is 80 percent, the owner will receive no more than 80 percent of the 10 percent gain in the index. This drops the credited interest rate in our example down to 8 percent.

An EIA's participation rate can range from more than 100 percent (when temporary bonuses are involved) to less than 50 percent. When shopping for an EIA and negotiating with issuing companies, the prospective buyer can influence the offered participation rate by making choices related to guarantees, liquidity and the type of interest that will be credited to the annuity.

If the consumer demands a guaranteed, 100 percent return of principal and wants minimum interest guarantees that exceed local statutory requirements, he or she might not receive a high participation rate. Conversely, people who demand fewer guarantees will probably have to share less of the investment gains with the insurance company.

Long-term contracts tend to have larger participation rates than short-term contracts. A 10-year term with no opportunities for penalty-free withdrawals might help push the percentage rate near 100 percent.

Also, even though it receives relatively little attention in the financial press, an owner's choice between simple interest and compounded interest for the EIA might affect the participation rate. Simple interest is credited only to the principal amount, whereas compounded interest is credited to the principal amount and any pre-existing interest that has been added to the account. An EIA featuring compounded interest will probably grow larger and more quickly than an annuity featuring simple interest. In exchange for giving up the opportunity to earn compounded interest, an EIA owner who accepts simple interest might be rewarded with a high participation rate.

According to the National Association of Insurance Commissioners, most EIAs with simple interest will combine the principal and the simple interest at the end of the contract term and will treat the sum as principal during the subsequent term. So, as long as the owner renews the contract after the term, even money earned through simple interest can eventually start earning some compounded interest.

Other factors that may affect participation rates are generally beyond the buyer's control. For example, when the government lowers interest rates for its bonds, the insurance company will need to spend more money in order to back up its guarantees and might decide to reduce participation rates. Likewise, the rising price of call options within a particular stock index can lessen the insurer's ability to share investment gains with its customers and may bring participation rates down. These economic factors create a market environment in which a buyer can look into the same EIA from the same company on consecutive days of the week and be offered different participation rates.

Once someone purchases the EIA, the participation rate can become as unpredictable as a renewal rate for a traditional fixed annuity. Many insurers guarantee the participation rate for the term of the contract and only change the rate when the contract comes up for renewal. Others will guarantee that the participation rate for a multi-year term will not change until the annuity's anniversary date. It's also possible for the participation rate to be guaranteed for a few years or for it to change every month. When the participation rate is not guaranteed for the entire contract term, some companies will at least promise not to reduce participation rates below a certain percentage.

Spreads

For many EIA owners, the reduction in interest credited to their annuity begins before the insurer applies the participation rate. As is the case with a regular fixed annuity, the insurance company may keep a spread for itself to cover administrative costs. Like the participation rate, the spread can be guaranteed for the entire contract term, or the insurer can take a different spread every year. The insurance company will deduct the spread from the gain in the index.

If the stock index goes up 10 percent during a term, and the contract permits the insurer to take a 2 percent spread, the annuity owner would be left with 8 percent interest. If that same annuity contract called for a participation rate of 80 percent, the insurer would then multiply 8 percent by 80 percent and might ultimately credit 6.4 percent interest to the owner's account. Contracts with spreads can come with or without participation rates and vice versa.

Caps

Insurance companies may put a "cap" on the amount of interest that can be credited to an EIA account for each year or each contract term. The cap prevents the owner from receiving interest above a certain percentage point. Typical caps range from 7 percent to 14 percent, with 10 percent perhaps representing the norm.

With a cap in place, EIA owners should get excited about a market boom but shouldn't necessarily become overjoyed. If an index goes up 20 percent during a term and an EIA has a 10 percent cap, the owner will receive no more than 10 percent interest.

The cap can replace or work hand-in-hand with participation rates and spreads. Suppose an EIA's index goes up 12 percent over a term. A 2 percent spread would knock the owner's interest down to 10 percent. At an 80 percent participation rate, that 10 percent would be cut to 8 percent. Then, with a 7 percent cap, the interest would drop another point, and the owner would end up receiving 7 percent interest from the insurance company.

Participation rates, spreads and caps may neutralize one another's negatives when they all appear together in an annuity contract. A contract with a cap, for example, might boast a higher participation rate than a contract with no cap.

EIA CREDITING METHODS

The insurance industry has taken a non-uniform approach to EIA crediting methods. Within the context of EIAs, crediting methods generally refer to the contractually defined times when insurers calculate gains or losses in stock indexes and to the contractually defined times when insurers add interest to the annuity owner's principal. Many people who sell annuities break these methods down into three general categories: annual reset methods, point-to-point methods and high watermark methods.

Annual Reset

According to multiple industry reports, most EIAs sold today use the annual reset method. This method—sometimes called "annual point-to-point" or "annual ratchet"—uses the annuity's issue date as the first starting point for the index and then calculates the change in the index from that starting point to the anniversary of the issue date. If a person bought an annuity when the corresponding index was at 1,000 points, and the index jumped to 1,100 points on its first anniversary date for a 10 percent annual gain, the owner would have been credited with 10 percent interest for that year.

In subsequent years, the insurer determines the appropriate interest rate by comparing the index at the previous anniversary date to the index at the next anniversary date. So, if the index in our previous example jumped from 1,100 points on its first anniversary, to 1,200 points on its second anniversary, for an annual gain of 9 percent, the owner would have been credited with 9 percent interest for the EIA's second year. If the market goes down between anniversary dates, the insurer may credit no interest (or only a minimum guaranteed amount) to the annuity for that year.

The annual reset method works well for consumers when the stock index experiences a major upturn near the contract's anniversary date. Unlike other crediting methods, it locks in interest for the owner every year, even when the contract term lasts several years. If the index performs well during one year, the resulting interest will not be jeopardized by the index's poor performance in other years. However, because the insurer calculates interest every year in the annual reset method, the owner will likely notice yearly changes in participation rates, spreads and caps. More so than any other crediting method, the annual reset method might allow owners to take previously calculated interest with them if they surrender the EIA before the end of a term.

Point-to-Point

The "point-to-point method"—sometimes called the "European method"—is probably the simplest way insurers credit interest to EIAs. Companies use the beginning of the term as the starting date for the index and then calculate the change in the index from that point to the end of the term. If a person bought an EIA with a seven-year term when the corresponding index was at 1,100 points, and the index jumped to 1,250 points at the end of its seven-year term for a 13.6 percent total gain over the entire period, the owner would be credited 13.6 percent interest, minus any insurer deductions for the seven-year term. Any annual gains or losses related to the index between those seven years would not factor directly into the insurer's calculations.

The point-to-point method might appeal to people who foresee a major, positive change in the index between the beginning of the term and the end of the term. The method will serve clients poorly if the market booms early or in the middle of the term before coming back down to earth at the end of the term. Since the interest rate depends on the index's status at the end of the term, owners do not receive interest from the insurance company every year, and therefore might not be able to take any interest with them if they surrender this kind of EIA before the end of a term. Insurers attempt to reduce point-to-point EIAs' long-term risks by including high participation rates and high caps within these contracts.

High Watermark

The "high watermark method" falls somewhere between the point-to-point method and the annual reset method. Like they do with point-to-point EIAs, insurance companies use the beginning of the term as the starting point for the index and do not credit any interest to the annuity until the end of the multi-year term. Yet, like they do with annual reset EIAs, companies keep track of the changes in the index from one anniversary to the next. At the end of the term, minus any insurer-imposed deductions, owners receive interest equal to the biggest gain in the index, as calculated on the various anniversary dates. So, if the index experienced a 9 percent gain for the third year of the EIA and experienced 6 percent gains in every other year of the term, the owner would receive 9 percent interest for every year of the term.

The high watermark method protects the owner's ability to earn a sizable portion of interest if the index goes up early or in the middle of the term, before tanking near the final anniversary date. Still, the high watermark's potential to generate more interest than the other two crediting methods comes with a few drawbacks. Participation rates for these annuities will probably be lower than those for point-to-point annuities. There is also a chance that the owner will receive no interest if he or she surrenders the annuity before the end of a term.

One potentially scary thing about all three of these basic crediting methods is that they depend on an index's status on a particular day, whether that is the anniversary date or the final day of the term. An unexpected drop in the index near one of these days could make an otherwise healthy index completely useless to the EIA's owner. Many companies tackle this issue by tracking the index daily or monthly to come up with an average gain for the year or for the entire term. Depending on the issuing company, a prospective buyer might be able to secure a daily or monthly averaged EIA that calculates interest via the annual reset method, the point-to-point method or the high watermark method.

EIA WITHDRAWALS AND SURRENDERS

Most EIA contracts stipulate that owners will have at least 30 days after the end of a term to withdraw some or all of their money and not suffer surrender fees or any loss of interest. But what if the owner wants some or all of the money back during the middle of a term? Many EIA contracts permit annual, penalty-free withdrawals equal to 10 percent of the account value. Others will at least let people take out several hundred dollars every year without having to worry about fees.

Full withdrawals, on the other hand, can hurt the owner's chances of receiving expected returns of principal and interest. If the consumer foresees any situation in which a premature surrender might be necessary, a careful look at the EIA contract's language (and perhaps state law) is in order.

Some contracts in the United States will not pay any index-based interest to someone who surrenders an EIA before the end of the term. Instead, the owner can usually expect a 87.5 percent return of principal and a nominal rate of interest (but not interest that is based on the index) that will apply to every year that the annuity was in force. If the owner has kept the annuity through multiple terms, the insurer might return a minimum of 87.5 percent of the principal and any index-based interest that was credited to the annuity in previous terms, but the company might not give the owner any index-based interest that covers the current term.

It is also possible for the owner to receive at least some interest that applies to the canceled term, but this credited interest will depend on the insurer's "vesting schedule." An EIA's vesting schedule dictates what percentage of calculated interest the contract owner may receive at any given time if the contract is surrendered prematurely or concludes naturally. For example, a vesting schedule for an EIA with a 10-year term might allow the owner to receive 10 percent of calculated interest if surrender occurs after one year, 20 percent of calculated interest if surrender occurs after two years, 30 percent of calculated interest if surrender occurs after three years and so on. The vesting schedule will be formulated in a way that ensures the owner will receive 100 percent of calculated interest at the end of a term.

Just because an EIA contract can deny interest to owners when they surrender their annuities doesn't mean that those owners will be exempt from surrender charges. A surrender charge can apply to the principal investment, the annuity's interest portion or the entire account balance.

During the first few years of the 21st century, many EIAs featured surrender fees that remained in effect for 10 years or more, thereby making these products a poor option for short-term investors. Recently, according to trade reports, these sorts of fees have decreased due in part to regulatory changes in some states that prohibit insurers from selling EIAs with surrender charges lasting more than 10 years. Still, even with such restrictions in place, liquidity ought to be addressed in any serious discussion about EIAs.

CHAPTER 5: ILLINOIS LAW AND SUITABILITY STANDARDS

NEW STANDARDS FOR ILLINOIS

In 2011, Illinois adopted new suitability standards that must be upheld whenever a consumer purchases, replaces or exchanges an annuity. The standards are designed to ensure that certain facts are taken into consideration before an annuity is recommended to someone. They contain requirements for insurance companies as well as for individual insurance producers. They generally don't apply to annuity transactions within employer-sponsored benefit plans or annuities that are part of a settlement.

SUITABILITY INFORMATION FOR PURCHASES, REPLACEMENTS AND EXCHANGES

Before an annuity is purchased, the insurer or the insurance producer needs to collect the buyer's "suitability information." The producer and the insurer are supposed to use the suitability information to determine whether the annuity is appropriate for the person. If a prospect refuses to provide the suitability information, the refusal must be documented in writing at the time of sale.

Suitability information includes the following details about the potential purchaser:

- Age
- Annual income
- Financial situation and needs
- Financial experience
- Financial objectives
- Intended use of the annuity
- Financial time horizon
- Existing assets
- Liquidity needs
- Liquid net worth
- Risk tolerance
- Tax status

When making a recommendation to purchase or exchange a particular annuity, the producer or insurance company also needs to reasonably believe that the following statements are true:

- The consumer is aware of the various features of the annuity (including surrender charges, fees, tax penalties, market risks, limits on returns, etc.).
- Certain features of the annuity (such as tax deferral, death benefits or living benefits) would be beneficial to the consumer.
- The annuity, the allocation of funds within it, and any riders attached to it are suitable for the consumer based on the collected suitability information.

If an annuity is being exchanged or replaced, the producer has a few extra factors to consider, such as:

- Will the consumer face a surrender charge, lose benefits or need to pay more fees?
- Will the new annuity be an improvement over the one that is exchanged or replaced?
- Has the consumer already exchanged or replaced an annuity (especially within the past three years)?

At the time of sale, the producer or insurer needs to make a record of any annuity-related recommendations. If the consumer decides to enter into an annuity transaction despite recommendations to the contrary, signed acknowledgement must be obtained from that person. All information that is used to make a recommendation to a consumer must be kept for at least seven years.

When they sell variable annuities, FINRA-registered broker-dealers can comply with the state's suitability requirements by following FINRA's suitability standards. They can use FINRA-compliant suitability standards to sell fixed annuities, but those standards must be similar to the ones used to sell variable annuities.

INSURER SUPERVISION

Insurance companies offering annuities need to incorporate the rules for product suitability into their producer training materials. Each company is required to explain all of their annuities' important features to insurance producers. An insurer also must create a system to ensure that producers' recommendations are reviewed and are appropriate. The effectiveness of supervision systems and procedures are to be evaluated every year in a report to senior management.

PRODUCER TRAINING COURSES

Insurance producers are required to complete a one-time training course before engaging in the sale of annuities. The training course must be equal to at least four hours of continuing education credit. (By passing the exam accompanying this course, you will satisfy this minimum four-hour requirement.) Producers who sell annuities with a long-term care insurance component may be required to complete additional, LTC-specific training.

ILLINOIS ADMINISTRATIVE CODE

The rules that have been summarized in this chapter come from Title 50, Part 3120 of the Illinois Administrative Code. Although definitions, training requirements and exemptions can be found in other sections of the code, most of the rules pertaining to suitability are in Section 3120.50. If you sell annuities or are responsible for producers who do, you should familiarize yourself with the details of the following section:

<u>Section 3120.50 Duties of Insurers and Insurance Producers</u>

a) In recommending to a consumer the purchase of an annuity or the exchange of an annuity that results in another insurance transaction or series of insurance transactions, the insurance producer, or the insurer when no producer is involved, shall have reasonable grounds for believing that the recommendation is suitable for the *consumer on the basis of the facts disclosed by the consumer as to his or her investments and other insurance products and as to his or her financial situation and needs, including the consumer's suitability information, and that there is a reasonable basis to believe all of the following:*

1) *The consumer has been reasonably informed of various features of the annuity, such as the potential surrender period and surrender charge, potential tax penalty if the consumer sells, exchanges, surrenders or annuitizes the annuity, mortality and expense fees, investment advisory fees, potential charges for and features of riders, limitations on interest returns, insurance and investment components and market risk;*

2) *The consumer would benefit from certain features of the annuity, such as tax-deferred growth, annuitization or death or living benefit;*

3) *The particular annuity as a whole, the underlying subaccounts to which funds are allocated at the time of purchase or exchange of the annuity, and riders and similar product enhancements, if any, are suitable (and in the case of an exchange or replacement, the transaction as a whole is suitable) for the particular consumer based on his or her suitability information; and*

4) *In the case of an exchange or replacement of an annuity, the exchange or replacement is suitable, including taking into consideration whether:*

   A) The consumer will incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living, or other contractual benefits), or be subject to increased fees, investment advisory fees or charges for riders and similar product enhancements;

   B) The consumer would benefit from product enhancements and improvements; and

   C) The consumer has had another annuity exchange or replacement and, in particular, an exchange or replacement within the preceding 36 months.

b) Prior to the execution of a purchase, or exchange or replacement of an annuity resulting from a recommendation, an insurance producer, or an insurer when no producer is involved, shall make reasonable efforts to obtain the consumer's suitability information.

c) Except as permitted under subsection (d), an insurer shall not issue an annuity recommended to a consumer unless there is a reasonable basis to believe the annuity is suitable based on the consumer's suitability information.

d) Recommendation to Consumers

1) *Except as provided under subsection (dc)(2), neither an insurance producer, nor an insurer, shall have any obligation to a consumer under subsection (a) or (c) related to any annuity transaction if:*

   A) No recommendation is made;

   B) A recommendation was made and was later found to have been prepared based on materially inaccurate information provided by the consumer;

   C) A consumer refuses to provide relevant suitability information and\ the annuity transaction is not recommended; or

   D) A consumer decides to enter into an annuity transaction that is not based on a recommendation of the insurer or the insurance producer.

2) *An insurer's issuance of an annuity subject to subsection (d)(1) shall be reasonable under all the circumstances actually known to the insurer at the time the annuity is issued.*

e) An insurance producer or, when no insurance producer is involved, the responsible insurer representative, shall, at the time of sale:

1) *Make a record of any recommendation subject to Section 3120.50(a) of this Part;*

2) *Obtain a customer signed statement documenting a customer's refusal to provide suitability information, if any; and*

3) *Obtain a customer signed statement acknowledging that an annuity transaction is not recommended if a customer decides to enter into an annuity transaction that is not based on the insurance producer's or insurer's recommendation.*

f) Supervision of Recommendations

1) *An insurer shall establish a supervision system that is reasonably designed to achieve the insurer's and its insurance producers' compliance with this Part including, but not limited to, the following:*

   A) The insurer shall maintain and incorporate reasonable procedures to inform its insurance producers of the requirements of this regulation into relevant insurance producer training manuals;

   B) The insurer shall establish standards for insurance producer product training and shall maintain reasonable procedures to require its insurance producers to comply with the requirements of Section 3120.60 of this Part;

   C) The insurer shall provide product-specific training and training materials that explain all material features of its annuity products to insurance producers;

   D) The insurer shall maintain procedures for review of each recommendation prior to issuance of an annuity that are designed to ensure that there is a reasonable basis to determine that a recommendation is suitable. The review procedures may apply a screening system for the purpose of identifying selected transactions for additional review and may be accomplished electronically or through other means, including, but not limited to, physical review. Such an electronic or other system may be designed to require additional review only of those *transactions identified for additional review by the selection criteria;*

E) The insurer shall maintain reasonable procedures to detect recommendations that are not suitable. This may include, but is not limited to, confirmation of consumer suitability information, systematic customer surveys, interviews, confirmation letters and programs of internal monitoring. Nothing in this subsection (f)(1)(E) prevents an insurer from complying with this subsection (f)(1)(E) by applying sampling procedures, or by confirming suitability information after issuance or delivery of the annuity; and

F) The insurer shall annually provide a report to senior management, including the senior manager responsible for audit functions, that details a review, with appropriate testing, reasonably designed to determine the effectiveness of the supervision system, the exceptions found, and corrective action taken or recommended, if any.

2) Nothing in this subsection (f) restricts an insurer from contracting for performance of a function (including maintenance of procedures) required under subsection (f)(1). An insurer is responsible for taking appropriate corrective action and may be subject to sanctions and penalties pursuant to Section 3120.90 of this Part regardless of whether the insurer contracts for performance of a function and regardless of the insurer's compliance with subsection (f)(3).

3) An insurer's supervision system under subsection (f)(1) shall include supervision of contractual performance under this subsection (f)(3). This includes, but is not limited to, the following:

A) Monitoring and, as appropriate, conducting audits to assure that the contracted function is properly performed; and

B) Annually obtaining a certification from a senior manager who has responsibility for the contracted function that the manager has a reasonable basis to represent, and does represent, that the function is properly performed.

4) An insurer is not required to include in its system of supervision an insurance producer's recommendations to consumers of products other than the annuities offered by the insurer

g) An insurance producer shall not dissuade, or attempt to dissuade, a consumer from:

1) Truthfully responding to an insurer's request for confirmation of suitability information;

2) Filing a complaint;

3) Cooperating with the investigation of a complaint.

h) Sales made in compliance with FINRA requirements pertaining to suitability and supervision of annuity transactions shall satisfy the requirements of this Part. This subsection applies to FINRA broker-dealer sales of variable annuities and fixed annuities if the suitability and supervision is similar to those applied to variable annuity sales. However, nothing in this subsection shall limit the Director's ability to enforce (including investigate) the provisions of this Part.

i) For subsection (h) to apply, an insurer shall:

1) Monitor the FINRA member broker-dealer using information collected in the normal course of an insurer's business; and

2) Provide to the FINRA member broker-dealer information and reports that are reasonably appropriate to assist the FINRA member broker-dealer to maintain its supervision system.

ETHICAL CONCERNS REGARDING THE ELDERLY OR DISABLED

Determining the suitability of an annuity cannot be accomplished without careful communication with the consumer. Unfortunately, having extensive conversations with someone can be challenging if the person's physical or mental health is in decline. If the person has trouble hearing, important points in a sales presentation might be missed. If the person is experiencing memory loss or is having trouble processing complex ideas, pursuing a sale might be inappropriate.

Ethical insurance producers may want to rely on feedback to determine whether someone understands how an annuity works. If the consumer's comments about a proposed annuity don't reflect its actual features, a more detailed explanation should be given. In some cases, a producer might decide that the best way to judge comprehension is to ask the person to explain the annuity in their own words.

When a consumer is having trouble hearing or speaking, a trusted family member or friend might be able to facilitate communication. Still, be aware that the person providing the assistance should not be making financial decisions for the consumer. Similarly, you should be on alert for situations in which a caregiver may be trying to influence an elderly or disabled person's choices.

CONCLUSION

The state's suitability standards collectively emphasize that there are many kinds of annuities in today's market. In order to follow the law and satisfy interested consumers, you need to understand the strengths and weaknesses of each type. For the sake of a final review, let's briefly go over those pluses and minuses.

Fixed annuities guarantee a return of principal and an amount of interest. The interest rate will usually be guaranteed for a limited time and will then be replaced by a new guaranteed rate. In exchange for these guarantees, the owner might earn less than an investor who is willing to take more risks.

Variable annuities offer few or no guarantees and can decrease in value during poor economic times. Guaranteed amounts of income or guaranteed death benefits are often available if the owner is willing to pay additional fees. Because there is more risk involved, owners of variable annuities sometimes earn higher returns than owners of fixed annuities.

Equity-indexed annuities are relatively new. Like fixed annuities, they generally guarantee a return of principal and a minimum amount of interest. However, as is the case with variable annuities, the actual returns that are credited to the owner's account can rise and fall depending on market performance. Insurance companies use complicated formulas to credit interest to equity-indexed accounts. When market performance is strong, these formulas can limit what an owner receives.

Deferred annuities are used mainly by people who want their principal to grow on a long-term, tax-deferred basis. At a certain point, owners can either withdraw all of their money and invest it elsewhere or elect to receive periodic payments from the insurance company. However, if withdrawals are made too early, the owner can be penalized by the insurance company and the IRS. Deferred annuities can be fixed or variable.

Immediate annuities provide periodic income to someone shortly after the contract has been signed. They aren't considered strong vehicles for tax deferral, but they can help current retirees develop a budget and meet their current needs. They usually are fixed, but variable products are also available.

Clearly, insurers and annuity sales professionals didn't create a multi-billion-dollar industry by sticking to the same standard contract features for several decades. Over time, they adapted to people's needs by making adjustments to their products. Adjustments will undoubtedly continue to be made as society changes. New types of annuities are bound to surface in the years to come.

Each new product (not to mention the basic annuities sold in today's market) has the potential to intimidate or confuse everyone from the inexperienced investor to the veteran bank or insurance customer. Even people with a background in insurance or finance might wonder what a certain annuity contract provision really means and whether a particular annuity will truly help them achieve their financial goals.

It is essential that you not only explain annuities well but also listen carefully to people's concerns and goals. By taking both of those responsibilities seriously, you give yourself a good chance of being a professional success and a future leader in your field

Below is the Final Examination for this course. Turn to page 29 to enroll and submit your exam(s). You may also enroll and complete this course online:
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Your certificate will be issued upon successful completion of the course.

FINAL EXAM

1. Variable annuities increase in popularity when financial markets are noticeably ________.
   A. strong
   B. weak
   C. stagnant
   D. volatile

2. The annuity shopper's choice between an immediate annuity and a deferred annuity will depend on when the person wants to ________.
   A. enter retirement
   B. conduct a 1035 exchange
   C. invest in the stock market
   D. start receiving payments from the insurance company

3. Between the time it's purchased and the time payments begin, a deferred annuity goes through a(n) ________.
   A. elimination period
   B. accumulation period
   C. payout phase
   D. annuitization phase

4. Most immediate annuities are ________.
   A. variable
   B. fixed
   C. equity-indexed
   D. tax-deductible

5. Like life insurance policies, annuities usually have ________.
   A. maximum issue ages
   B. no loan features
   C. no cash surrender value
   D. equity-indexed death benefits

6. The insurance company behind the annuity has a contractual obligation to ________.
   A. eventually pay money to a person or other entity
   B. invest premiums in income-producing stock funds
   C. follow the beneficiary's investment instructions
   D. increase payments if an annuitant exceeds life expectancy

7. The annuity owner is the person who ________.
   A. receives death benefits
   B. is the measuring life for the annuity
   C. puts money into the annuity
   D. is responsible for the contract's guarantees

EXAM CONTINUES ON NEXT PAGE

8. The ________ is a person, corporation or trust that receives death benefits.
   A. annuitant
   B. consumer
   C. insurer
   D. beneficiary

9. If an annuity owner is ready for the insurance company to start paying an income stream, the ________ process will begin.
   A. annuitization
   B. accumulation
   C. elimination
   D. waiver

10. In most annuitization situations, payouts are fixed at an equal amount and are scheduled to continue ________.
    A. throughout the annuitant's lifetime
    B. for a period of 10 to 20 years
    C. until a surviving spouse passes away
    D. until the chosen stock index decreases

11. The benefit rates offered by different insurance companies will vary, but all benefit rates will be based, to a large extent, on ________.
    A. the owner's income-tax bracket
    B. the beneficiary's life expectancy
    C. the annuitant's life expectancy
    D. the annuitant's income

12. On a federal level, an annuity generates no tax bills until the owner or annuitant ________.
    A. receives a payout from the insurer
    B. deposits money into a variable account
    C. reaches his or her life expectancy
    D. reaches full retirement age

13. Non-qualified annuities are funded with ________.
    A. after-tax dollars
    B. pre-tax dollars
    C. employer contributions
    D. Social Security benefits

14. When beneficiaries receive money from the insurance company, they will usually need to pay taxes on the difference between the account's value and the ________.
    A. size of the death benefit
    B. owner's principal investment
    C. amount loaned to heirs
    D. expected accumulation amount

15. ________ are often the biggest drawback to annuities.
    A. Surrender charges
    B. Crisis waivers
    C. High participation rates
    D. Capital gains rates

16. An annuity that only pays a death benefit if the annuitant dies during the accumulation period is sometimes called a ________.
    A. fixed variable rate annuity
    B. straight life annuity
    C. period certain annuity
    D. flexible-premium annuity

EXAM CONTINUES ON NEXT PAGE

17. The federal government allows people to exchange insurance policies for annuities and exchange one annuity contract for another annuity contract via a ________.
    A. Roth exchange
    B. 1035 exchange
    C. 402(b) exchange
    D. living benefit exchange

18. If the annuity owner is at all displeased with an aspect of an annuity contract, he or she might be able to take advantage of the contract's ________.
    A. free-look period
    B. market value adjustment
    C. variable annuitization option
    D. bonus rate provisions

19. Variable annuitization is a complex settlement option that will result in a regularly timed but ________ sized income for the annuitant.
    A. large
    B. individually
    C. uniformly
    D. inconsistently

20. Regulations require that all variable annuities come with a _______.
    A. prospectus
    B. period certain settlement option
    C. guaranteed minimum accumulation benefit
    D. tax-free death benefit

21. A lot of the differences between EIAs and variable annuities relate to _______.
    A. guarantees
    B. length
    C. size
    D. equalization

22. The EIA's_______ is the percentage of the increase in the stock index that the insurer will credit to the owner's annuity.
    A. participation rate
    B. high watermark
    C. spread
    D. benefit rate

23. ________ guarantee a return of principal and an amount of interest.
    A. Fixed annuities
    B. Variable annuities
    C. Stock options
    D. Crisis riders

24. ________offer few or no guarantees and can decrease in value during poor economic times.
    A. Fixed annuities
    B. Variable annuities
    C. Certificates of deposit
    D. Term life policies

25. ________ are used mainly by people who want their principal to grow on a long-term, tax-deferred basis.
    A. Immediate annuities
    B. Deferred annuities
    C. Mutual funds
    D. Living benefits

END OF EXAM

Turn to page 29 to enroll and submit your exam(s)

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(Use Pen or Pencil To Darken Correct Choice For Each Question)

1. Ⓐ Ⓑ Ⓒ Ⓓ	6. Ⓐ Ⓑ Ⓒ Ⓓ	11. Ⓐ Ⓑ Ⓒ Ⓓ	16. Ⓐ Ⓑ Ⓒ Ⓓ	21. Ⓐ Ⓑ Ⓒ Ⓓ
2. Ⓐ Ⓑ Ⓒ Ⓓ	7. Ⓐ Ⓑ Ⓒ Ⓓ	12. Ⓐ Ⓑ Ⓒ Ⓓ	17. Ⓐ Ⓑ Ⓒ Ⓓ	22. Ⓐ Ⓑ Ⓒ Ⓓ
3. Ⓐ Ⓑ Ⓒ Ⓓ	8. Ⓐ Ⓑ Ⓒ Ⓓ	13. Ⓐ Ⓑ Ⓒ Ⓓ	18. Ⓐ Ⓑ Ⓒ Ⓓ	23. Ⓐ Ⓑ Ⓒ Ⓓ
4. Ⓐ Ⓑ Ⓒ Ⓓ	9. Ⓐ Ⓑ Ⓒ Ⓓ	14. Ⓐ Ⓑ Ⓒ Ⓓ	19. Ⓐ Ⓑ Ⓒ Ⓓ	24. Ⓐ Ⓑ Ⓒ Ⓓ
5. Ⓐ Ⓑ Ⓒ Ⓓ	10. Ⓐ Ⓑ Ⓒ Ⓓ	15. Ⓐ Ⓑ Ⓒ Ⓓ	20. Ⓐ Ⓑ Ⓒ Ⓓ	25. Ⓐ Ⓑ Ⓒ Ⓓ

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