Indexed Products

Welcome

Indexed Products Training Course

Indexed annuities and indexed life insurance products have become increasingly popular for addressing the financial concerns of consumers who want to achieve more balance between safety of principal and the size of their returns. In this course, you will learn about the indexed products designed specifically to offer the potential for greater returns without sacrificing safety.

The course reviews the basics of both annuities and life insurance, followed by an in-depth look at the features that make indexed products unique. You will also become familiar with suitability issues and marketing practices with respect to these products, as well as special concerns with marketing to senior consumers.

We recommend you proceed through the course in the order in which the menu items appear. Good luck.

Types of Annuities
Annuity Contract Provisions
Annuity Advantages & Disadvantages
Fixed Indexed Life Products
Suitability & Marketing Practices
Special Issues
New Developments

Types of Annuities

Identifying Annuities

In this course about indexed products, we will be focusing primarily on indexed annuities and indexed life insurance. Before we look at indexed annuities, we will review briefly the basic information you need to know about annuities in general. Indexed annuities are, first of all, like any other annuity in the basic structure and functioning.

Key Ideas

- **Benefit payment timing**
- **Premium payment method**
- **Risk to policyowner**
- **Two-tiered**

In general, annuities can be identified in a number of ways, including:

- **Benefit payment timing**…or when the annuity benefits will be paid
- **Premium payment method**…or how and when premiums are paid
- **Risk to the policyowner**…or the possible loss of principal in variable annuities as contrasted to safety of principal in fixed annuities, and within fixed annuities, whether the interest crediting method is declared rate-driven or indexed interest rate-driven
- **Two-tiered**…or structured to pay different rates of interest depending on how the payout is taken

Types of Annuities

Identifying Annuities: Benefit Payment Timing

The timing of benefit payments identifies annuities as one of these types:

- **Immediate…**which means benefit payments begin in just a short period of time…typically not more than 12 months after purchase
- **Deferred…**which means benefit payments will not begin until some time in the future
- **Split…**which means one premium payment purchases both an immediate annuity and a deferred annuity in order to receive some income immediately while also enjoying earnings on the balance in the deferred arrangement to be paid out later

Key Ideas

Benefit Payment Timing

- **Immediate**
- **Deferred**
- **Split**

Types of Annuities

Identifying Annuities: Benefit Payment Timing

Immediate Annuities

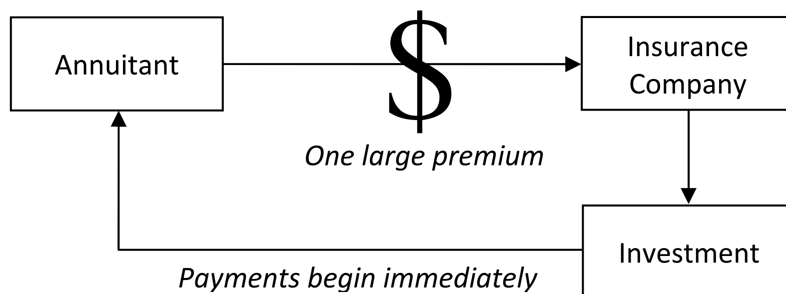
An annuity must be fully paid for before benefit payments can begin, which means an individual who wants to begin receiving benefits immediately must pay with a single payment. This arrangement produces a **single-premium immediate annuity (SPIA)**.

Key Ideas

- **Premium paid in full before benefits will be paid**
- **Single premium payment**
- **Benefits begin immediately or within one year**
- **Purchaser has a single sum to invest**

Although payment of benefits is considered “immediate,” typically the purchaser waits either one month or up to one year before receiving the first payment.

Since full payment is required for immediate annuities to be distributed, the purchaser must have a sum of money that can be paid in a single installment.



Types of Annuities

Identifying Annuities: Benefit Payment Timing

Deferred Annuities

A **deferred annuity** is one under which benefit payments are, in fact, deferred until some time in the future. While most annuity contracts sold today are paid with a single premium, deferred annuities frequently allow for subsequent premium payments.

Key Ideas

- **May be paid by a single premium**
- **May be paid by periodic premium payments**

Later we will discuss the single premium and periodic premium methods of purchasing annuities. A deferred annuity may be purchased either way.

Because not everyone has a lump sum of money to pay for an annuity in full, periodic premium payments allow an individual to accumulate cash in the annuity on a “pay-as-you-go” basis. When this is the case, premiums might be paid semi-annually or annually.

Types of Annuities

Identifying Annuities: Benefit Payment Timing

Deferred Annuities

During the accumulation period, interest paid by the insurer on the premium deposits accumulates on a tax-deferred basis until withdrawn in the future.

Key Ideas

- **Enjoys tax-deferral on interest paid during the accumulation period**
- **Benefits paid in the future**

If a maturity date on which benefit payments begin is included, the "date" might be a specific age (e.g., 70, 75, 80) or based on a period of years (e.g., 10) or the later of these two.

Types of Annuities

Identifying Annuities: Benefit Payment Timing

Split Annuities

A **split annuity** refers to splitting premium payments to purchase both an immediate annuity and a deferred annuity. This is often done where the purchaser needs some immediate income and also wants to defer additional benefits until some future time. The purchaser does not have to pay separate premiums for each annuity; instead, the insurance company issuing the annuities divides the premium paid to provide for both annuities.

Key Ideas

- **Premium divided to purchase both immediate and deferred annuities**
- **Deferred annuity earns tax-deferred interest**
- **Immediate annuity benefits paid for a limited time**
- **Deferred annuity benefits begin after immediate annuity ends**

While the immediate annuity is being paid out, payments made into the deferred annuity are earning interest on a tax-deferred basis. The "immediate" period typically lasts for a relatively short time (often about five years), after which benefit payments from the deferred annuity begin. The period during which payments are made by the immediate annuity is specified in the contract.

Types of Annuities

Identifying Annuities: Premium Payment Methods

Annuities are also identified by how and when the premiums are paid. The two basic types are:

- **Single premium annuities**…where one lump sum is used to fully pay for the premium
- **Flexible premium annuities**…requiring more than a single premium and for which the buyer has flexibility in terms of amount and frequency of payment

Key Ideas

- **Single premium**
- **Flexible premiums**

Types of Annuities

Identifying Annuities: Premium Payment Method

Single Premium Annuities

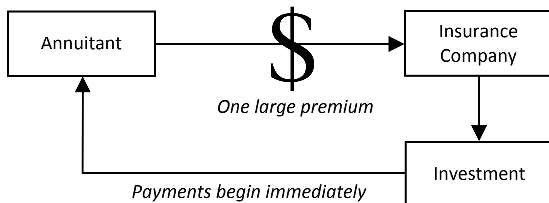
A **single-premium annuity**—whether for immediate or deferred distribution—is often purchased by someone who has a relatively large sum of cash, perhaps from an inheritance, life insurance proceeds, a one-time sale of assets, a pension distribution or similar circumstances.

Key Ideas

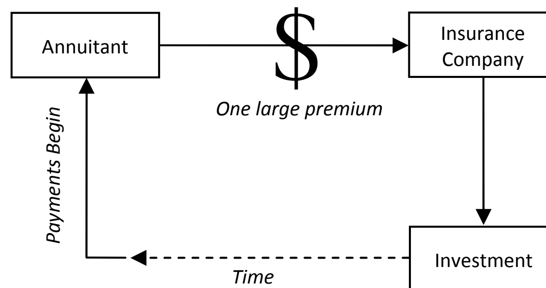
Single Premium Annuities

- **One premium**
- **Immediate or deferred annuity**

Single-Premium Immediate Annuity



Single-Premium Deferred Annuity



Types of Annuities

Identifying Annuities: Premium Payment Method

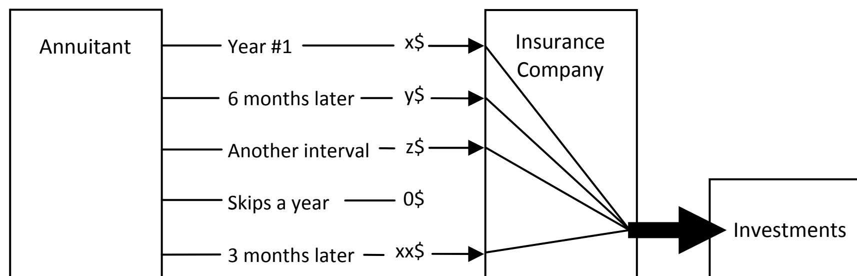
Flexible Premium Annuities

The **flexible-premium deferred annuity** is essentially an accumulation contract that permits premiums of varying amounts to be paid at irregular intervals to provide an indeterminate amount of future income. This modern product can meet the budget needs of individuals whose income may vary from year to year, as well as those with steady incomes.

Key Ideas

- **Deferred annuities only**
- **Smaller premiums**
- **Premium amounts may vary**
- **Premium intervals may vary**
- **Premiums may be skipped**
- **Indeterminate future income**

This product is designed for those who need or want to pay smaller premiums and also want the benefits of accumulation over time. It is also ideal for people whose incomes vary, such as people who receive bonuses or sales commissions.



Types of Annuities

Identifying Annuities: Risk to Policyowner

Another way to identify annuities is by the risk that the policyowner assumes with respect to the money paid into the annuity. At one time, all annuities were fixed-dollar annuities, which pose essentially no financial risk to the principal amount during the accumulation period.

Key Ideas

Risk to Policyowner

- **Fixed Annuities: Minimal risk**
- **Variable Annuities: Risk to principal**

Today, there are:

- **Fixed-dollar annuities**…for which each premium dollar deposited provides a guaranteed minimum fixed-dollar amount of income—the return of principal
- **Variable annuities**…which pose some risk for the policyowner because the premiums paid are actually invested in equities that can earn or lose money as the stock markets fluctuate during the accumulation period, but interest credited can be greater

Types of Annuities

Identifying Annuities: Risk to Policyowner

Fixed Annuities

Fixed annuities have evolved into two basic rate-paying methods:

- **Declared rate fixed annuities**…where the rate of interest to be paid is stated and guaranteed for one or more years and typically will have a lesser guaranteed rate, providing a conservative return
- **Indexed fixed annuities**…where, in addition to a guaranteed interest rate, the annuity delivers interest crediting linked to an outside index that measures the performance of equity markets, providing the potential for greater interest. The most commonly used index is the Standard & Poor's 500® (S&P 500®). You will be learning more about how indexed crediting strategies work later in this course.

Note that both declared rate and indexed fixed annuities have a guaranteed interest rate.

Types of Annuities

Identifying Annuities: Risk to Policyowner

Variable Annuities

Not everyone is satisfied with having the underlying guarantees and relatively modest accumulation potential normally associated with most fixed annuities.

Key Ideas

- **Potentially greater returns**
- **Potential for loss**

Variable annuities were developed to meet investors' desires for an annuity product that potentially can provide greater returns. With that possibility, however, goes the potential for greater losses as well.

Types of Annuities

Identifying Annuities: Risk to Policyowner

Variable Annuities

Variable annuities carry a greater risk because the premiums are actually invested in equities. Investment is accomplished through **separate or segregated accounts** (separate from the insurer's general accounts) used to purchase equities, typically through mutual funds.

Key Ideas

- **Premiums invested in equities**
- **Separate accounts**
- **Variety of funds**

Insurers offer a variety of funds from which the purchaser may choose. There is often even a fixed account in the event the investor wants a slight hedge against the risk of the equity accounts.

Types of Annuities

Identifying Annuities: Risk to Policyowner

Variable Annuities

The primary reason for investing in a variable annuity is for the possibility of getting a greater return. However, as with all types of financial products, the greater the possibility for a higher return, the greater the risk to principal.

Key Ideas

- **Greater return**
- **Greater risk**
- **Principal can be lost**

Types of Annuities

Identifying Annuities: Two-Tiered

Tiers Based on Payout Method

A **two-tier annuity** is actually a fixed annuity, but it has unique characteristics that distinguish it from other fixed annuities. The two "tiers" refer to the interest rate that will be paid. With a two-tier annuity, the rate depends on how the individual chooses to have the payout distributed.

Key Ideas

Two-Tiered: Payout Method

- **Fixed annuity**
- **Tiers = interest rates**
- **Rate depends on payout method**

Types of Annuities

Identifying Annuities: Two-Tiered

Tiers Based on Payout Method

If Annuitized…

If the policy is annuitized—paid out in small, perhaps monthly or annual, installments—the rate of interest credited to the owner's account value is higher.

Key Ideas

- **Annuitized = higher rate**
- **Not annuitized = lower rate**

If Not Annuitized…

If the annuity is not annuitized, the insurer credits a lower interest rate to the account value. For example, the owner could choose to take the proceeds in one lump sum or could take several large payments until the account value is exhausted.

Types of Annuities

Identifying Annuities: Two-Tiered

Tiers Based on Payout Method

While the higher interest rate is often attractive to purchasers at first blush, you must be sure they understand that if they do not annuitize—if they should need to withdraw all or a large portion of the accumulated funds—the second and lower tier of interest will apply.

The difference in credited interest rates can be significant and the payout decision should be considered carefully.

Types of Annuities

Identifying Annuities: Two-Tiered

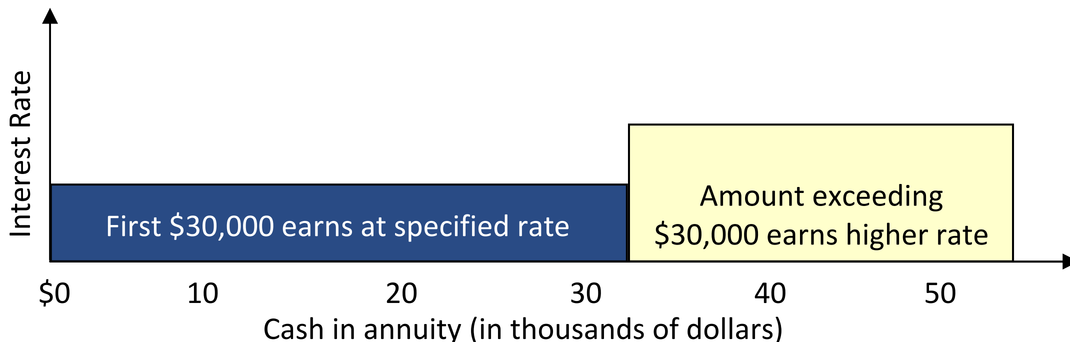
Tiers Based on Funding Level

A two-tiered approach can also have a second meaning. In this case, the rate of interest paid is based on the amount of cash in the annuity, with the rate increasing slightly when the amount exceeds the top of each "tier."

Key Ideas

- **Rate based on amount in annuity**
- **Succeeding tiers receive higher interest rate**
- **Insurers may have several tiers**

For example, the insurer might pay the specified rate of interest on the first tier of $30,000. Then, amounts paid in that cause the level of funding to exceed $30,000 receive a slightly higher rate of interest, perhaps another quarter of a percent. Insurers might use several tiers, the actual number differing from company to company.



Types of Annuities

Identifying Annuities: Parties to an Annuity

A typical annuity contract involves three parties:

- the insurance company,
- the owner, and
- the annuitant.

The insurance company issues the annuity contract and distributes regular payments.

Key Ideas

- **Three parties to an annuity**
- **Insurance company issues the contract**
- **Insurance company distributes payments**

Continue on to learn more about the owner and the annuitant.

Types of Annuities

Identifying Annuities: Parties to an Annuity

The Owner

The **owner** of an annuity:

- purchases the annuity contract
- makes any necessary contributions
- decides when to begin taking income
- holds the power to change the beneficiary designation at will
- pays income tax on the interest portion of the annuity payment

Key Ideas

- **Owner makes the purchase**
- **Owner makes the contributions**
- **Owner keeps control of the investment**
- **Surviving spouse beneficiary may assume ownership**

The owner can be a person, a trust, a partnership, a corporation or an employer, as long as a natural person is named as annuitant.

If an annuity owner names a spouse as beneficiary, when the owner passes away, the surviving spouse is considered the new owner. This allows the spouse to defer income taxes on the annuity until his or her subsequent death. Non-spousal beneficiaries do not assume ownership.

Types of Annuities

Identifying Annuities: Parties to an Annuity

The Annuitant

The **annuitant** is the natural person upon whose life the annuity benefits are determined. (A corporation, trust, or other non-natural entity cannot be an annuitant because these entities do not have a lifespan that could be used to measure the annuity benefits.) The annuitant receives the annuity payments under the terms of the contract.

Key Ideas

- **Annuitant must be natural person**
- **Contract benefits based on life of annuitant**
- **Annuitant receives annuity payments**
- **Annuitant is usually the same as the owner**

The annuitant cannot make any contract decisions—those are made by the owner—but many of the terms of the contract depend upon the annuitant. As we already discussed, the annuitant's life expectancy determines the amount of the annuity payments, and a deferred annuity is structured to begin payments in the future when the annuitant reaches a certain age.

The annuitant and the owner are usually the same person; however, they don't have to be.

Types of Annuities

Identifying Annuities: Parties to an Annuity

Two Annuity Designs

There are two categories of annuities:

- Annuitant-driven annuities, and
- Owner-driven annuities.

Key Ideas

- **Annuity-driven pays death benefit at annuitant's death**
- **Owner-driven pays death benefit at owner's death**
- **Choice not as important if owner and annuitant are the same**

Annuitant-driven annuities pay a death benefit when the annuitant dies. The death of the annuitant causes the contract to terminate, and any death benefit is paid to the beneficiary. (If the owner dies, distribution is required within five years.)

Owner-driven annuities are less common. They pay a death benefit only when the owner dies. If the annuitant dies, the owner names a new annuitant and the contract continues on.

If the owner and the annuitant are the same person, it doesn't matter much which type of annuity a person chooses to purchase. However, if the owner and annuitant are different, it becomes very important to explain the difference and to help the prospect select the appropriate type of annuity to meet stated objectives.

Types of Annuities

Identifying Annuities: Parties to an Annuity

The Beneficiary

A possible fourth party to an annuity contract is a beneficiary named by the owner. A beneficiary receives any benefits (e.g., a lump-sum payment) payable upon the owner's death under the terms of the contract. The owner usually has the power to change the beneficiaries at any time.

Key Ideas

- **Beneficiary is possible fourth party to an annuity contract**
- **Can be primary or contingent beneficiary**

A primary beneficiary is the owner's first choice to receive the assets upon the owner's death. If the owner chooses more than one primary beneficiary, the assets will be split evenly between them, or divided according to some other percentages that the owner dictated. The owner may list a contingent beneficiary to serve as a backup in case the primary beneficiary dies.

Types of Annuities

Identifying Annuities: Stranger-Originated Annuity Transactions

As we've already discussed, the owner and the annuitant are usually the same person. When they are different, they are almost always spouses or other family members. In other words, according to the NAIC, in a proper annuity transaction the owner and annuitant know each other well.

Key Ideas

- **If owner and annuitant are strangers, it is a STAT**
- **Owner is investor who pays a fee to the annuitant**

However, more and more frequently there have been cases of investors who purchased and owned annuities on strangers, paying a fee to those strangers for their role in the transaction, usually in the range of $2,000 - $10,000. This scheme is called a **stranger-originated annuity transaction (STAT**, **or STOA)**, and it may be happening more than you think. Thomas R. Sullivan, Connecticut's Insurance Commissioner and Chair of the NAIC Life Insurance and Annuities Committee, said that these transactions were like cockroaches—"For every one you see, there are most likely hundreds in hiding."

Types of Annuities

Identifying Annuities: Stranger-Originated Annuity Transactions

How They Work

With a STAT, the owner is simply making a bet on the future (shortened) lifespan of a stranger. These so-called "investors" target seniors and terminally ill patients who are not expected to live past the first policy year. They find targeted strangers through advertisements or in nursing homes or hospice care.

Key Ideas

- **Owner/investor makes a bet on the annuitant's approaching death**
- **Rider assures no loss on investment**
- **If market performs well, risky investment vehicles could prove highly rewarding**

Investors usually purchase a variable annuity with a guaranteed minimum death benefit rider, although in some instances deferred bonus annuities have been used. The rider ensures that the investor receives a positive return when the annuitant dies (at least the amount invested, and potentially much more depending on market performance and the terms of the rider). Because such a rider protects the investor from loss, it allows the choice of riskier sub-accounts as the annuity's investment vehicles in the hopes that the market does well.

Types of Annuities

Identifying Annuities: Stranger-Originated Annuity Transactions

The NAIC

Key Ideas

- **The NAIC strongly opposes STATs**
- **Insurers encouraged to prevent STATs**

Because STATs are, in essence, a way to bet on the death of vulnerable individuals, the NAIC has taken strong opposition to them, forcefully discouraging their use in a model bulletin released on March 27, 2011. The NAIC stated that these transactions are "detrimental to both companies and consumers." It has encouraged insurers to: (1) create detection methods that identify STATs, and (2) avoid paying benefits on improper STAT transactions.

As Mr. Sullivan pointed out when he compared STATs to cockroaches, however, detection may prove difficult. Producers often take measures to avoid drawing attention to a STAT transaction. For example, they might ensure that the amount of the annuity falls below specific guidelines, or that it hides the true beneficiaries through the use of a corporation or trust.

While state insurance regulators are not required to adopt the NAIC's bulletin, we will likely see a crackdown on STATs, including stricter compliance procedures and possible penalties for selling STATs.

Annuity Contract Provisions

In this section we will look at provisions for typical fixed annuity contracts that are declared rate fixed annuities as well as indexed fixed annuities. Topics include:

- **Common provisions**
- **Indexed crediting strategies**
- **Index strategy performance**
- **Typical annuity riders**

Annuity Contract Provisions

Common Provisions: Interest Rates

Insurers typically use one of two methods for selecting the rates of interest to be paid on their declared rate products:

- **Portfolio based rates**…based on the earnings of the insurance company’s total portfolio of assets
- **New money based rates**…based on current earnings on new investments

Key Ideas

- **Portfolio based rates**
- **New money based rates**

Annuity Contract Provisions
Common Provisions: Interest Rates
Portfolio Based Rates

Portfolio based rates will be more stable because they are based on investments the insurer has held for some time, and which have proven to be able to "weather the storms" of rising and falling rates over time.

While portfolio based rates are typically conservative, they are also a better choice for the consumer when interest rates in the marketplace are headed down because the rate to be paid is based on a broad portfolio of securities with varying maturity dates.

Key Ideas

Portfolio Based Rates

- **Based on insurer's investment portfolio**
- **Conservative but stable**
- **Better for consumers when rates in general are headed down**

Annuity Contract Provisions

Common Provisions: Interest Rates

New Money Based Rates

In contrast to portfolio rates, **new money rates** can change more frequently because they are based on the investment earnings of current investments.

New money rates are often more attractive to consumers when rates are going up, but since they can change, they are not as predictable. Purchasers must understand that current market changes can cause rates to fluctuate more than a rate based on a broad portfolio with varying maturity dates.

Key Ideas

New Money Based Rates

- **Based on earnings of current investments**
- **Can change frequently**
- **Attractive to consumers when rates are going up**

Annuity Contract Provisions

Common Provisions: Interest Rates

As you have seen, the general interest rate environment plays a role in determining which interest-paying method is the better choice for the consumer at a given time.

Key Ideas

- **Interest rate environment**
- **Higher rate not always best**
- **Stable rate may be better choice**

Overall, the rate that appears to be "best" to the annuity purchaser because it is higher is not necessarily the smartest choice. The better choice might well be the somewhat lower, but more stable rate.

Annuity Contract Provisions

Common Provisions: Interest Rates

Initial Rates

The **initial interest rate** paid when the annuity is first purchased:

- Is commonly guaranteed for one year.
- Might be guaranteed for as little as three months up to one year.
- Is sometimes available as a multiple-year guarantee.
- In the case of multiple years, is guaranteed for two to five or even up to 10 years.

Key Ideas

Initial Rates

- **One-year guarantee typical (or up to one year)**
- **Multiple year guarantee (two to five or up to 10 years)**

Annuity Contract Provisions

Common Provisions: Interest Rates

Initial Rates

An insurance company's interest rates are derived from its investment earnings. Be cautious about dealing with an insurer offering unusually high initial interest rates. Very high rates in comparison to the marketplace can indicate that the insurer might have a higher risk investment policy.

Key Ideas

Initial Rates

- **Rates derived from investing earnings**
- **Be cautious of unusually high initial rates**
- **High rates might mean insurer has higher risk investment policy**

Annuity Contract Provisions

Common Provisions: Interest Rates

Bonus Rates

Insurers sometimes provide for **bonus rates** to be paid under certain circumstances. There are three types of bonus rates:

- **Premium bonus**
- **Persistency bonus**
- **Annuitization bonus**

Key Ideas

Bonus Rates

- **Premium bonus**
- **Persistency bonus**
- **Annuitization bonus**

Annuity Contract Provisions

Common Provisions: Interest Rates

Bonus Rates

A **premium bonus** is a special higher interest rate that is paid under circumstances described in the annuity contract. The particular way such a bonus is applied can vary widely from insurer to insurer. It is your responsibility to determine how such bonuses, if paid, apply for each individual contract. In some cases the bonus might be paid immediately; in others, after 12 months. In all cases, it's likely the bonus will be revoked if the owner withdraws any money from the annuity before a specified period.

Key Ideas

Premium Bonus

- **Special higher rate**
- **Circumstances vary**
- **5% rate increase common; varies**
- **Bonus payment can increase initial deposit**
- **Earnings paid on higher amount**

A common application is for the bonus to apply immediately when the first premium is paid. A 5% bonus rate is common. It's likely the owner will be unable to withdraw cash before a specified period expires and still keep the bonus. Adding the bonus to the annuity immediately upon premium payment can have a significant impact on the first year earnings. Here's an example:

- First year's premium of $50,000 is paid in advance.
- Current rate of interest is 4%, but insurer pays a bonus of 5% ($2,500) on the first year's premium.
- Insurer immediately adds $2,500 to the annuity ($50,000 × .05 = $2,500).
- Interest begins to accumulate immediately on $52,500 instead of $50,000.

Annuity Contract Provisions

Common Provisions: Interest Rates

Bonus Rates

Another type of bonus is the **persistency bonus**, which is sometimes also called a premium bonus. This type of bonus is paid to reward the purchaser for keeping the annuity contract in force for a specified number of years.

Key Ideas

Persistency Bonus

- **Rewards contract persistency**
- **Paid in future specified date**
- **Typically uses basis points to increase rate**
- **May be guaranteed or not**

Typically, the bonus takes the form of additional basis points added to the credited rate. A basis point is equivalent to 0.01%. Therefore, if an interest rate is increased by 25 basis points, rates have risen by 0.25%, increasing a rate of 3.00% to 3.25%.

A common example: After the 10th policy year, a certain insurer, on a guaranteed or non-guaranteed basis, will add 50 to 100 basis points to the rate that would ordinarily be credited to the contract at that time.

Annuity Contract Provisions

Common Provisions: Interest Rates

Bonus Rates

A third type of bonus is the **annuitization bonus**. This bonus comes into play with the two-tiered annuity discussed previously. To review, when it is time to pay out the annuity…

- If the policy is paid out in installments, or annuitized, the rate of interest to be credited to the annuitant's account for purposes of annuitization is greater than if the account value is taken as a lump sum.
- If the contract is not annuitized—for example the annuitant takes the proceeds in a lump sum rather than in installments—the insurer pays the lower interest rate.

Key Ideas

Annuitization Bonus

- **Bonus paid if contract is annuitized at payout**
- **Lower rate is paid if contract is not annuitized**

The annuitization value is greater than the cash value, with the former being the value used to calculate annuity payments and the latter being the amount available to the contract owner or annuitant in a lump sum.

Annuity Contract Provisions

Common Provisions: Interest Rates

Renewal Rates

Remember that the initial interest rate is guaranteed for a limited period—as little as one year or sometimes several years. In any event, at some point the insurer will pay a different rate when additional premiums are deposited and the annuity contract is renewed.

Key Ideas

- **Initial interest rate guarantee is limited**
- **Rate will change at some renewal**
- **New money based approach = market rates**
- **Portfolio based approach = portfolio rates**

If the insurer used a new money approach, the **renewal rate** will typically be based on interest rates in the marketplace at the time of renewal. If the rate paid is a portfolio rate, the renewal rate will be based on portfolio earnings.

Annuity Contract Provisions

Common Provisions: Interest Rates

Minimum Guaranteed Rates

Fixed deferred annuities usually offer a **guaranteed minimum interest rate**, typically from 2% to 4%. Guaranteed rates are often quite low compared to market rates, but the insurer chooses to be conservative since this minimum guarantee is likely to be in effect for many, many years. An insurer who guarantees a rate that is too high could have problems in the future if rates in general drop significantly. Once the annuity contract goes into effect, the minimum rate specified in the contract will not change.

Key Ideas

- **Lower interest rate**
- **In effect for many years**
- **Rate will not change after contract goes into effect**

Annuity Contract Provisions

Common Provisions: Issue Age Guidelines

Insurance companies typically specify the **issue ages** for which they are willing to write new annuity contracts—both a minimum age and a maximum age.

The minimums and maximums can vary within the same company for different annuity products.

Key Ideas

- **Minimum issue age**
- **Maximum issue age**
- **Can vary by company and by annuity form**

Annuity Contract Provisions

Common Provisions: Issue Age Guidelines

Minimum and Maximum Age Ranges

In many cases, the **minimum issue age** is zero, which means the annuity could be purchased as soon as a child is born.

In other cases, for a standard deferred annuity, the minimum might be age 16 or 18.

Maximum issue ages are typically high—from age 74 to age 80 or even 90.

In the case of a tax-qualified annuity, the maximum issue age may be lower for the same product where qualified money is involved.

Annuity Contract Provisions

Common Provisions: Issue Age Guidelines

Key Ideas

- **Age limits can be different for purchaser and for annuitant**
- **Insurers have varying limits**
- **States may regulate issue age limits**

Since the owner and the annuitant are not always the same person, insurers sometimes establish different limits for the purchaser and for the annuitant—the person who will receive the benefits from the annuity. With respect to owners, although a 16 year old, for example, might be legally permitted to buy an annuity as a minor, the purchase can typically be rescinded by the teenager at age 18. Therefore, many insurers will establish a minimum age of 18 for purchase of an annuity.

You can see that it is important to know the details of each annuity contract you sell. And, not only do annuities vary from company to company and within the various offerings of a company, the state where you do business might have minimum and maximum ages specified in the insurance code.

Annuity Contract Provisions

Common Provisions: Annuity Date

The **annuity date**, or the maturity date of the annuity, is the date on which the accumulation of funds stops and the payout begins. While most annuity contracts today are probably not written with a stipulated maturity date, such dates may be included in older contracts. This date can be either:

- **A fixed date or**
- **An optional date**

Annuity Contract Provisions

Common Provisions: Annuity Date

Fixed or Optional Date

Earlier you learned that if a maturity date on which benefit payments begin is included, the "date" might be a specific age (e.g., 70, 75, 80) or based on a period of years (e.g., 10) or the later of these two.

Key Ideas

- **Maturity date might relate to age or a period of years**
- **Earlier access may be granted for specific circumstances**

When an annuity is intended to mature on a **fixed date**, it is likely to be stated as "the annuitant's age 75" or something similar. However, insurers might allow the annuitant to choose an **optional date** that better meets the anticipated needs of the particular individual.

In addition, the owner or annuitant is often granted access to an annuity without negative tax or penalty consequences under certain unpredictable circumstances, such as a serious illness. You'll learn more about these options in the next section.

Annuity Contract Provisions

Common Provisions: Withdrawal/Surrender Charge Waivers

Waiving Penalties

Fees and penalties may apply if an annuity owner decides to withdraw any portion of an annuity or surrender it completely before its maturity date. However, when certain circumstances arise, the owner or annuitant may be permitted to make withdrawals or surrender the annuity completely without penalty. Common types of waivers used for this purpose include:

- **Nursing home waiver**
- **Terminal illness waiver**
- **Unemployment waiver**
- **Disability waiver**

Annuity Contract Provisions

Common Provisions: Withdrawal/Surrender Charge Waivers

Nursing Home Waiver

When a **nursing home waiver** is attached to the annuity contract, withdrawal and surrender charges are waived if the individual needs funds to pay for nursing care—generally in a licensed nursing facility. In order for the waiver to be triggered, certain requirements usually must be met, such as:

Key Ideas

Nursing Home Waiver

- **Funds for nursing care**
- **Licensed nursing facility**
- **After first year anniversary**
- **Specified confinement period**
- **Physician's statement**

- The annuity contract must have passed its first anniversary.
- The individual must be confined to the nursing facility for a specified period before benefits are paid. Sixty, 90 or 180 days are common.
- Insurers often require a physician's statement and/or an examination by a physician of the insurer's choice.

Annuity Contract Provisions

Common Provisions: Withdrawal/Surrender Charge Waivers

Terminal Illness Waiver

A **terminal illness waiver** operates much like the nursing home waiver. In fact, both waivers are sometimes combined into a single waiver rider. In this case, the funds may be used for any purpose deemed necessary as the result of the terminal illness. No fee or penalty is charged for surrender or withdrawal. Typical requirements include:

Key Ideas

Terminal Illness Waiver

- **Funds for any purpose**
- **After first year anniversary**
- **Expectation of death**
- **Physician's diagnosis and prognosis**

- Diagnosis by a physician occurs after the annuity has been in effect for at least a year.
- A physician projects a specific life expectancy—from as little as six months or less up to a year.

Annuity Contract Provisions

Common Provisions: Withdrawal/Surrender Charge Waivers

Unemployment Waiver

An annuity issued with an **unemployment waiver** provides for surrender or withdrawal without penalty if the owner becomes unemployed. Requirements:

- Accessible anytime after the annuity is purchased, provided the owner has not yet reached age 65.
- Normally, the owner must be unemployed for a certain number of consecutive days—commonly 30—before the waiver takes effect.

Key Ideas

Unemployment Waiver

- **Anytime after issue**
- **Owner under age 65**
- **Unemployed for specified period**

Annuity Contract Provisions

Common Provisions: Withdrawal/Surrender Charge Waivers

Disability Waiver

Less common is the **disability waiver**. When an insurer does offer a disability waiver, it is vital to understand the definition of disability used in the annuity contract. In some cases, the waiver is vague—simply that the owner cannot work. In others, the definition may be very precise about what is meant by being unable to work.

Key Ideas

Disability Waiver

- **Anytime after issue**
- **Owner under age 65**
- **Definition important**
- **Physician's statement**

A statement of disability is normally required from a physician.

Annuity Contract Provisions

Common Provisions: Premium Payments

Earlier you learned two ways that premiums might be paid. To review:

- **Single premium annuities**…one large lump sum is used to fully fund the annuity with a single payment
- **Flexible premium annuities**…more than a single premium is required, and the buyer typically has flexibility in terms of the amount and frequency of payment

Key Ideas

Premium Payments

- **Single premium**
- **Flexible premium**

Annuity Contract Provisions

Common Provisions: Premium Payments

In the past, it was not uncommon for an annuity contract to include a requirement that the owner pay a **specified premium** amount on a regular basis for a certain length of time. This arrangement allows the insurer to determine more closely how much will be available in the annuity when the individual is ready to start withdrawing it in the future.

Key Ideas

Premium Payments

- **Specified premium payments**
- **Flexibility through optional premium payments**

Later annuities often provided for significant **flexibility**, not only in the amount and frequency of premium payments, but in making payments optional at some point.

Today, most deferred annuity products are purchased with a single premium, but allow for subsequent premium deposits at the contract owner's option. Very few deferred annuity contracts sold today have multiple scheduled premiums.

Annuity Contract Provisions

Common Provisions: Withdrawal/Surrender Charge

Because money placed in an annuity is generally intended to stay there for the long term, there are penalties for withdrawing money early. The insurer may impose a **withdrawal or surrender charge** during the early years unless one of the waivers discussed previously is included in the contract.

Key Ideas

- **Applies in early years**
- **Insurer specifies number of years the charge applies**

Annuity Contract Provisions

Common Provisions: Withdrawal/Surrender Charge

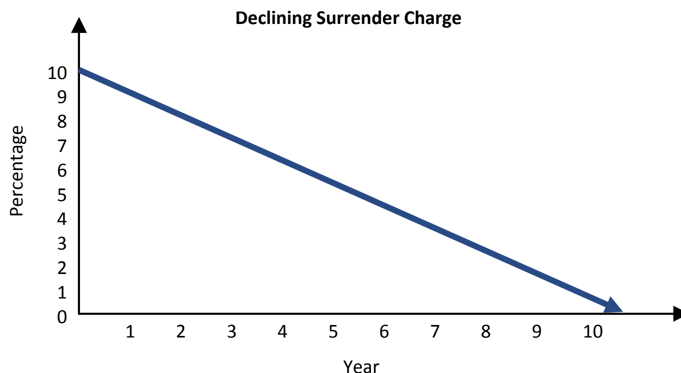
The surrender charge is generally a percentage of the annuity value that declines over a specified number of years (10 years is about average) and is then eliminated. Surrender charges vary among companies, both by percentage and by the number of years the charge applies.

Key Ideas

- **Rate typically declines over the period, then disappears**
- **Charges vary by company and time period**
- **Charges vary by period**

Surrender charges are also likely to vary from product to product offered by the same insurance company.

In this illustration, the insurer imposes a 10% surrender charge during the first year, reducing by 1% per year until the 11th year, when it disappears.



Annuity Contract Provisions

Common Provisions: Withdrawal Privilege Options

However, many insurers permit free **withdrawal privileges** up to a certain percentage of the total in the annuity at specified times, usually once a year. The percentage of the total available for withdrawal generally is about 10% to 15% of the contract's cash value.

Key Ideas

- **Free withdrawals**
- **Usually one per year**
- **Percentage of annuity cash value**

If the owner withdraws no more than the permitted amount, and does so during the specified period, there will be no withdrawal or surrender charge.

Annuity Contract Provisions

Common Provisions: Market Value Adjustments

Annuities can be written with a feature known as **market value adjustments (MVA)**. The insurer agrees to pay a specified fixed interest rate for a "guarantee period." On a declared rate MVA product, the guarantee may run for only one year. However, these contracts typically have longer guarantee periods ranging from three to 10 years.

Key Ideas

- **Fixed interest rate locked in**
- **Guarantee period specified**
- **Early withdrawal triggers adjustment**

However, if the owner makes a withdrawal or surrenders the contract before the end of the guarantee period, the insurer makes an adjustment to the rate.

Annuity Contract Provisions

Common Provisions: Market Value Adjustments

Key Ideas

- **Adjustment may or may not be favorable to owner**
- **Market conditions control outcome**
- **Early withdrawal charge may apply**

The adjustment may be favorable or unfavorable for the owner, depending on market conditions at the time the adjustment is made.

- If interest rates are rising, the adjustment is downward, protecting the insurer from a huge demand for funds during a time of rising rates, but also lowering the owner's account value.
- If interest rates are falling, the rate is adjusted upward, increasing the account value.

In addition to the market value adjustment, there may be an early withdrawal charge depending on the point at which the withdrawal is made.

Annuity Contract Provisions

Common Provisions: Contract Administration Charges

An insurance company incurs a number of costs in providing annuities. As a result, each annuity premium must include charges or fees to help meet these **administration costs**. These costs include:

- Issuing the contract
- Maintaining the contract
- Compensating agents
- Paying the insurance company's general overhead

Key Ideas

- **Costs to provide annuity**
- **Included in premiums**

Annuity Contract Provisions

Common Provisions: Annuitization Options

When an individual is ready to begin receiving funds from the annuity, he or she can choose to take the funds in one lump sum or to have the funds annuitized—paid out in a series of periodic payments. This is **annuitization**—converting the accumulated funds into an income stream, as opposed to taking them all at once.

Key Ideas

- **Occurs at payout**
- **Funds paid in series of payments**

While one option is, in fact, to take a lump sum, this is not annuitization. The definition of annuitization is converting the annuity value into a series of substantially equal periodic payments made for the life of the owner or the lives of the owner and a beneficiary.

Annuity Contract Provisions

Common Provisions: Annuitization Options

Settlement Options

Annuitization options are also called **settlement options**. The details are discussed in the section titled "Annuity Advantages & Disadvantages." Meanwhile, the common options include:

- **Life income**…payments as long as the annuitant lives, ceasing only when the annuitant dies no matter how little or how much has been paid
- **Life income with period certain**…payments as long as the annuitant lives and up to the period of time specified if the annuitant dies before all payments are made (e.g., 10 years certain and life would be for at least 10 years and thereafter until the annuitant dies)
- **Joint survivor life**…two annuitants named, payments continue until both have died
- **Period certain**…payments made for a specific period, ceasing whether the annuitant is living or dead (e.g., 10 years certain would be for 10 years only, and would then end even if the annuitant is still alive)
- **Cash refund**…if the annuitant dies before receiving payments equal to the purchase price of the annuity, a cash payment is refunded to the annuitant's estate

Annuity Contract Provisions

Common Provisions: Death Benefits

Many insurers offer an annuity featuring a **death benefit** that comes into play if the annuitant dies before the contract matures. Annuity death benefits generally bypass probate and are paid directly to the beneficiary named by the annuitant or owner.

When death occurs before payments begin, the beneficiary is generally guaranteed to receive either:

- The full amount accumulated, or
- The full amount paid in, if this amount is greater.

Key Ideas

- **Annuitant dies before contract matures**
- **Paid directly to beneficiary**
- **May bypass probate**
- **Guaranteed amount**

If death occurs after payments have begun, there may also be a death benefit, depending upon the annuity **settlement option** chosen. As you've learned, the annuitant can choose either to take the annuity in a lump sum or have it annuitized—paid out in a series of payments over time.

Key Ideas

- **Annuitant dies after payments begin**
- **Settlement option effect on death benefit payment**

Obviously, if a lump sum is paid at contract maturity, the contract is terminated at that time. Additionally, if the annuitant chooses a lifetime guarantee option, no death benefit will be available. For example, if the choice is a life income option, payments are made only as long as the annuitant lives, so there will be no death benefit after the annuitant dies.

Annuity Contract Provisions

Common Provisions: Death Benefits

Settlement Options

If the annuitant has selected a settlement option other than a lifetime guarantee, a death benefit will be available. For example, if the annuitant chooses a cash refund option and dies before receiving payments equal to the purchase price, the remainder will be paid as a death benefit to the beneficiary, typically in a lump sum.

Key Ideas

- **Non-lifetime option selected**
- **Lump sum to beneficiary**
- **Periodic payments to spouse/beneficiary**

Another example: An annuitant chooses a period certain payout and dies before the period has ended. If the beneficiary is a spouse, annuities typically offer the spouse the option of continuing with the annuity payout just as the annuitant had been receiving it before death until the period expires. Other beneficiaries, such as children, however, may not have that option and must take the remainder in a lump sum.

Annuity Contract Provisions

Common Provisions: Death Benefits

Settlement Options

Key Ideas

- **Extended payout or “stretch” option**
- **Based on beneficiary’s life expectancy**

Some annuities offer a feature sometimes called a “stretch” option, where a non-spousal beneficiary is permitted to extend or stretch the payout period. In this case, the periodic payments are based on the beneficiary’s life expectancy, rather than the original annuitant’s life expectancy. This arrangement allows an extension of the tax-deferral period. The particular periodic settlement options available for this type of annuity can vary from insurer to insurer.

Annuity Contract Provisions

Common Provisions: Principal Guarantee

All fixed annuities have a **principal guarantee**, which means the annuity owner is always guaranteed access to at least the amount of premiums paid minus any surrender charges that may apply.

Key Ideas

- **Guarantees owner amount of premiums paid**
- **Guaranty association available**
- **Surrender charges can affect principal**

Stated another way, the fixed annuity's account value will never be less than the premiums paid into the contract. However, if the owner should surrender the contract before the end of the surrender period, a surrender charge applies. In this case, the principal paid to the owner could conceivably be less than the amount paid in.

This is true regardless of how the markets are treating the insurer's general investments upon which interest rates are based—assuming the insurance company remains solvent. Even then, a state's insurance guaranty association would step in for annuity contract owners in the same way it would for insurance policy owners. (Read more about the role of the guaranty association in the Suitability & Marketing Practices section.)

Annuity Contract Provisions

Common Provisions: Loan Provisions

Some annuities include a **loan provision**, under which the owner is permitted to borrow up to a specified amount or percentage of the accumulated value.

Key Ideas

- **Included in some annuities**
- **Loan up to specified amount or percentage**

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

The Index

Earlier you learned that indexed annuities differ from other fixed annuities because, in addition to a guaranteed interest rate, the annuity interest that will be paid is linked to an outside index that measures the performance of equity markets. This feature, which provides the potential for greater interest crediting than the guaranteed rate, is referred to as an **indexed crediting strategy**.

Key Ideas

- **Interest rate linked to outside index**
- **Provides potential for greater interest crediting**
- **Insurers use different indices**
- **Selected index is the tied index**

The index an insurer uses with a specific indexed annuity is referred to as the **tied index**. While the most commonly used index is the Standard & Poor's 500® (S&P 500®), other possibilities include:

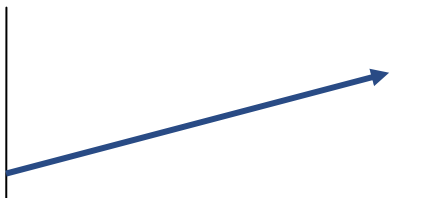
- Dow Jones Industrial Average
- NYSE Composite Index
- Russell 2000® Index
- NASDAQ-100 Index
- S&P 400 Midcap Index

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

The index can move up or down.

If the index goes up, the accumulation value of the indexed annuity increases.



Key Ideas

- **Index can move up or down**
- **Annuity value increases when index moves upward**
- **Value does not change if index moves downward**

If the index goes down, the accumulation value remains the same because no interest is credited for that period. This is one of the major advantages of indexed annuities—although the value will not increase when the index is down, neither will it decrease.

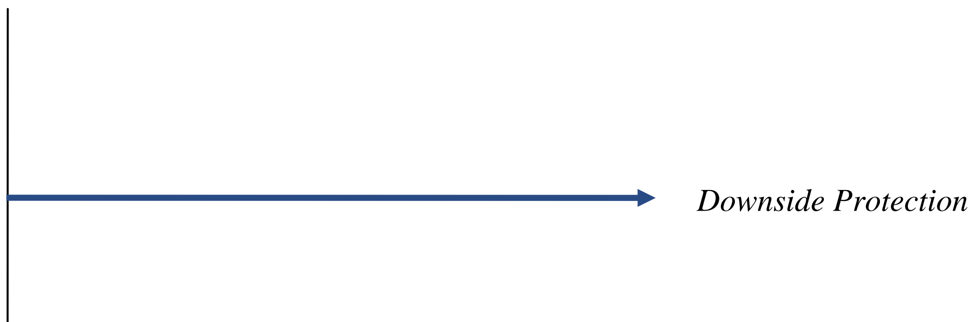
Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

This built-in downside protection is a key element of the indexed annuity. It provides that even with downward fluctuations, the annuity value will never be less than the premiums paid. In this manner, the indexed annuity offers participation in market upswings with guarantees the owner can count on (similar to a fixed annuity).

Key Ideas

- **Downside protection feature**
- **Limits effect of decreases**



Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

It's important to remember these key facts:

- The tied index is a link or a measuring tool and nothing more.
- An indexed annuity does not represent investment in equity securities.
- The indexed annuity is a fixed annuity that allows account values to increase if the selected index moves upward.
- Account values remain the same if the selected index moves downward.

Key Ideas

- **Index is link only**
- **Not an investment in equity securities**
- **Values increase when index moves upward**
- **Values remain the same when index moves downward**

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Moving Parts

Key Ideas
- Participation rate
- Cap or cap rate
- Spreads/asset fees

Indexed annuities are written with certain provisions that can change during the life of an annuity contract. These are often referred to as the contract's **moving parts**. Most insurers attempt to have only one moving part in a single contract. That is, although all three parts could change, the insurer's intention is to keep two stable and have only one subject to change.

The three moving parts are:

- **Participation Rate**
- **Cap or Cap Rate**
- **Spreads/Asset Fees**

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Terminology: Participation Rate

The indexed annuity generally does not earn exactly the same interest rate as the gain in the index to which it is linked. Insurers establish a **participation rate**, which is the percentage of the index gain that will be used to compute the interest rate paid.

Key Ideas

- **Rate earned is not equal to index gain**
- **Typical range is 20-100%**

Although in some cases the participation rate might be 100%, actual rates typically range from as low as 20% up to 100%.

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Terminology: Participation Rate

Suppose the index gain is 10% during the index term, and the annuity's participation rate is 70%. The gain credited to the indexed annuity in this case will be 7%, which is the result of the participation rate times the index increase percentage (70% × 10% = 7%).

Key Ideas

- **Rate × % Index Increase = Credited %**
- **Minimum and maximum might be guaranteed**
- **As a moving part, rate can change**

Participation Rate × % of Index Increase = Credited %

70% × 10% = 7%

Insurers sometimes guarantee that the indexed annuity participation rate will never be less than a specified minimum or more than a specified maximum. When the participation rate is one of the moving parts, it may change from time to time.

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Terminology: Cap or Cap Rate

Insurers might include a **cap rate** or maximum rate of interest that can be earned. Typical cap rates of various insurers now average 3% - 4%, but currently can run as low as 1.5% or as high as 6%.

Key Ideas

- **Maximum rate of interest that can be earned**
- **Wide range of cap rates**
- **Minimum might be guaranteed**

An indexed annuity with a cap rate of 4% will never pay more than 4% of the gain in the index to which it is linked. For example, if the cap rate is 4%, only 4% will be credited even if the index gain is 6%.

As is the case with participation rates, an insurer might guarantee minimum cap rates.

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Terminology: Cap or Cap Rate

Not all indexed annuities have a cap, and a cap frequently is not used when a participation rate is applied. However, because a specific annuity could, in fact, use both a participation rate and a cap rate, you must be aware of how, together, the two rates significantly affect the interest rate actually credited. For example:

Key Ideas

- **Caps not always used**
- **Often omitted when a participation rate applies**
- **Significant effect if both rates are applied.**

Assume a participation rate of 90% and a cap rate of 5%. When it is time to credit the interest to the indexed annuity, the index gain is 7%. The participation rate is applied first; then the cap rate is compared to that result to determine the actual credited rate, like this:

Index Gain × Participation Rate = Rate Credited

7% × 90% = 6.3%

If no cap rate is applicable, the interest credited would be 6.3% for this period.

However, because there is a cap rate of just 5%, the interest paid will be only 5%.

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Terminology: Spreads/Asset Fees

Many insurers charge a fee that might be referred to variously as the **spread, asset fee, margin or administrative fee**. When such a fee is charged, the interest rate to be credited is calculated by subtracting a specified percentage from the index gain. This might be computed instead of or in addition to the participation rate. Again, the insurer might specify guaranteed minimum and maximum fees.

Key Ideas

- **Spread, asset fee, margin, administrative fee**
- **Spread subtracted from index gain**
- **Minimum and maximum might be guaranteed**

Here's an example when the participation rate is 100%. With an index gain of 6.2% and a spread of 2%, an insurer subtracts the spread from the gain with the resulting figure being the rate that will be credited to the indexed annuity:

6.2% – 2% = 4.2%

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Terminology: Spreads/Asset Fees

Assuming the same figures as the previous example, now also assume that a participation rate does apply:

Index gain	**= 6.2%**
Spread	**= 2%**
Participation rate	**= 90%**
6.2% - 2%	**= 4.2%**
4.2% x 90%	**= 3.78%**

Key Ideas

- **Participation rate applies**
- **Spread applies**
- **Further reduction in crediting rate**

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

You have seen the importance of understanding precisely what provisions are made for **crediting interest** to an indexed annuity. Remember that details can differ from insurer to insurer and, with the same insurer, from contract to contract.

Always know how all of the parts work together to affect the rate that will ultimately be credited to the indexed annuity for each individual client.

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Common Strategies

The indexing strategy or method refers to the approach the insurer uses to measure the amount of change in an index. Large differences can result from choosing one approach over another. Indexing strategies include:

- **Fixed interest**
- **Point-to-point**
- **Monthly averaging**
- **High-water mark**
- **Annual reset (also called ratcheting)**
- **Combination strategies**

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Common Strategies: Fixed Interest

You are about to learn a great deal about the strategies commonly used with indexed annuities to determine how interest will be credited. An indexed annuity might have several different strategies applicable to several different accounts.

Key Ideas

- Fixed interest account
- Guaranteed interest
- Range of guaranteed rates
- Life of annuity contract
- Current interest rate may be paid for specific period

One such account is a **fixed interest** account. Certain annuity buyers might want to put at least part of their premiums into a fixed interest account where they know they are guaranteed to earn interest, even though it might be a relatively low rate.

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Common Strategies: Point-to-Point

Using the **point-to-point** method, interest is based on the difference between the index value at the beginning and end of the index term—that is, between two specific points. The beginning point is when the term begins, so the value of the index at that point is the first value to consider. The ending point is when the period ends, and the value at that point is used to determine the crediting amount. Here's an example using a one-year period, representing an **annual point-to-point**.

Key Ideas

- **Value at the beginning of the term vs. value at the end of the term**
- **Annual point-to-point**
- **Crediting rate formula**

Index value at beginning	1204
Index value at end	1252

To calculate the **crediting rate**:

1252 – 1204 = 48 ÷ 1252 = 3.83%

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Common Strategies: Point-to-Point

Don't forget there are other considerations in determining the final rate to be credited. A participation or cap rate is likely to apply. A spread/asset fee is another possibility. Any of these that are applicable must be factored in to determine the actual rate the insurer will credit as interest.

So, for the previous example, let's assume the participation rate is 80% and there is no cap rate or spread to consider. The 80% participation rate is applied to the initial crediting rate of 3.83% to calculate the actual credited rate:

$$3.83\% \times 80\% = 3.06\%$$

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Common Strategies: Point-to-Point

A variation of the annual point-to-point is the **long-term point-to-point**, when the period is longer than just a year. "Long-term" typically means five years or more. Again, the value at the beginning of the period is compared to the value at the end of the period. In this case, let's suppose the period is five years and the values are:

Index value at beginning	700
Index value at end	1090

To calculate the **crediting rate**:

1090 – 700 = 390 ÷ 700 = 55.7%

Key Ideas

- **Long-term point-to-point**
- **Value at the beginning of the term vs. value at the end of the term**
- **Crediting rate formula**

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Common Strategies: Monthly Averaging

Key Ideas

- Similar to point-to-point
- Period measured is shorter
- Averaging periods can vary

Monthly averaging is a variation on the point-to-point strategy. In this case, the period is shorter—running from the beginning of the month to the end of the month. At the end of the year, then, the total of these values is averaged. The result is the ending value. The beginning value and ending (averaged) value are then compared just as before. It's important to know what type of averaging, if any, is used. The insurer might instead use daily or weekly averaging. Another variation is monthly averaging spread over a two-year period.

Averaging has both an upside and a downside. If the index value drops suddenly, the annuity owner has some protection. On the other hand, if there is a significant increase in the index value, the owner doesn't participate in it directly. Over the long term, then, the owner might have had the potential for earn greater interest if not for the averaging.

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Common Strategies: Monthly Averaging

Ignoring any participation or cap rates, here's an example of monthly averaging:

Value 1st month	$ 635
Value 2nd month	645
Value 3rd month	649
Value 4th month	655
Value 5th month	660
Value 6th month	668
Value 7th month	677
Value 8th month	690
Value 9th month	701
Value 10th month	713
Value 11th month	740
Value 12th month	+ 746
	$8179

8179 ÷ 12 = 682
682 – 635 = 47
47 ÷ 635 = 7.4%

Key Ideas

- **Total of monthly values is averaged**
- **Formula applied**

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Common Strategies: High-Water Mark

The **high-water mark** approach credits interest at the end of the term. The interest is based on the difference between the index value at the start of the term and the highest value at various points (such as policy anniversaries) during the term. Interest is then added at the end of the term. Again ignoring any additional limits that may apply, here is an example.

Index value at beginning	700
Index value at end	1090
Highest index value during term	1100

To calculate the **crediting rate**:

1100 – 700 = 400 ÷ 700 = 57%

Under this approach, the beginning value for the next term will be the high-water mark rather than the ending value for the previous term.

Key Ideas

- Value at the beginning of the term vs. highest value within the term
- Formula applied
- Interest added at end of term
- High-water mark becomes beginning value

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Common Strategies: High-Water Mark

Remember, once this rate is determined…

1100 – 700 = 400 ÷ 700 = 57%

…any additional elements that are part of the particular annuity contract must also be applied. These could include a participation rate, a cap rate and a spread or asset fee. Assuming only a participation rate of 90%, the result is:

57% × 90% = 51.3%

Key Ideas

- **Apply additional elements as applicable**
- **Participation rate, cap rate, and spread or asset fee**

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Common Strategies: Annual Reset

Another crediting strategy, the **annual reset**, compares the index value at the beginning of the contract year with its value at the end of the contract year. This is done every year the contract is in force. Any gain is immediately credited.

After the interest is determined and credited, the beginning index value for the next contract year is reset to equal the ending value of the contract year just ended. In one of our previous examples, the beginning value was 700 and the ending value was 1090. Using the annual reset, the beginning value for the subsequent contract year will be 1090.

Key Ideas

- **Value at beginning of the contract year vs. value at the end of the contract year**
- **Determined every contract year**
- **Gain credited immediately**
- **Ending value becomes beginning value for next contract year**
- **Also called ratcheting**
- **Participation rate, cap rate, and spread or asset fee may apply**

This strategy, also known as **ratcheting**, is of course subject to participation and cap rates and fees.

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Common Strategies: Combination Methods

Key Ideas

- **Variety of strategies in a single annuity**
- **Different indexing methods selected by insurer**
- **Many combinations possible**

An insurer is likely to use a variety of indexing strategies in combination in a single annuity. To do so, a number of different accounts are used. For example, the same indexed annuity might have three accounts with three different indexing methods:

1. **Fixed interest**
2. **Monthly averaging**
3. **Annual reset**

Another might have these two:

1. **Fixed interest**
2. **Point-to-Point**

The possible combinations are many. The contract itself will explain what strategies are used and how they operate. Be sure you know what is included in the indexed annuities you will offer.

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Consumer Choice for Allocations

Although the insurer initially selects the various crediting strategies to be offered with an indexed annuity, the purchaser has the option to allocate the premiums to one or more of the strategies that best fit his or her objectives.

Key Ideas

- **Buyer may choose how to allocate**
- **May allocate among any or all accounts**

For example, using examples from the previous page, a certain consumer might choose to allocate values like this:

Fixed interest	**10%**
Averaging account	**40%**
Annual reset account	**50%**

Annuity Contract Provisions

Provisions Common to Annuities with Indexed Crediting Strategies

Consumer Choice for Reallocations

Key Ideas

- **Buyer may choose to reallocate values**
- **Minimums apply**

Typically, the consumer also has the option to reallocate the accumulated funds from one account to another at certain times—usually on the contract anniversary date. Minimum transfer amounts normally apply, and there is also generally a minimum on the amount that must remain in the account from which funds are transferred to another account.

The individual from the previous example could choose to increase the fixed interest account to 20%, taking 10% from the averaging account for that purpose, and moving another 10% from the averaging account to the annual reset account. The result is:

Fixed interest	**20%**
Averaging account	**20%**
Annual reset account	**60%**

Annuity Contract Provisions

Issues Concerning Index Strategy Performance

Why Participation Rates Are Less Than 100%

An obvious question with respect to the working of indexed annuities is, "Why might the participation rate be less than 100%?" First, by using a lower participation rate, the insurer is able to recoup certain expenses, such as:

Key Ideas
- **Recoup expenses**
- **Make a profit**

- Costs to issue a policy
- Marketing costs
- Taxes
- Business overhead

And…paying less than 100% also allows the insurer to make a profit.

Annuity Contract Provisions

Issues Concerning Index Strategy Performance

Why Participation Rates Are Less Than 100%

Another very important reason that participation rates are sometimes less than 100% has to do with managing the guarantees that are included in the annuity contract. Guarantees that provide for principal protection and payment of a minimum interest rate represent costs to the insurer.

Key Ideas

- **Managing guarantees**
- **Premium protection**
- **Minimum interest rate**
- **Annuitization**

In addition, the insurer must be able to guarantee the payout if the annuity is eventually annuitized and the owner expects payments for life.

All of these costs and guarantees must be paid regardless of the rise or fall of the index. Therefore, the lower participation rate leaves funds available for the insurer to cover its costs.

Annuity Contract Provisions

Issues Concerning Index Strategy Performance

Why Participation Rates Are Less Than 100%

So how does this square with the fact that some insurers do pay a 100% participation rate? You can be sure that, in this case, there will be a cap rate and/or a spread/asset fee. There must always be a way for the insurer to keep the promises it makes in the annuity contract.

Key Ideas

- **Managing guarantees**
- **Handling uncertainty of interest credits**

In a non-indexed annuity, these costs are covered by the returns the insurer receives through investments in its general account. Recall that a fixed interest amount applies here. With the indexed annuity, on the other hand, the interest credits depend on the index values—making them less predictable. The uncertainty of indexed interest credits makes it more difficult for the insurer to predict how much will be available to cover costs.

Annuity Contract Provisions

Issues Concerning Index Strategy Performance

Participation Rate Fluctuation

Another question that arises is why participation rates fluctuate over the life of the annuity contract. This is a function of the market activity. For an indexed annuity, an additional insurer cost is the purchase of call options in the linked index. A call option is the right to purchase a security at a fixed price.

Key Ideas

- **Participation rates fluctuate as a function of market activity**
- **Insurer purchases call options**
- **Rates change to cover cost of options**

To cover the cost of these options, one of the variable features—the participation rate or the cap rate—will change. This allows the insurer to maintain its ability to fulfill its guarantees.

Annuity Contract Provisions

Issues Concerning Index Strategy Performance

Investing the Premium

As is the case with any insurance product, part of the premium paid for an indexed annuity goes to pay for certain costs associated with selling and maintaining the contract. The three broad areas that share in the premium are:

Key Ideas

Premium Allocations

- **Expenses**
- **Guarantees**
- **Index participation**

- **Expenses or spread**…insurer's operating expenses, expenses to provide the annuity, agent compensation/commissions, profits
- **Contract guarantees**…costs to guarantee rates, principal, annuitization options
- **Equity index participation**…a portion of the premium earmarked to purchase options that will provide the potential for a greater return through the linked index

Annuity Contract Provisions

Issues Concerning Index Strategy Performance

Midterm Withdrawals and Interest Credits

You learned that there can be a surrender charge for making withdrawals before the annuity matures if the owner withdraws too much or does so sometime other than during the period specified by the insurer.

Key Ideas

- **Surrender charges**
- **Interest rate credit**

However, there is another drawback to making withdrawals before the contract matures. Depending on the specific policy, the actual interest credited might be less than if the annuity had reached maturity, thus reducing the accumulated value.

Annuity Contract Provisions

Issues Concerning Index Strategy Performance

Midterm Withdrawals and Interest Credits

Key Ideas

- **Market value adjustment**
- **Interest paid on lower value**
- **Rate might not be linked to index**

You learned that certain annuities are subject to a market value adjustment to the rate credited if the individual surrenders the annuity before it matures.

In addition, with an indexed annuity, certain types pay interest only at the end of the term. As a result, if withdrawals are made before that, the accumulation value drawing interest will be less. In other indexed annuities, the rate paid might not be linked to the index at all if any withdrawals have occurred.

Annuity Contract Provisions

Issues Concerning Index Strategy Performance

Minimum Nonforfeiture Interest Rate vs. Minimum Annual Credited Interest Rate

With respect to minimum interest rates, there are two terms you must not confuse:

- **Minimum nonforfeiture interest rate**
- **Minimum annual credited interest rate**

Annuity Contract Provisions

Issues Concerning Index Strategy Performance

Minimum Nonforfeiture Interest Rate vs. Minimum Annual Credited Interest Rate

The **minimum nonforfeiture interest rate** is the rate used in determining minimum nonforfeiture amounts that apply for a paid-up annuity, for a cash surrender, or to provide death benefits. Determining this amount requires following guidelines found in state laws and regulations and based on the revised Standard Nonforfeiture Law for Individual Deferred Annuities.

Key Ideas

Minimum Nonforfeiture Interest Rate

- **Helps determine minimum nonforfeiture amounts**
- **Standard Nonforfeiture Law for Individual Annuities**
- **Rate can be reset**

At one time, the nonforfeiture rate was static. The revised law permits the rate to be reset based on steps provided in the law. This is a fairly complicated process, so it will not be covered here. The point for you to remember is that the minimum nonforfeiture interest rate functions to help determine the annuity's nonforfeiture values.

Annuity Contract Provisions

Issues Concerning Index Strategy Performance

Minimum Nonforfeiture Interest Rate vs. Minimum Annual Credited Interest Rate

Distinct from the nonforfeiture rate is the **minimum annual credited interest rate**. This is the guaranteed rate the insurer will pay on an indexed annuity during an interest crediting period. This minimum is commonly 3% annually. This means 3% will be paid even if the index rate is lower.

Key Ideas

Minimum Annual Credited Interest Rate

- **Minimum rate paid annually**
- **3% is common**
- **Paid if index rate is less**
- **May apply to less than 100% of premiums paid**

However, the 3% rate commonly used might well apply to less than the full amount of premiums paid, so the actual minimum rate will be less. You should be aware of how the minimum rate is applied for the indexed annuities you sell.

Annuity Contract Provisions

Issues Concerning Index Strategy Performance

Historical Perspective & Realities

It is plain to see that the operation of indexed annuities in the real world depends on a myriad of factors—so many of which are subject to ongoing change. Therefore, it is very important to be careful about what you say to prospective purchasers, and to address the realities of owning an indexed annuity.

Key Ideas

- Hypothetical models
- Actual interest credited
- Renewal rates

Hypothetical models (both historical and projected) are useful, of course, but must be accompanied by caveats that historical performance doesn't guarantee future performance, and that projections are just that…projections.

Actual interest credited to indexed annuities is often different from projections. This is the result of market activity, withdrawals the owner may make, and the potentially changing parts of an indexed annuity. Remember, insurers have the option to make changes in participation and cap rates, and that option is exercised regularly.

Although **renewal interest rates** are seldom emphasized or even of great interest to a purchaser at the time the annuity is sold, these rates can obviously have a significant impact on the future performance of the annuity. It is not unusual for the renewal rate to be substantially lower than the initial interest rate. Be sure the client knows that the initial rate is guaranteed only for the period specified in the contract.

Annuity Contract Provisions

Typical Riders for Annuities

Annuity owners who want to add other coverages or extend the benefits of their annuities can do so by means of riders. Commonly used riders include:

- **Life insurance riders**
- **Long-term care benefit riders**
- **Guaranteed minimum withdrawal benefit riders**
- **Guaranteed minimum death benefit riders**

Key Ideas

- **Life insurance**
- **Long-term care**
- **Guaranteed minimum withdrawal**
- **Guaranteed minimum death benefit**

Annuity Contract Provisions

Typical Riders for Annuities

Life Insurance Riders

A **life insurance rider** provides for payment of a specified amount to a beneficiary named in the life insurance contract if the annuitant dies while the contract is in effect. This amount is in addition to any death benefit that might be provided by the annuity.

Key Ideas

- **Specified amount of life insurance**
- **Paid to named beneficiary**
- **Additional to annuity death benefit, if any**

Types of life insurance riders available vary from insurer to insurer.

Annuity Contract Provisions

Typical Riders for Annuities

Long-Term Care Benefit Riders

A rider that provides **long-term care benefits** may be available from some insurers. This type of rider will help pay for the costs associated with long-term care in a nursing home or possibly for at-home care, depending on the particular rider.

Key Ideas

- **Nursing home or other long-term care costs**
- **Income in addition to annuity income**
- **Know the restrictions**
- **Know what triggers coverage**

A long-term care benefit rider can provide income in addition to income being paid from the annuity. It is vital to read the rider carefully since there will always be certain restrictions on receiving this coverage. For example, most require that the annuity has been in effect for a specified period, such as 10 years. Scrutinize the rider for such limits, including the definitions of circumstances required to trigger coverage.

Annuity Contract Provisions

Typical Riders for Annuities

Nursing Home Waiver and Long-Term Care Rider Differentiated

The long-term care benefit rider described above is not the same as the nursing home waiver discussed previously. Under the waiver, you'll recall, the insurer will waive any withdrawal and surrender charges if the individual needs funds to pay for nursing care, and if other requirements of the waiver are met.

The long-term care rider, however, has nothing to do with using the money accumulated in the annuity. It provides a separate amount of money for long-term care, subject to its own contractual requirements.

Annuity Contract Provisions

Typical Riders for Annuities

Guaranteed Minimum Withdrawal Benefit Riders

Guaranteed minimum withdrawal benefit riders add another level of access to income after the annuity has been annuitized. With this rider, the annuitant can have both a lifetime income payment plus access to a portion of the principal.

Key Ideas

- **Access to additional income**
- **After annuitization**
- **Amount may be based on age**
- **Method for determining amount varies**
- **Provision continues even if annuity is exhausted**
- **Payments can start and stop**

The amount that may be withdrawn is specified in the contract and is usually based on the annuitant's age when he or she begins to take withdrawals. For example, the rider might state that if the annuitant starts withdrawals at age 75, he or she is allowed to take up to 6% of the accumulated value each year. The exact method for determining the withdrawal amount varies among insurers.

The provision typically lasts for the individual's lifetime—even if the annuity is used up before the annuitant dies. In addition, the annuitant is allowed to start and stop receiving funds under the rider any time.

Annuity Contract Provisions

Typical Riders for Annuities

Guaranteed Minimum Death Benefit Riders

Among the most desired riders is the **guaranteed minimum death benefit rider**, which promises a minimum amount that will be paid to a beneficiary if the annuitant dies before the annuity payout begins. The minimum is typically the greater of the:

Key Ideas

- **Benefit to beneficiary**
- **Minimum amount specified**
- **Ends when annuity payout begins**

- Current accumulated value, or
- Total amount of premiums paid less any withdrawals.

While the rider generally ends when annuitization begins, some riders may offer the option to pay the minimum benefit for a specified number of years after the payout starts.

Annuity Advantages & Disadvantages

Guaranteed Principal

Earlier you learned that **guaranteed principal** is the basis of all fixed annuities. This means that at the least, the premiums paid in to the annuity are always guaranteed to be available to the owner as long as there have been no withdrawals or partial surrenders. This is an advantage a fixed annuity has over other types of retirement accumulation vehicles.

Key Ideas

- **Principal always available**
- **Subject to surrender charges**
- **Withdrawals, surrenders can reduce principal**
- **Security of principal attractive to older investors**

You also learned that surrendering the contract before the end of the surrender charge period would entail a surrender charge—so this is a situation that would reduce the principal amount.

While the security of the principal can appeal to purchasers of any age, it is this security that especially appeals to older buyers. As they grow older, individuals sometimes no longer want to take the risks involved with securities investments.

Annuity Advantages & Disadvantages

Tax-Deferred Growth

Taxable, Tax-Deferred and Tax-Free Returns

One of the ways annuities compare favorably with most other retirement savings strategies is that annuity interest is not **taxable** when credited. On the other hand, returns on most investments, including stocks, bonds, mutual funds and certificates of deposit, are taxable in the year paid.

Key Ideas

Taxable Interest

- **Annuity returns are not immediately taxable**
- **Non-annuity returns are immediately taxable when paid**
- **No current income taxation**
- **Higher accumulation level**

The advantage is twofold:

1. Current income taxation is avoided.
2. Untaxed credited interest allows retirement accumulations to grow faster.

Annuity Advantages & Disadvantages

Tax-Deferred Growth

Taxable, Tax-Deferred and Tax-Free Returns

As you've learned, during the accumulation period, interest paid by the insurer on the annuity premium grows on a **tax-deferred** basis until withdrawn. This tax-deferred interest is a very attractive feature.

Key Ideas

Tax-Deferred Interest

- **Interest is tax-deferred**
- **Interest taxed at payout**
- **Premiums returned tax free**
- **Withdrawals before age 59½ may incur 10% penalty tax**

Tax-deferred, of course, does not mean tax-free. If the annuity owner surrenders the contract, all of the gain in the contract will be subject to ordinary income tax. Likewise, if the annuity owner takes a withdrawal (partial surrender), it will be subject to income tax to the extent of the gain in the contract on the date of the withdrawal. In addition, if a withdrawal or a full surrender occurs prior to the annuity owner's attaining the age of 59½, a 10% penalty is imposed on the taxable portion of that distribution.

If the contract is settled for a stream of payments at some point (i.e., "annuitized"), a different form of taxation, referred to as "exclusion ratio" taxation applies. Part of each payment will be taxable as gain and part will be excluded from taxation as a recovery of the investment in the contract. This concept is discussed in more detail later in the course.

Annuity Advantages & Disadvantages

Tax-Deferred Growth

Taxable, Tax-Deferred and Tax-Free Interest

An investment that has somewhat more favorable tax treatment than annuities is a completely **tax-free** investment. For example, interest that is paid to investors on state and other municipal securities is free from federal income taxation.

Key Ideas

Tax-Free Interest

- **State and municipal securities**
- **Federal income tax-free**
- **Probably free of state income taxation**

These investments are also usually free of income taxation by the state in which the municipality is located. However, if, for example, someone in Indiana bought a bond issued by the state of Ohio, the interest might be subject to income taxation by the state of Indiana.

Annuity Advantages & Disadvantages

Tax-Deferred Growth

Long-Term Effects of Compounding

When dollars that would otherwise be used to pay current taxes on credited interest are left to grow and compound, they can accumulate faster. Even taking into account the income tax payable when the funds are withdrawn, tax deferral may mean many more dollars for the investor when the payout begins. The **long-term effects of compounding** with a tax-deferred investment such as an annuity as compared to a currently taxable retirement vehicle can be significant.

Key Ideas

- **Rapid growth**
- **Interest compounding**
- **Increased accumulation**

Annuity Advantages & Disadvantages

Tax-Deferred Growth

Long-Term Effects of Compounding

Key Ideas

- **CD income taxed**
- **Annuity income not taxed until distributed**
- **Annuity principal not taxed**
- **Better interest crediting on annuity**

The following example compares the growth of a bank certificate of deposit with an annuity over several time periods. Remember—the interest paid on the annuity is tax-deferred until distributed. The principal, which comes from after-tax dollars, is not taxed when distributed. This table clearly shows the advantage of using a tax-deferred annuity. Although both were started with $20,000, the annuity leads through every time period. And, after 30 years, the annuity has accumulated more than twice the funds as the CD.

Comparison of principal growth between a bank certificate of deposit subject to income tax annually and an annuity subject to tax only upon withdrawal, assuming a $100,000 initial deposit, a 28% tax bracket and an interest rate of 6% on each investment throughout the periods indicated:

Deposit Term	CD Accumulation	Annuity Accumulation
10 years	$ 152,642	$ 179,084
20 years	232,998	320,713
30 years	355,654	574,349*

*Tax on growth is payable in the year of withdrawal. After 30 years, assuming a tax bracket of 28%, the tax payable would be $132,818, leaving an after-tax accumulation of $441,531. Thus, the value of tax deferral based on these assumptions would be $85,877.

This example ignores the advantage annuitization might provide by having payments spread out and possibly taxed in a lower bracket.

Annuity Advantages & Disadvantages

Income Distributions

Settlement Options

Settlement options are annuitization options—that is, in what manner the annuity will be paid out at maturity. Previously we briefly described the common options listed here. After you read through the list, let's take a closer look.

- **Life income**
- **Life income with period certain**
- **Joint survivor life**
- **Period certain**
- **Cash refund**

Key Ideas

- **Life income**
- **Life income with period certain**
- **Joint survivor life**
- **Period certain**
- **Cash refund**

Annuity Advantages & Disadvantages

Income Distributions

Settlement Options: Life Income

The **life income option** provides that the annuitant will receive income payments for as long as he or she lives. When the annuitant dies, the payments stop. You can easily see that an annuitant who dies after a very short time will not receive payments equal to the premiums deposited over the years. Although this arrangement will permit the insurer to pay the annuitant the greatest periodic income, few people want this arrangement because there is no guarantee of receiving the amount deposited or its earnings if death occurs too soon.

Key Ideas

- **Income payments for life**
- **Payments stop when annuitant dies**
- **No guarantee to pay out all funds**
- **Payments continue even if annuity funds are exhausted**

On the other hand, if the annuitant is still living after all the annuity funds are exhausted, the insurer will continue making payments until the annuitant dies. This part of the contract is a better deal. However, because of the downside of this option, insurers developed other possibilities.

Annuity Advantages & Disadvantages

Income Distributions

Settlement Options: Life Income with Period Certain

Under the **life income with period certain** option, the insurer promises to make payments:

- For as long as the annuitant lives, or
- Up to the period of time specified in the contract if the annuitant dies before all payments are made, whichever occurs last.

Key Ideas

- **Income payments for life**
- **Payments continue for specified period**
- **Smaller monthly payments than life income only**

For example, an annuity identified as providing “life income, 10 years certain,” will pay as long as the annuitant lives. If the annuitant dies before 10 years have passed, payments continue to a beneficiary to complete that 10-year period. To accomplish this guarantee, the monthly income payments will be smaller than for an annuity that pays for life only.

Annuity Advantages & Disadvantages

Income Distributions

Settlement Options: Joint Survivor Life

The **joint survivor life** option provides monthly payments for two annuitants. In this case, the insurer again promises to make payments for life…until both annuitants have died. Spouses often use this annuitization option.

Key Ideas

- **Two annuitants**
- **Pays until last annuitant dies**
- **Can be designed for reduced payments after first death**

A common type of joint-and-last-survivor annuity makes payments of a reduced amount (one-half or two-thirds) to the survivor of two annuitants, on the theory that one individual needs less income than two. Joint-and-last-survivor annuities are widely used to provide income for a surviving spouse.

Annuity Advantages & Disadvantages

Income Distributions

Settlement Options: Period Certain

The **period certain** option, unlike the *life income with period certain* option, permits payments to continue only for the period specified in the contract. After that, payments cease. In this case, the monthly income paid to the annuitant is calculated to use up all of the accumulated funds during the specified period. Payments then cease, even if the annuitant is still living.

Key Ideas

- **Payments for specified period only**
- **Funds used up**
- **No payments beyond specified period**
- **Longer period = smaller monthly payments**

For example, an annuity identified as “20 years certain” will be divided to provide monthly payments of the same amount that will last for 20 years. The amount of each payment depends on how long the funds must last. A “10 years certain” option will produce larger monthly payments than one guaranteed for 20 years, all other factors being equal.

Annuity Advantages & Disadvantages

Income Distributions

Settlement Options: Cash Refund

The **cash refund** option was developed to guarantee that a certain amount of premiums paid in will be distributed to the annuitant or heirs. Under this option, if the annuitant dies before receiving payments equal to the purchase price of the annuity, a cash payment is refunded to the annuitant's estate or other beneficiary. The refund amount is equal to the difference between the amount paid to the annuitant and the amount equal to the premiums paid. Another option might be available—to continue making monthly payments to the beneficiary until funds are exhausted.

Key Ideas

- **Promises to pay certain amount**
- **Funds remaining when annuitant dies are refunded to heirs**
- **Refund may be in cash or monthly payments**

Like the life income options, if the annuitant is still living when funds are exhausted, income continues to the annuitant for life. In this case, there will be no refund for beneficiaries.

Annuity Advantages & Disadvantages

Income Distributions

Advantages & Disadvantages of Annuitization Options

From the previous discussion, you can see that there are both advantages and disadvantages to each of the annuitization options. Some of the important considerations and differences, all other factors (such as age and annuity value) being equal, include:

Key Ideas

- **Longer guarantee = smaller periodic payment**
- **Life only guarantee = greater periodic payment**
- **Period certain only guarantee = greater periodic payment**

- A larger periodic payment is available with a fixed amount life income option, but if the annuitant dies before receiving the full amount of annuity savings, the money reverts to the insurer.
- If the annuitant chooses the period certain only option, each individual payment to the annuitant will be larger, but the payments could end while the individual is still living.
- In contrast, an option for a life income with period certain, joint and survivor or cash refund results in a smaller periodic payment in order to provide the guarantees under each of these options.

In all cases, the amounts received are based not just on the annuitization option selected, but also on additional factors: (1) the age at which annuitization begins; (2) the value of the annuity at that time; and (3) how interest is computed. An insurer uses actuarial tables to make these determinations.

Annuity Advantages & Disadvantages

Income Distributions

Tax Ramifications of Annuitization

With respect to the taxation of annuity funds, two definitions are important:

Key Ideas

- **Qualified = premiums are before-tax dollars**
- **Non-qualified = premiums are after-tax dollars**

1. The term **"qualified"** means that the annuity has met the requirements of the Internal Revenue Code to receive special tax treatment. Premiums paid to a qualified annuity are considered to be paid with before-tax dollars.

2. The term **"non-qualified,"** then, means money going into the annuity is not eligible for an income tax deduction since it has already been taxed.

Annuity Advantages & Disadvantages

Income Distributions

Tax Ramifications of Annuitization

When a **non-qualified annuity** is annuitized, each payment represents, in part, a return of the principal paid in, called the owner's "investment in the contract." This part of each annuity payment has already been taxed and so need not be taxed again.

Key Ideas

Non-Qualified Annuities

- **Part of payout is return of principal, after-tax dollars**
- **Remainder of payout is earnings, before-tax dollars**

Only the balance of each payment, which represents earnings on the owner's premiums, is subject to taxation. Thus, a part of each periodic payment is income tax-free to the recipient.

Annuity Advantages & Disadvantages

Income Distributions

Tax Ramifications of Annuitization

The tax-free portion of each annuity payment is a fraction determined by comparing the **investment in the contract** to the **expected return** and is called the **exclusion ratio**.

The investment in the contract is, generally, the cost of the annuity. The expected return is the guaranteed annual return multiplied either by the life expectancy in years of the annuitant(s) or by the guaranteed period, depending on the type of annuity. Here's an example of how to find the exclusion ratio:

Key Ideas

Non-Qualified Annuities

- **Exclusion ratio determines tax-free portion of payout**
- **Calculation depends on annuity facts**

$50,000 is invested in a contract guaranteed to return a total of $75,000 to the annuitant over a period of 10 years. The exclusion ratio in this case is 50,000/75,000, or 66.7%. If the monthly periodic payments are to be $625 each, $416.88 is the amount of each payment the annuitant is entitled to receive tax-free (66.7% of $625).

Investment in Contract ÷ Expected Return = Exclusion Ratio

$50,000 ÷ $75,000 = 66.7%

$625 × 66.7% = $416.88 is received tax-free

$625 - $416.88 = $208.12 is taxed

Annuity Advantages & Disadvantages

Income Distributions

Tax Ramifications of Annuitization

In actually calculating the tax for specific annuitization options, adjustments must be made. For example, in calculating the investment in the contract for a life annuity with a refund feature, the cost of the refund feature (as determined by an IRS annuity table) has to be excluded. In calculating the expected return for an annuity with quarterly, semi-annual, or annual payments (instead of monthly payments), a frequency of payment adjustment is required (using factors from a another table found in the tax regulations).

Key Ideas

Non-Qualified Annuities

- **Adjustments made by type of annuitization**
- **IRS tables used**
- **Insurers can provide information**

While it is entirely possible to make the exclusion ratio calculation for any annuity by following the directions in the tax regulations, the same information is generally available from the insurer. After payments begin, the insurance company will be able to determine how much of each payment is taxable. Companies generally make this calculation in connection with meeting their government-imposed tax information reporting requirements.

Annuity Advantages & Disadvantages

Income Distributions

Tax Ramifications of Annuitization

Key Ideas

Qualified Annuities

- **Intended for use with tax-qualified retirement plans**
- **Contributions are tax-deductible**

Qualified annuities are contracts insurance companies have developed for use with certain tax-qualified retirement plans. Everyone who sells annuities needs to be aware of the special tax advantages afforded by these qualified retirement plans and the qualified annuities sold to fund them.

Annuities purchased under a qualified retirement plan offer the ultimate tax advantage. Not only is there tax deferral on interest earned, but within limits and depending on the type of plan, the tax law allows a tax deduction for contributions to a qualified plan. Annuity premiums are thus paid with before-tax—tax-deductible—dollars.

Annuity Advantages & Disadvantages

Income Distributions

Tax Ramifications of Annuitization

Perhaps the most well-known qualified retirement vehicle is the Individual Retirement Account or Annuity (IRA) which can be established on an individual basis by everyone who meets the IRS requirements. In addition, qualified annuities can be used by employers to fund retirement plans for their employees. Common qualified plans funded by annuities include the:

Key Ideas

Qualified Annuities

- **Individual annuities**
- **Employer-sponsored annuities**

- **Individual Retirement Annuity (IRA)**
- **Tax-Sheltered Annuity (TSA), also known as a Section 403(b) plan**
- **Simplified Employee Pensions (SEPs)**
- **SIMPLE (Savings Incentive Match Plan for Employees) IRA**

Employers are also permitted to use annuities to fund certain other types of plans, such as pension and profit-sharing plans. The amount that may be contributed annually to all of these plans is limited by law.

Annuity Advantages & Disadvantages

Income Distributions

Tax Ramifications of Annuitization

Remember—qualified annuities are purchased with before-tax dollars, which means they have never been income-taxed. As a result, when annuitization begins, taxation is due not only on the interest paid, but also on the principal.

Key Ideas

Qualified Annuities

- **Each annuity payment is fully taxable**
- **Minimum distributions must be taken**

To be sure Uncle Sam gets his due, there comes a point where distributions from the annuity must be taken, whether the individual needs the income or not. Depending on the circumstances, distributions must equal a specified minimum amount annually, which is then taxed.

Annuity Advantages & Disadvantages

Retirement Savings

Annuities are a time-proven way to accumulate **retirement savings**. Individuals may buy annuities as a primary source of retirement income, as a supplement to company pensions and Social Security, or simply as a long-term retirement strategy that is essentially worry-free.

Key Ideas

- **Proven for retirement savings**
- **Purchased by individuals**
- **Purchased by businesses**

Businesses also buy annuities for their employees, usually as part of a tax-qualified retirement program for all employees, but sometimes also for selected employees as a way to recruit and retain key employees.

Annuity Advantages & Disadvantages

Retirement Savings

Here are some of the reasons annuities are attractive to individual purchasers.

- Annuities may appeal to people who want security of principal and assured accumulation of interest. Fluctuations in the stock market have taught the lesson that, while stocks are still desirable assets, the direct purchase of stocks and bonds involves risks that may be unacceptable to certain individuals.
- The tax deferral advantages of annuities are of significant value.
- Annuities may appeal to people as a valuable risk management device. Properly structured, annuity payments cannot be outlived.
- The relative safety of the nation’s life insurance companies may appeal to those seeking retirement security.
- Modern annuities have built-in flexibility enabling their owners to withdraw funds before maturity if their plans change. (Of course, taxes will be due, and a company may impose a surrender charge.)

Annuity Advantages & Disadvantages

Retirement Savings

Businesses and other organizations can use annuities to fund retirement savings for their employees. Many non-profit organizations are eligible to offer employees significant tax deferrals through the Tax-Sheltered Annuity authorized by Internal Revenue Code Sec. 403(b) mentioned previously.

For many years, major companies and other large organizations have provided retirement income for their employees through tax-qualified pension and profit-sharing plans. But the American economic landscape is rapidly changing. For example, many former employees of large manufacturing firms have moved to smaller concerns or to the service industries that comprise a significant segment of employment opportunities.

Too often, these newer or smaller enterprises simply cannot afford to provide significant retirement benefits for their people. However, annuities can be arranged so employers can assist employees in funding their own retirement savings at little cost to the business.

Annuity Advantages & Disadvantages

Retirement Savings

The only real disadvantages to using annuities to accumulate retirement savings are:

- Earnings can be less than for investments in securities.
- Funds are usually locked in for the long term and may be subject to penalties for early withdrawal.

Annuity Advantages & Disadvantages

Potential to Avoid Probate

When an annuitant dies before all of the proceeds are paid out, the remainder can be left to beneficiaries. In most cases, the proceeds can pass to heirs without having to go through probate; that is, the funds do not become part of the deceased person's probate estate.

Key Ideas

- **Can avoid probate**
- **Consult experts**

To be certain probate is avoided, annuity purchasers should consult with their own legal and tax advisors.

Annuity Advantages & Disadvantages

Certain characteristics of annuities provide different advantages and disadvantages depending upon whether the individual is younger or older.

Let’s take a look at these issues, rather arbitrarily dividing these groups into people who are under age 65 and those who are 65 and older.

Annuity Advantages & Disadvantages

For Individuals under Age 65

Under Age 65 Advantages:

- Tax deferral until potentially far into the future
- Longer period to accumulate interest earnings
- Longer period provides greater growth possibilities to provide more income
- Longer opportunity to change investments in certain types of annuities
- Can provide death benefits to heirs in the event of early death

Under Age 65 Disadvantages:

- If money is needed before annuity maturity, IRS penalties may apply
- Withdrawals made before age 59½ may be subject to a 10% penalty tax on earnings in addition to ordinary income tax
- Withdrawals are subject to surrender fees during the surrender period

Annuity Advantages & Disadvantages

For Individuals over Age 65

Over Age 65 Advantages:

- Provides more safety than investments in equities
- Can provide a lifetime income
- If non-qualified, only part of the annuity is taxable at payout
- Can provide a death benefit or continuing annuity for heirs
- Can avoid probate

Over Age 65 Disadvantages:

- Depending on the annuity, annuitant might be unable to change the amount of each payment
- Lower interest rates can limit income

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products

Before we specifically discuss *indexed* life insurance, let's briefly review the various types of life insurance products available. We will refer to non-investment types of life insurance products as fixed products to distinguish them from variable products. We'll begin with **fixed products**, which include:

- **Participating whole life insurance**
- **Interest sensitive whole life insurance**
- **Universal life insurance**
- **Term life insurance**
- **Indexed life insurance**

Key Ideas

- **Participating whole life**
- **Interest sensitive whole life**
- **Universal life**
- **Term life**
- **Indexed life**

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products: Participating Whole Life

Whole life insurance is so named because it covers the insured for his or her whole life and premiums are paid for the insured person's whole life as well. In actuality, if the insured lives to a certain age specified in the policy, usually age 100, the policy is considered to be paid up and no further premiums are required.

Key Ideas

- **Whole life = lifetime insurance coverage for a lifetime**
- **Premiums paid for life**
- **Permanent insurance**

Because the policy continues as long as the insured lives, it is considered to be *permanent* insurance as opposed to term insurance, which we'll discuss later.

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products: Participating Whole Life

Participating whole life insurance refers to a policy that pays dividends—the policyowner "participates" in the profits of the insurance company. Not all policies do so, in which case they are called non-participating policies. In a participating policy, dividends may be paid when any of these events occurs:

Key Ideas

- **Pays dividends**
- **Dividends result from savings**
- **Not guaranteed**

- The insurer realizes a savings in death claims due to lower mortality than expected
- The insurer experiences an increase in earnings on its investments
- The insurer realizes some efficiency in its operation that reduces expenses

Even in a participating policy, however, dividends are not guaranteed.

Key Ideas
- **Level premiums**
- **Builds cash value**

Whole life policies are purchased with periodic premiums that are generally level—that is, the same amount is paid each time a premium is due for the entire lifetime. In the early years of a whole life policy, the level premium substantially exceeds the amount required to pay the current cost of insurance protection. On the other hand, in the later years, as the individual grows older, the level premium falls far short of the amount needed.

The coverage can continue, however, because the excess premium charged in the early years of the whole life policy permits the policy to build a *cash value accumulation*. This cash value is one of the distinguishing features of whole life insurance.

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products: Participating Whole Life

A whole life insurance policy is made up of two elements:

1. Pure insurance protection
2. Cash value accumulation

Key Ideas

- **Pure insurance**
- **Cash value**

The cash value portion of the whole life policy gradually increases over the lifetime of the policy until it eventually equals the face amount of the policy, generally when the insured reaches age 100. The portion of the policy not represented by the cash value accumulation is the pure insurance protection portion of the policy.

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products: Participating Whole Life

The face amount of a whole life policy always equals the pure insurance protection plus the cash value accumulation:

Face Amount = Cash Value Accumulation + Pure Insurance Protection

Dividends used to purchase paid-up additions buy small amounts of paid-up life insurance which will increase the death benefit.

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products: Participating Whole Life

When the participating whole life policy is kept in force, the cash values grow on a tax-deferred basis. Cash values are available to the policyowner in the form of loans or, if the policy is surrendered, the insurer pays the surrender value to the owner. Alternately, if the individual wants to keep the coverage in force, cash values can be used to provide a lower level of permanent coverage or to buy term insurance. In any event, cash values belong to the policyowner in the manner specified in the contract.

Key Ideas

- **Loans**
- **Cash surrender value**
- **Less coverage**
- **Term insurance**

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products: Interest Sensitive Whole Life

Key Ideas

- **Interest is based on insurer's investment returns**
- **Minimum guaranteed rate**
- **Inflation protection**

Interest sensitive whole life insurance ties the interest rates paid on cash values to the insurance company's investment experience.

By basing the interest rate to be paid on current interest rates, the insurer provides the potential for greater growth than is expected with the minimum guaranteed rate. The rate will never go below the minimum guarantee, but when the current rate the insurer is earning on its investments is greater than the minimum, the policy shares in the increase.

This approach, which is also referred to as current assumption whole life insurance, is designed to help keep the cash values in line with inflation.

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products: Universal Life

Perhaps one of the most widely known types of interest sensitive life insurance is **universal life insurance**, which is technically a flexible premium, adjustable life policy.

Key Ideas

- **Interest sensitive policy**
- **Flexible premium**
- **Adjustable amount**
- **Can adapt over a lifetime**

The term universal life aptly describes the broad adaptability of the policy to a wide range of changing financial needs over a policyowner's entire lifetime. It also suggests its flexibility and versatility—its universality—in personal planning for financial security.

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products: Universal Life

Universal life differs in several ways from traditional whole life insurance. Consider:

- Premium payments are not fixed and can be increased or decreased at any time within certain limits, or sometimes skipped entirely. Premium payment can be discontinued as long as the cash value is sufficient to cover expense charges and insurance costs for the following month.
- The amount of insurance protection is not fixed; it can be adjusted up or down as needs change, subject to any evidence of insurability required by the insurer.
- Partial withdrawals can be made from the cash value. Policy loans are another option.

Key Ideas

- **Premiums can be increased, decreased, skipped**
- **Amount of insurance can change**
- **Partial withdrawals and loans available**

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products: Universal Life

Universal life insurance policies offer two distinct death benefit options:

- A level death benefit, known as Option A
- An increasing death benefit, known as Option B

Key Ideas

- **Level death benefit Option A**
- **Increasing death benefit, Option B**

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products: Universal Life

Under Option A, the death benefit equals the initial face amount, which includes the cash value of the policy. Thus, as the cash value increases, the pure protection decreases, just as with traditional whole life. The result is a level death benefit, at least in the early years.

Key Ideas

- **Level death benefit**
- **Death benefit could increase to meet legal requirements**

Still, to retain its legal identity as life insurance, the policy must provide a minimum amount of pure protection at all times. This minimum is often referred to as a corridor. As a result, Option A provides that as the cash value approaches the face amount, the death benefit will automatically increase to maintain the required corridor. This could occur earlier in the life of the contract if premium payments are near statutory maximums and/or interest rates have been relatively high.

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products: Universal Life

Under Option B, the death benefit is equal to the face amount plus the cash value. The face amount remains level while the cash value increases.

Key Ideas

- **Death benefit = face amount + cash value**
- **Option may be changed**

The policyowner is permitted to change from one death benefit option to another at any time. If the change is from level Option A to increasing Option B, evidence of insurability is required because of the greater potential risk the insurer assumes. No such requirement applies if the change is from Option B to Option A.

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products: Term Life

Term insurance is temporary insurance, providing protection for a limited number (or term) of years, unlike whole life insurance, which lasts for a lifetime.

Key Ideas

- **Temporary insurance**
- **Limited number of years**
- **Pure insurance protection**
- **No cash values**

Term insurance is often called pure insurance protection because it provides nothing beyond the protection element. Generally, a term insurance policy builds no cash value. When the term ends, the policy expires without value, and all protection ceases.

This is a significant difference between whole life and term insurance that policyowners must realize. With term, proceeds are payable only if death occurs during the stipulated term. Nothing is payable if the insured survives the stipulated policy term and does not renew the policy.

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products: Term Life

Since term insurance builds no cash values, the premiums paid for term insurance require a smaller annual cash outlay. As a consequence, for an equivalent amount of insurance, term insurance premiums are, at least initially, lower than premiums for any other type of coverage.

Key Ideas

- **Lower premiums**
- **Different durations**

Term policies are available for different durations—that is, the length of time the term policy remains in effect. Common term periods are 10, 15, 20, and 30 years.

Fixed Indexed Life Products

Types of Life Insurance

Fixed Products: Indexed Life

Indexed life insurance, which follows many of the same general principles as indexed annuities, can be provided as any interest sensitive life insurance product. The most commonly used product is universal life insurance. The basic principles that are similar to indexed annuities are:

Key Ideas

- **Indexing principles**
- **Outside index**
- **Fixed interest account available**
- **Variety of crediting strategies**

- The interest rates paid are linked to an outside index, such as the S&P 500® or one of the others mentioned previously.
- Purchasers have the option to allocate premiums to a fixed interest account.
- Various index crediting strategies can be used.

Indexed life insurance, however, has some significant differences that we will address shortly.

Fixed Indexed Life Products

Types of Life Insurance

Variable Products

The life insurance products we've mentioned so far are fixed products. While the indexed life products we will discuss fall into the fixed group, you should be aware that another type of life insurance has elements that are not fixed, but variable.

Key Ideas

- **Variable elements**
- **Variable life**
- **Variable universal life**

Variable life insurance products include:

- **Variable life insurance**
- **Variable universal life insurance**

Fixed Indexed Life Products

Types of Life Insurance

Variable Products: Variable Life

In **variable life insurance** policies, both the death benefits and cash values vary according to the investment performance of separate accounts in which the premiums are deposited.

These variables are the primary distinction between variable and fixed life policies.

Key Ideas

- **Death benefits vary**
- **Cash values vary**
- **Separate account controls**

Fixed Indexed Life Products

Types of Life Insurance

Variable Products: Variable Life

When a variable life policy is issued, a minimum death benefit is guaranteed. This guaranteed minimum death benefit is the policy face amount.

Key Ideas

- **Minimum death benefit guaranteed**
- **Actual death benefit may be more, but not less than minimum**
- **Cash value not guaranteed**

However, the actual death benefit payable when the insured dies may be greater than the policy face amount, depending upon the investment performance of the separate accounts. So, while the death benefit may be more, it may not be less than the minimum guaranteed amount.

Like the death benefit, the cash value of a variable life policy varies according to the investment performance of the separate accounts. However, there is no guaranteed minimum cash value for a variable life policy.

Fixed Indexed Life Products

Types of Life Insurance

Variable Products: Variable Life

Insurance companies that issue variable life policies are required to place the net premiums into separate accounts. The premiums are then invested in a variety of investments, including equities, and the fluctuating value of these investments is reflected in the accumulation value of the policy.

Key Ideas

- **Net premiums in separate account**
- **Invested in variety of investment**
- **Returns account for increase or decrease in death benefit**

It is the investment performance of the equities in the separate accounts that provides for the positive or negative investment returns which, in turn, causes the increase or decrease in the cash value/account value as well as the death benefit.

Fixed Indexed Life Products

Types of Life Insurance

Variable Products: Variable Universal Life

Variable universal life policies combine features of both universal life and variable life insurance. While a variable life policy has fixed premiums, the premiums in a variable universal life policy are flexible—as is the case with a universal life policy.

Key Ideas

- **Features of universal and variable life**
- **Variable premiums**
- **Cash value and death benefits vary**
- **Policyowner controls investments**

The cash value and the death benefits of variable universal life can vary with the performance of investments that the policyholder selects. In this way, the policy is similar to a variable life policy.

The owner of a variable life or a variable universal life product is in control of the investments (such as stocks, bonds, money market funds, etc.). In a universal life policy or a whole life policy, though, the investments are totally controlled by the insurer.

Fixed Indexed Life Products

Types of Life Insurance

Characteristics of Fixed vs. Variable Products

Here's a summary of the primary characteristics that distinguish fixed life insurance products from variable life insurance products.

- The variable death benefit and variable cash values are the primary distinguishing features of variable and fixed life policies.
- Insurers are required to deposit premiums in separate investment accounts selected by the policyholder for variable products.
- In a variable product, separate accounts can control the death benefit amount and the cash value amount. In a fixed product, insurer guarantees control these amounts.
- The cash value and the death benefits of variable universal life vary with the performance of investments that the policyholder selects. In this way, the policy is similar to a variable life policy.
- A variable life policy has fixed premiums, like a fixed product; a variable universal life policy, however, has flexible premiums.
- Investment control in a variable universal life product lies wholly with the policyowner, whereas the insurer controls investments in fixed policies.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Similarities: Indexed Crediting Strategies

Some features of indexed life insurance are similar to indexed annuities, especially with respect to the crediting strategies. For example:

Key Ideas
- **Similar terminology**
- **Similar mechanics**
- **Same indices**

- **Terminology** is essentially the same with respect to defining the unique features of indexed products…participation rates, caps, spreads or fees, point-to-point crediting, daily averaging, annual reset, fixed interest, etc.
- The **mechanics** of crediting interest are also quite similar…participation rates, cap rates and fees are applied, and the insurer's approach to measuring the amount of change in an index produces results in the same way for life insurance as for annuities.
- The **indices** that may be used as the equity link are also typically the same for both life and annuity products…S&P 500®, Dow Jones Industrials, NYSE Composite, Russell 2000®, NASDAQ-100 and S&P 400 Midcap being among the most common.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Periodic vs. Single Premiums

Segments (Buckets) & Timing of Allocation

Indexed life insurance has many features that differentiate it from indexed annuities, including the terminology associated with and the treatment of the periodic premiums typically paid (rather than single premiums).

Key Ideas

- **Premiums paid to fixed rate strategy**
- **Fees and expenses deducted from fixed rate strategy**
- **Remainder becomes segment or bucket**
- **Segments created monthly, quarterly, or more frequently**

When a premium is paid, it goes first to a fixed rate strategy (which might also be called a declared interest rate strategy) from which any required policy charges and fees are deducted. These include the amount to pay for the insurance plus administrative and policy fees. The remainder, then, can be sent to the desired fixed rate and indexed crediting strategies. (For a new policy, there must typically be a specific amount accumulated in the fixed account before the excess may be directed to one of the indexed strategies.)

The amount directed to the indexed strategy is called a **segment** or **bucket**. Once the fixed rate segment has enough value to pay policy charges and the cost of insurance for the required period, the excess is directed to the fixed rate or indexed strategies selected. A segment is typically created monthly, quarterly or more frequently depending on company practice.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Periodic vs. Single Premiums

Segments (Buckets) & Timing of Allocation

A new segment is created each time a portion of a premium is directed to a certain strategy. Each segment is subject to its own participation rate and cap rate, depending on what caps the insurer is applying at that time.

Key Ideas

- **New segment created with each allocation**
- **Each segment has individual participation and cap rates**
- **Segments remain in strategy for segment term**

Each segment remains where it is until the end of the segment term, at which time it could be transferred to a different strategy if permitted. For example, the strategy might be a one-year or five-year strategy, which means the segment term is one or five years. During the specified term, the minimum guarantee applies and no transfers may be made until the end of the segment term.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Periodic vs. Single Premiums

Timing of Credits

Key Ideas

- **Different methods to calculate and credit interest**
- **Calculations often made on anniversary of segment creation date**
- **Interest might be credited annually during a multiple year term**

Various methods are used by insurers for calculating and crediting interest on indexed life products. Although a segment term may last, for example, five years, interest might be calculated (and credited) annually on every segment anniversary.

For example, for calculating interest for a typical one-year point-to-point strategy, the beginning value for the measurement would be the index value as of the date the segment is created. The index value on the segment anniversary date (12 months later) would then be compared to the beginning value to determine the index earnings for that 12-month period. After any applicable participation rate, cap, etc., are applied, the resulting number represents the interest that is credited to that segment of the account value. In this example, that calculation and the resulting interest credit would occur on each segment anniversary through the end of the five-year term.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Periodic vs. Single Premiums

Timing of Credits

Key Ideas

- **Each strategy defines timing**
- **Participation and cap rate applied to index gain**
- **Typically 100% participation; can be less**
- **Index loss = no credit less than 0%**

Each strategy clearly defines the timing of the indexed crediting. Each premium has the potential to become an additional segment with its own interest crediting period.

Whatever timing the policy stipulates, at the end of that term, the change in the index is recorded and the amount to be credited is calculated. If the change in the index represents a gain, the participation rate and cap rate are applied, determining the amount to be credited to the particular segment. The participation rate for indexed life insurance is usually 100%, unlike the annuity contracts we've discussed. Remember the word "usually." You will find indexed policies with lower participation rates.

But suppose the index measurement produces a loss instead of a gain. Insurers guarantee the credit will never be less than 0%—in other words, there will never be a negative applied to the segment.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Periodic vs. Single Premiums

Timing of Credits

The annual point-to-point crediting method discussed in the indexed annuity section of this course (see Annuity Contract Provisions) is commonly used for indexed life insurance policies. Here's an example from that section that uses the annual point-to-point approach:

Key Ideas

- **Annual point-to-point common**
- **Application is same as for annuities**

Index value at beginning	**700**
Index value at end	**860**

To calculate the crediting rate:

860 – 700 = 160
160 ÷ 700 = 22.85%

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Periodic vs. Single Premiums

Timing of Credits

The other modifications that may be made are also applied in the same way for indexed life insurance as for indexed annuities. Remember, we said that the participation rate is generally 100% for indexed life. Let's assume that is the case, then use the same example as the previous page and apply the participation rate and the cap rate, which in this case is 10%.

Key Ideas

- **Participation rate application is same as for annuities**
- **Cap rate application is same as for annuities**
- **Cap rate also called growth cap**
- **Minimum called growth floor**

$$22.85\% \times 100\% = 22.85\%$$

The fact that the participation rate is 100% appears to be a positive feature of this indexed life policy; however, in this case the cap rate is 10%, so 10% is the maximum gain the policyowner will enjoy—not 22.85%.

You should know that with indexed life insurance, the cap rate is sometimes referred to as the growth cap. The minimum of 0% is called the growth floor.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Monthly Deductions

Policy Charges: Premium Load

Indexed life insurance is subject to policy charges just as other policies are. Most such policies are indexed universal life, so in this respect operate the same as non-indexed universal life. One such charge is the **premium load**.

Key Ideas

- **Premium expense**
- **Premium tax**
- **3% to 9% range common**
- **Varies among insurers and policies**

A premium load combines a premium expense charge and any premium tax required. This is expressed as a percentage of each premium, typically ranging from 3% to 9%. The specific percentage differs from insurer to insurer and an insurer might charge different loads for different policies.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Monthly Deductions

Policy Charges: Cost of Insurance

Another monthly deduction is for the **cost of insurance**. This is generally expressed as a dollar amount per thousand dollars of coverage. This is where the insured person's age, gender, and other underwriting data are considered to arrive at a fair rate.

Key Ideas

- **Dollar amount per thousand**
- **Subject to underwriting data**
- **Separate premium cost for riders**

Cost of insurance also includes the cost of any riders attached to the policy that require a separate premium or charge.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Monthly Deductions

Policy Charges: Expenses

Some insurers might have a separate **expense charge** (different from the premium load charges) covering administrative costs.

This is typically a flat dollar amount per month, such as $5 or $10. The amount is likely to increase after a specified number of years. For example, the fee might be $5 per month for the first five years, then $10 per month after that.

Key Ideas

- **Administrative costs**
- **Flat amount per month**
- **Likely to increase**

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Monthly Deductions

Alternatives to Handling Monthly Deductions. The various policy charges are automatically deducted from the existing cash values. This occurs whether or not premiums are currently being paid. Remember, one of the features of any universal life policy is the ability to skip premiums. However, there must be enough money in the cash value to cover the cost of insurance and other charges. If not, the cash value will eventually be exhausted and the policy will lapse. To avoid such a situation, the policyowner could pay the monthly costs separately from the premium payments or pay an additional amount along with the minimum premium.

Key Ideas

- **Cash value must be adequate to keep coverage in effect**
- **Pay monthly costs separately or additionally**
- **Interest credits smaller when cash value is reduced**
- **Insurers use different methods for making deductions and crediting interest**

Impact on Indexed Interest Credits when Deducted from Indexed Crediting Strategies. One reason to have additional funds covering the monthly deductions is to be sure the maximum amount of interest is credited. It's easy to see that when the monthly charges are deducted, the cash value is reduced so interest is paid on that reduced amount.

It's important to remember that insurers differ in terms of the account where the monthly deductions come from, and how interest, if any, is credited to those funds prior to their being deducted from the policy.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Underlying Guarantees

Terminology & Alternative Minimum Guaranteed Rate

It is important to understand the contractual **terminology** of indexed life insurance so you can explain it to clients. This is especially valuable when examining the guarantees that underlie the policy. Always notice which items are described as "current" and which are described as "guarantees." For example, the current cost of insurance charge might be X number of dollars per thousand per month, but it's not guaranteed to remain at that level unless the provision includes wording such as "for the life of the policy."

Indexed products may include a provision specifying a guaranteed minimum interest rate. Some insurers offer an annual minimum guaranteed interest rate. This is the strongest guarantee an insurer can make. Because this guarantee costs more, insurers typically use lower caps and/or participation rates to pay the cost. Other insurers offer a minimum guarantee applicable over the segment term. Still others offer a minimum guarantee that applies only upon policy termination—this is the weakest guarantee.

Policies might include a provision for an **alternative minimum guaranteed rate** or cumulative minimum guarantee. This provision means that, when the market is falling, the policy will still earn a certain minimum effective annual interest rate when computed over a specified period of time. Many insurers offer such a feature, but the time periods and rates vary.

Here's one example. One company's policy provides that, over a five-year period, if needed the strategy value will be increased according to the guarantee. In this policy, the guarantee is that on fixed rate strategies, the declared interest rate will never be less than 2%. On indexed strategies, the policy guarantees that the interest credited will never be less than 2% compounded annually over the segment term (the number of years of the particular segment).

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences

Account Value Enhancements/Bonus Interest Rates

Key Ideas

- **Great variation in terms and conditions for payment**
- **Not always offered**
- **May or may not be guaranteed**

Some indexed life insurance policies offer **account value enhancements** or **bonus interest rates**. Among insurers and among policies sold by the same insurer, the terms and conditions under which such amounts will be paid can vary greatly. For example, one insurer had three different indexed life policies. One included no such enhancements. The other two offered enhancements that differed for each policy:

Policy #1: When the policy begins its 10th year in force, the insurer credits 0.5% of the average monthly account value annually to a specified account. This enhancement is **guaranteed** to be paid.

Policy #2: When the policy begins its 10th year in force, the insurer *projects* that it will credit 1% of the average monthly account value annually to a specified account. The 1% amount, however, is **not guaranteed**, and if paid, may be more or less than the projection.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Liquidity

Cash Surrender Value & Charges

Like other insurance products, indexed life provides **liquidity** in various ways. One way is to surrender the policy for its cash surrender value—which means the insurance will cease. And, surrendering the policy can trigger surrender charges.

Key Ideas

- **Surrendering for cash surrender value**
- **Insurance coverage ceases**
- **Surrender charge may be assessed**

Cash surrender value means the total accumulations minus surrender charges and minus any indebtedness (such as the amount of a policy loan and any interest due on it).

A **surrender charge** is a specified amount that will be assessed against the cash value if the policy is surrendered during the surrender charge period, also specified in the policy.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Liquidity

Cash Surrender Value & Charges

The surrender period—the period during which a charge will be assessed—can vary greatly. It's not uncommon for the policy to have a surrender charge period of up to 20 years.

Surrender charges also vary. They are typically based on factors such as issue age, gender, face amount, risk class and policy duration.

Key Ideas

- **Surrender periods vary**
- **Surrender charges vary**
- **Surrender charges expressed as per $1,000 of face amount**
- **Charges typically decrease gradually**

Expressed as per $1,000 of the policy's face amount, surrender charges ordinarily decrease gradually over the surrender period.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Liquidity

Transfer Provisions

Indexed life insurance policies include **transfer provisions** that permit the policyowner to transfer funds from one strategy to another at certain times. The point at which a transfer can be made is typically when a particular segment term ends.

Key Ideas

- **Transfer funds to another strategy or strategies**
- **Transfers occur when the segment term ends**

For example, suppose the policy has a five-year indexed strategy. At the end of the five years, the policyowner may redirect the value of that account to another—or to more than one different account if preferred. If it's a one-year strategy, transfers may occur after one year when the segment term ends. The policyowner may also have the freedom to select what percentages of the segment will be directed to each new strategy.

On the other hand, *new* premiums can be directed to different strategies at any time. But, you cannot generally reallocate money within a segment until the end of the segment term.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Liquidity

Transfer Provisions

In most cases, **withdrawals** from the cash value are allowed after the policy has been in force for at least a year. It's typical for a charge to be made for each withdrawal. About $25 is a common administrative charge for withdrawals.

The **death benefit** and cash value will be reduced by the amount of the withdrawal.

And, if withdrawals from the indexed strategies are made before interest is credited, **no indexed earnings** will be credited to the withdrawn amount.

Key Ideas

- **Withdrawals permitted after one year**
- **Subject to charges**
- **Death benefit and cash value will be reduced**
- **No indexed earnings credited to withdrawn amount**

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Liquidity

Policy Loans: Fixed & Variable Rates

Another way to gain access to indexed life insurance values is through a **policy loan**. Most insurers offer loans with either a fixed rate or a variable rate. A few companies offer both. Which type is most advantageous depends on the particular client and the current economic climate.

Key Ideas

- **Fixed rate specified in policy**
- **Preferred loans may be available after specified period**
- **Preferred loans have a net rate of zero**

A **fixed rate** loan from an insurance policy involves an interest rate that is usually lower than loan rates in the marketplace. Currently, the range is from about 3% to 5%, but the actual percentage or range will be specified in the policy.

Some insurers offer a so-called preferred loan after the policy has been in force for a certain number of years. These loans result in a net interest rate of zero because they credit interest to the borrowed funds matching the interest rate charged on policy loans.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Liquidity

Policy Loans: Fixed & Variable Rates

A loan with a **variable interest rate** operates uniquely among types of insurance policy loans. The rate is based on the Moody's Corporate Bond Yield Average—Monthly Average Corporates—published by Moody's Investors Service. The loaned values continue to earn interest and will be credited with the indexed rate as determined on the interest crediting date—just as if the loan had not occurred.

Key Ideas

- **Loan rate based on Moody's rate**
- **Loaned funds continue to earn interest**
- **Potential for credited rate greater than loan rate**
- **Risk that credited rate will be lower than loan rate**

A variable rate loan is a good choice when the index is headed upward because the growth of the cash value may be greater than the actual loan interest charged by the insurer. However, if the index does not rise, it's likely that the interest credited will be lower than the loan rate. This is the risk of a variable rate loan.

By contrast to the variable interest rate, the annually declared or fixed loan rate is not based on an index. It is set each month by the insurance company and is effective for one year. Fixed loans tend to be less expensive when interest crediting is expected to be down or flat.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Liquidity

Policy Loans

Assuming the policy is not classified as a modified endowment contract (MEC), policy loans are **not taxed** as current income. Policy loans unpaid at the insured person's death will **reduce the death benefit** amount by the amount of the loan and any interest due.

Key Ideas

- **Loaned amounts typically not taxed**
- **Unpaid loans reduce death benefit**
- **Interest credited will be lower**

With a fixed rate loan, loaned values will typically be credited with a low guaranteed interest rate of about 2%.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Liquidity

Riders

A number of **riders** are available with indexed life insurance policies. Two common riders are:

Accelerated death benefit rider…allows a stipulated percentage of the death benefit up to a specified dollar amount to be accessed if the insured has a terminal illness—typically one where life expectancy is 12 months or less.

Key Ideas

- **Access to part of death benefit when a terminal illness is diagnosed**
- **Surrender charges waived for withdrawals under conditions specified in rider**
- **Usually available at no charge**

Waiver of surrender charges upon confinement…A specified amount or percentage of the cash value may be withdrawn without surrender charges if the insured is confined to a hospital or similar facility. The insured typically must be confined for a certain number of days before the waiver is triggered.

Many insurers make these two riders available with the indexed life policy at no additional cost.

Fixed Indexed Life Products

Indexed Life Insurance Compared to Indexed Annuities

Differences: Liquidity

Riders

Some additional riders that might be added include:

No-lapse guarantee…provides a guaranteed death benefit for the insured's lifetime. Some insurers offer this guarantee as a base policy benefit rather than as a rider.

Accidental death benefit…if an accident causes death, a payment is made in addition to the policy death benefit. This rider may expire at a certain age—65 is common.

Maturity date extension…extends the maturity date indefinitely, the policy being paid up when the insured reaches age 100. The cash value becomes the death benefit.

Waiver of stipulated premium…waives the monthly specified premium when the insured is deemed totally disabled. The monthly amount will be added to the accumulation value.

Waiver of monthly deductions…waives the monthly cost of insurance and other charges when the insured is totally disabled.

Guaranteed purchase option…allows the policyowner to buy additional amounts of insurance at certain attained ages without evidence of insurability.

Early or enhanced cash value rider…added at the time of policy issue, this rider provides higher values in the policy's early years, slightly lower values in later years.

Fixed Indexed Life Products

Policyowner Understanding of Indexed Life Policy Performance Illustrations: Agent Responsibilities under Model Regulation

Key Ideas

- An illustration is only a projection, not a guarantee
- NAIC Life Insurance Illustration Model Regulation governs use of illustrations
- Insurers and agents have responsibilities with respect to illustrations

A life insurance **illustration** is used to show a client how the policy an agent is proposing might potentially perform. It is only a *projection* and is definitely *not* a guarantee that the policy will perform in the manner shown in the illustration.

To help assure that illustrations are properly prepared and that they are properly explained to clients, the National Association of Insurance Commissioners (NAIC) has developed a **Life Insurance Illustration Model Regulation**. This Model has been generally adopted by the states. Both insurers and agents have **responsibilities** with respect to preparing and using illustrations as described in the Model.

Fixed Indexed Life Products

Policyowner Understanding of Indexed Life Policy Performance

Illustrations: Agent Responsibilities under Model Regulation

Every agent should be aware of the contents of the Illustration Model, which provides information about:

- Preparing illustrations
- Using illustrations only with policies filed to be used with illustrations
- Explaining the contents of the illustration
- Determining that the client understands that the illustrated figures are only projections
- Determining that the client understands the illustrated figures are not guaranteed
- Emphasizing to the client that certain elements of the illustration are likely to change over time
- Providing copies of illustrations and revised illustrations by the agent to both the applicant and the insurer

Key Ideas

- **Agents must know what is required of them under the Model**
- **Agents must be able to use illustrations as required in the Model**
- **Agents must be able to explain illustrated figures**
- **Agents must determine client understands significance of illustration**
- **Agents must provide copies to applicant and insurer**

Fixed Indexed Life Products

Policyowner Understanding of Indexed Life Policy Performance

Illustrations: Illustrated Rates for Crediting Strategies

Alternative Approaches

When an illustration is used with a policy, it must show a guideline rate to be illustrated for the indexed crediting strategies shown in the illustration. Insurers may use alternative approaches to developing the guideline rate.

Key Ideas

- **Guideline rate must be illustrated for indexed crediting strategies**
- **Alternative approaches to developing guideline rate**
- **Insurer provides information about data used to develop the rate**

Some insurance companies use an illustrated rate that does not vary by strategy and is not based on historical data, but which has been determined by some other means. There are no industry standards today for developing the guideline rate. For this reason, two different insurers might illustrate the same strategy using different rate caps and eventually credit exactly the same interest. Agents must consider such differences when comparing company illustrations to ensure they are comparing illustrations on the same bases.

Fixed Indexed Life Products

Policyowner Understanding of Indexed Life Policy Performance

Illustrations: Illustrated Rates for Crediting Strategies

Disclaimer & Actual Credited Rate vs. Illustrated Rate

On the indexed life policy illustration, a **disclaimer** must be included stating essentially:

> **Historical index performance does not represent future performance of the S&P 500 Index (or other index used), nor past or future indexed interest crediting rates.**

In addition to pointing out the disclaimer, it is an agent's responsibility to make clear that the **actual interest credited** to the policy will differ from the illustrated rate. It may be higher or lower, based on the actual index movement.

Fixed Indexed Life Products

Policyowner Understanding of Indexed Life Policy Performance

Illustrations: Best Practices

The term **best practices** as used by businesses, including insurers, refers in general to standardizing procedures and practices in order to:

Key Ideas

- **Standardization of procedures and practices**
- **Best practices evolve**
- **Client understanding**

- Better assure desired outcomes
- Improve and streamline business processes
- Eliminate or minimize costly errors
- Avoid inadvertently breaking the law and the resultant legal problems

It's important to remember that standardization does not necessarily result in a static condition. What constitutes best practices is constantly evolving as experience is gained and new technologies are developed.

The meaning of best practices in the context of insurance policy performance and the use of illustrations can be focused on what must occur to ensure that customers know what they are purchasing.

Fixed Indexed Life Products

Policyowner Understanding of Indexed Life Policy Performance

Illustrations: Best Practices

Before continuing, let's be sure certain terminology is clear by reviewing these terms. These definitions are based in part on the National Association of Insurance Commissioners Life Insurance Illustration Model Regulation.

Guaranteed elements are the premiums, benefits, values, credits and charges under a policy of life insurance that are guaranteed and determined at issue.

Non-guaranteed elements are the premiums, benefits, values, credits and charges under a policy of life insurance that are not guaranteed or not determined at issue, and which are subject to change.

Fixed Indexed Life Products

Policyowner Understanding of Indexed Life Policy Performance

Illustrations: Best Practices

Range of Results

Life insurance policy illustrations must include a **range of possible results** including guaranteed values, mid-point values, and current assumptions. These results are typically shown for five, 10 and 20 years and possibly other periods. Showing the range provides a more realistic view of how the policy can be expected to perform.

Key Ideas

- **Illustrations must show a range of possibilities**
- **Guaranteed values**
- **Mid-point values**
- **Current assumptions**

Guaranteed values are the elements we defined on the previous screen that are established at policy issue and will not change during the policy term.

Mid-point values are values shown on the illustration that result from averaging the current assumption rate and the guaranteed rate as well as policy charges that are at the midpoint between the guaranteed values and the current assumptions.

Current assumptions refer to the figures on the illustration showing the anticipated premium payments and the rates being paid currently by the insurer. Current rates are also referred to as assumed rates or illustrated rates.

Fixed Indexed Life Products

Policyowner Understanding of Indexed Life Policy Performance

Illustrations: Best Practices

Non-Guaranteed Elements

The NAIC Life Insurance Model Regulation requires that when **non-guaranteed elements** are shown on an illustration, they must be clearly identified as such, and guaranteed values must be shown as well. Information about non-guaranteed elements must include a reference to where the individual can find information about the guaranteed elements.

Key Ideas

- **Clearly identify non-guaranteed elements**
- **Show and refer to guaranteed values**
- **Include Model Regulation statements**

The model also requires that any "illustration of non-guaranteed elements must be accompanied by a statement indicating that:

a) The benefits and values are not guaranteed;
b) The assumptions on which they are based are subject to change by the insurer; and
c) Actual results may be more or less favorable."

The illustration must also include the following statement or one that is substantially similar:

> "This illustration assumes that the currently illustrated nonguaranteed elements will continue unchanged for all years shown. This is not likely to occur, and actual results may be more or less favorable than those shown."

Fixed Indexed Life Products

Policyowner Understanding of Indexed Life Policy Performance

Illustrations: Best Practices

In-Force Illustrations

An **in-force illustration** refers to an illustration that is prepared after the policy has been in force for at least a year.

Key Ideas

- **Available after one year**
- **Shows insurer's current projections**
- **Available once per policy year**

Agents should encourage policyowners to request such an illustration in order to examine the insurer's projections of current and future benefits and values based on current conditions. These are typically available once per policy year, but may be made available by some insurers more frequently.

Fixed Indexed Life Products

Policyowner Understanding of Indexed Life Policy Performance

Annual Statements

Key Information

Life insurance policies that use illustrations require the insurer to provide policyowners with annual reports of the status of their particular policies. An indexed universal life policy report typically must include at least this **key information**:

- The beginning and end date of the current report period;
- The policy value at the end of the previous report period and at the end of the current report period;
- The total amounts that have been credited or debited to the policy value during the current report period, identifying each by type (e.g., interest, mortality, expense and riders);
- The current death benefit at the end of the current report period on each life covered by the policy;
- The net cash surrender value of the policy as of the end of the current report period;
- The amount of outstanding loans, if any, as of the end of the current report period; and either
    - For fixed premium policies: If, assuming guaranteed interest, mortality and expense loads and continued scheduled premium payments, the policy's net cash surrender value is such that it would not maintain insurance in force until the end of the next reporting period, a notice to this effect shall be included in the report; or
    - For flexible premium policies: If, assuming guaranteed interest, mortality and expense loads, the policy's net cash surrender value will not maintain insurance in force until the end of the next reporting period unless further premium payments are made, a notice to this effect shall be included in the report.

In addition, indexed policy reports include information about all of the individual segments currently in place for the particular policy, and how the above information applies to each segment.

Fixed Indexed Life Products

Policyowner Understanding of Indexed Life Policy Performance

Annual Statements

Timing Relative to Indexed Interest Crediting

The annual statements are provided each year on the policy's anniversary date. For this reason, any given report will show only the earnings credited to the various segments during that policy year.

Because **indexed interest crediting** occurs on the anniversary of the segment—not on the anniversary of the policy—the statement might not show any crediting for a particular segment. Why? Because the segment anniversary and the policy anniversary are not necessarily the same date, only the credits made during the policy year will be shown.

This is another good reason for an individual to request an in-force illustration later on in order to see earnings that were credited to other segments. In fact, when no in-force illustration is included with the annual report, the insurer must include a statement to the effect that one may be requested annually.

Key Ideas

- **Only interest credited to segments during policy year will be shown**
- **Policy anniversary and segment anniversary may not be the same**
- **Illustration for unreported segment credits can be requested**

Fixed Indexed Life Products

Policyowner Understanding of Indexed Life Policy Performance

Annual Statements

Importance of Annual Follow-Up

Policies such as indexed policies that have a number of variable elements should be monitored on a regular basis to determine if the policy is performing as desired. Because non-guaranteed elements can change, agents must be aware of the **importance of annual follow-up** with the policyowner.

Key Ideas

- **Elements of policy can change**
- **Adverse changes must be noted**
- **Agent follow-up important**

The annual statement is one form of follow-up required by law, and the law specifically describes a notice that must be included to warn of possible negative effects. The insurer must provide what the law calls a "prominently displayed" notice of any adverse changes in non-guaranteed elements that can affect the policy negatively. In addition, the insurer must notify the policyowner if the cash value has dwindled too much to keep the policy in force until the next reporting period.

Delivery of the annual statement is a prime opportunity for agents to follow up and be certain the policyowner understands the significance of the report.

Fixed Indexed Life Products

Policyowner Understanding of Indexed Life Policy Performance

Full Contract Disclosure

Excess Interest & Death Benefits

The agent must be able to help the policyowner read and understand how an indexed life insurance policy performs through the **full contract disclosures** required by law. Here are some of the key points.

Key Ideas

- **Application of excess interest credits**
- **Death benefit guarantees**

The contract must fully disclose (and agents must be able to explain) the application of **excess interest credits**—how the performance of each index is calculated and how the insurer's participation rate and cap rate affect the index gain that is added to each segment.

Depending on the type of policy, the amount of the **death benefit** may or may not be guaranteed. The policy must be clear about the circumstances under which a guaranteed death benefit amount will be paid. Of course, there must always be a death benefit in order for the policy to retain its insurance character. As you know, depending on the death benefit option selected, there is the potential, but not a guarantee, for the death benefit to increase.

Fixed Indexed Life Products

Policyowner Understanding of Indexed Life Policy Performance

Full Contract Disclosure

Liquidity & Signed Illustrations

Additional disclosures include the following.

Policyowners must be made aware of the **liquidity** options available to them through policy loans and surrender of the policy. They must also know the consequences, positive and negative, of such measures.

Key Ideas

- **Liquidity through loans or policy surrender**
- **Illustration must be signed by applicant and agent**

Some disclosures are included with the illustration. As a result, when an illustration is used, a **signed illustration** must be obtained. Both the policyowner and the agent must sign. The law provides that wording substantially similar to the following must be used:

Signed by the policyowner or applicant:

> "I have received a copy of this illustration and understand that any non-guaranteed elements illustrated are subject to change and could be either higher or lower. The agent has told me they are not guaranteed."

Signed by the agent or other representative of the insurer:

> "I certify that this illustration has been presented to the applicant and that I have explained that any non-guaranteed elements illustrated are subject to change. I have made no statements that are inconsistent with the illustration."

Suitability & Marketing Practices

NAIC Suitability in Annuity Transactions Model Regulation

Purpose of Regulation

The National Association of Insurance Commissioners (NAIC) has developed a model regulation addressing issues that have arisen with respect to annuities. This regulation, known as the **NAIC Suitability in Annuity Transactions Model Regulation**, provides a model that state insurance departments may adopt or amend to conform to state laws. Historically, most states adopt and/or rework model regulations the NAIC develops.

Key Ideas

- **NAIC develops model regulation**
- **States can adopt and/or amend**
- **Purpose: conduct appropriate annuity transactions**

The purpose, according to the regulation, is to:

> "…set forth standards and procedures for recommendations to consumers that result in transactions involving annuity products so that the insurance needs and financial objectives of consumers at the time of the transaction are appropriately addressed."

Suitability & Marketing Practices

NAIC Suitability in Annuity Transactions Model Regulation

State Codes: Suitability

In states where the NAIC model is adopted, the state laws are often modeled closely, if not identically. For example, a state's insurance code might state specifically:

Key Ideas

- **Suitable recommendation**
- **System to monitor recommendations for compliance**
- **Rules for implementation**

1. A person shall not recommend to any individual the purchase, sale, or exchange of any annuity contract, or any rider, endorsement, or amendment thereto, unless the person has reasonable grounds to believe that the recommendation is suitable for the individual based on a reasonable inquiry into the individual's financial status, investment objectives, and other relevant information.

2. A person engaged in the business of annuities shall establish and maintain a system to monitor recommendations designed to ensure compliance with state law.

3. The commissioner shall adopt rules establishing procedures and standards for implementation of the suitability requirements.

Suitability & Marketing Practices

NAIC Suitability in Annuity Transactions Model Regulation

Duties of Insurers and Insurance Producers

The NAIC model sets forth some specific and detailed duties of insurers and insurance producers, including these:

- An agent who recommends that a consumer purchase or exchange an annuity resulting in another or a series of insurance transactions must have reason to believe the recommendation is suitable based on information provided by the consumer.
- Before executing the transaction, the insurer or producer must attempt to acquire information about the consumer's suitability. Suitability information includes age; income; financial situation and needs, including resources used to fund the annuity; financial experience, objectives and time horizon; intended use of the annuity; existing assets, including investments and life insurance; liquidity needs; liquid net worth; risk tolerance; and tax status.
- Insurers and producers have no obligations to the consumer if no recommendation is made (whether due to the consumer's refusal to provide suitability information or for any other reason), if the recommendation is later found to have been based on inaccurate information provided by the consumer, or if the consumer's annuity purchase is not based on the recommendation of the insurer or producer.

Continue to the next screen for more information about duties.

Suitability & Marketing Practices

NAIC Suitability in Annuity Transactions Model Regulation

Duties of Insurers and Insurance Producers

More duties:

- Insurers must establish a system to supervise annuity recommendations in order to achieve compliance with the regulation.
- Insurers must inform producers of the requirements of the regulation, including standards for product training and annuity suitability training.
- Insurers must review each recommendation prior to issuance of an annuity to ensure that there is a reasonable basis to determine that the recommendation is suitable.
- Insurers must maintain reasonable procedures to detect recommendations that are not suitable.
- Insurers must implement procedures to detect transactions that replace existing policies or contracts that have not been reported as replacements by the applicant or producer.
- Insurers may contract with a third party to establish and maintain the system.
- Insurers must monitor the third party to ensure that functions are being performed as required.

Continue to the next screen for more information about duties.

Suitability & Marketing Practices

NAIC Suitability in Annuity Transactions Model Regulation

Duties of Insurers and Insurance Producers

Here is more information.

- Insurers, general agents and independent agencies are not required to review all insurance producer solicited transactions.
- Insurers, general agents and independent agencies are not required to include in the system producer recommendations other than annuities offered by the insurer, general agent or independent agency.
- Upon insurer’s request, a general agent or independent agency must provide the required certification that the third party functions are being properly performed.
- Certification must be provided only by a senior manager responsible for the functions and only if the manager has a reasonable basis for making the certification.

Suitability & Marketing Practices

NAIC Suitability in Annuity Transactions Model Regulation

Mitigation of Responsibility

With respect to violations of the regulation, the commissioner may order:

- An insurer to take appropriate corrective action for a consumer harmed by a violation by the insurer or producer.
- A producer to take appropriate corrective action for a consumer harmed by the producer's violation of the regulation.
- A general or independent agency that employs producers to sell or solicit annuities to take appropriate corrective action for a consumer harmed by the producer's violation.

In addition, penalties for violations may be reduced or eliminated if corrective action was taken promptly after the violation was discovered.

Suitability & Marketing Practices

NAIC Suitability in Annuity Transactions Model Regulation

Additional provisions of the model include:

- **Scope of regulation**
- **Authority**
- **Exemptions**
- **Definitions**
- **Recordkeeping**
- **State references**

This model regulation includes other provisions with respect to the scope of the regulation, authority for implementing it, exemptions, definitions and recordkeeping.

Typically, NAIC model regulations adopted by the states are amended to include references to particular state laws. Additional changes are permitted as well.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need to Gather & Use Information before Recommendations

Why is it so important for producers to **determine client suitability** for indexed products? Aside from the fact that there is a legal requirement to do so, it is vital for producers to **gather information** about their potential clients and **use that information before recommending a purchase** because certain features of indexed products make them more suitable for some clients than for others.

Key Ideas

- **Indexed products not suitable for everyone**
- **Adequately informed clients are vital**

Gathering and thoroughly analyzing the required information can help reduce the chance that legal issues will arise from clients who decide they were not adequately informed before purchasing indexed products.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need to Gather & Use Information before Recommendations

Financial Experience

While it is true that suitability is important in any insurance product transaction, indexed products in general operate somewhat differently from traditional products, and annuity products specifically include some complex features.

Insurers typically provide guidelines and a suitability questionnaire for producers to use in making suitability determinations.

Key Ideas

- **Annuities specifically require attention**
- **Insurer guidelines/suitability questionnaires**
- **Financial experience plays a central role in understanding indexed annuity contracts**

In addition, financial experience will greatly affect a prospect's understanding of indexed annuity features. Prospects without financial experience will require that you take more time to carefully explain all of the features and benefits of the annuity contract. Not only do you want to make certain an annuity is suitable for a particular individual, you want to be sure that prospects are never surprised by a particular feature of an annuity contract down the road. For example, if a consumer does not understand the difference between tax free and tax deferred, he or she could be in for a shock when earnings are distributed and income taxes are due on those amounts.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need to Gather & Use Information before Recommendations

Financial Status & Liquidity Needs

A **consumer's financial status** begins with information about both available income and liquid assets.

Key Ideas

- **Income**
- **Liquid assets**

Income is any money that the individual receives on a regular basis. This can include employment wages, investment income, Social Security payments, disability payments, and others.

Liquid assets are any assets owned by the individual that are readily convertible to cash. Not all of a prospect's existing assets will count toward their liquid net worth. For example, real estate is not a liquid asset—it is difficult to sell quickly for full value. Even among liquid assets, liquidity levels will vary. CDs are considered liquid assets, although their liquidity is restricted. Securities are liquid assets, but some securities may be difficult to sell, or the consumer may not want to sell them for a loss in a down market.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need to Gather & Use Information before Recommendations

Financial Status & Liquidity Needs

However, just determining the amount of income and assets the potential client has is not enough. How money is currently being used and whether it is adequate to make additional purchases is the key to suitability with respect to finances. To determine liquidity needs, suitability forms typically include questions such as:

Key Ideas

- **Determine liquidity needs**
- **Determine income and assets**
- **Determine usage now and in the future**

1. How much of your income is being used to pay current bills?
2. How much is discretionary?
3. Is emergency money available for immediate use if you should need it?
4. Are you going to need to use any of your accumulated savings soon?
5. Is money available to pay for this insurance product?

Remember, with annuities, surrender charges apply if the owner should need access to the funds in excess of any free withdrawal provision before the surrender charge period expires. In addition, withdrawals can trigger penalties before the owner reaches age 59½.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need to Gather & Use Information before Recommendations

Tax Status

The consumer's **tax status** is also important during the annuity accumulation period and at payout during the distribution period. During the accumulation period, the higher the tax bracket, the more valuable the tax deferral is. A producer can easily learn about the purchaser's tax bracket at the time of purchase.

Key Ideas

- **After-tax versus pre-tax dollars**
- **Timing of payout**
- **Tax bracket**

You will recall that because annuities (other than tax-qualified annuities) are purchased with after-tax dollars, only the interest credited to the annuity is taxable during the distribution period. This means part of each annuity payment will be taxed and part of it is nontaxable as you learned earlier. If the annuity is tax-qualified, each payment to the annuitant is fully taxable because no taxes have been paid on the premium deposits.

Annuities are often paid out when the annuitant has retired and is no longer receiving income from employment. This situation might place the annuitant in a lower tax bracket, which is a better time to be paying taxes. Of course, the future tax bracket can't be known at the time the annuity is sold.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need to Gather & Use Information before Recommendations

Investment Objectives and Risk Tolerance

Key Ideas

- **Compatibility of objectives and risk tolerance**
- **Clearly identify objectives**
- **Consider risk tolerance**

Another step toward making a suitable recommendation is determining the consumer's **investment objectives**. Along with this consideration is measuring the individual's **risk tolerance**. In some cases, the desired objectives and the tolerance for risk are not compatible. For example, an individual's stated objective might be to acquire a certain number of dollars by a certain date. However, if the individual has a low tolerance for risk, this might be impossible given the timeline stipulated. (Although there are other types of risk, we are dealing here with the risk of loss of principal only.)

Therefore, no recommendation should be made without getting the client to clearly identify his or her investment objectives—such as modest or aggressive growth, regular income, preservation of principal, or whatever it is.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need to Gather & Use Information before Recommendations

Investment Objectives and Risk Tolerance

When the investment objective is known and risk tolerance is considered, producers might need to provide an explanation of the relationship between risk and reward. It can be simply stated like this:

Key Ideas

- **Clearly identify risk tolerance**
- **Risk-rewards relationship**

The greater the risk, the better the potential for greater rewards

versus

The lower the risk, the more likely the rewards will also be lower

No recommendation should be made until you are certain the prospective client understands this.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need to Gather & Use Information before Recommendations

Time Horizon

Another important element is the individual's **time horizon**—that is, how much time does the individual have to accomplish the objectives?

Key Ideas

- **Length of time to accomplish objectives**
- **Annuities not suitable for short time horizon**

For example, if a prospect will need to begin using the money being considered for premium payment within perhaps as soon as 12 months, an annuity is definitely **not** suitable—surrender charges will erode the principal.

On the other hand, an individual who hopes to leave account values untouched for 20 years or more might be a candidate for either an annuity or a life insurance policy (depending upon how other suitability characteristics come into play).

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need to Gather & Use Information before Recommendations

Intended Use

Understanding your prospect's **intended use** of a recommended annuity is also essential. As such, "intended use" encompasses much of the information we've already discussed. In essence, it means determining if an annuity and all of its key features—tax-deferred growth, annuitization, death or living benefits—are suitable for the client.

Key Ideas

- **Intended use of the annuity is key to determining suitability**
- **Look at annuity as a whole, not just one aspect or benefit**

For example, let's say an elderly prospect has a CD that is coming due and your product offers a better return. If the prospect's intended use is not for long-term savings and a guaranteed income stream, then an annuity would not be suitable. Furthermore, an annuity would not be suitable for prospects who need liquidity to meet unforeseen emergencies over the next several years.

In the NAIC's own words, producers must ensure that, "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 [all] suitable."

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need to Gather & Use Information before Recommendations

Other Information: Pre-Retirement or Post-Retirement Age

The prospect's **age** is another key piece of information, including whether he or she is in the **pre-retirement** or **post-retirement** stage of life. This terminology is somewhat indeterminate, of course, especially with older people staying in the work force longer than ever.

Key Ideas

- **Age at time of suitability analysis**
- **Indeterminate number of years before and after retirement**
- **Use of actuarial tables**

Rather than a specific number of years, think of pre-retirement as some period before the individual intends to retire, when the individual has several income-earning years remaining. Post-retirement refers to the number of years an individual might live without earning income—impossible to know for certain, but a number that can be obtained from actuarial tables.

The issue of age can be especially pertinent with respect to the surrender charge period in an annuity. An older person might be more likely to die than to survive this period. In this case, the annuity is certainly not a good idea for an older individual who will need the funds for income sooner than the end of the period. In addition, some contracts do not waive surrender charges even if the individual dies, so the charge would be deducted before the proceeds pass along to any beneficiaries.

With this type of information analyzed along with other suitability data such as investment objectives and risk tolerance, it's possible to determine what products are and are not suitable for a particular client.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need to Gather & Use Information before Recommendations

Other Information: Financial Concerns

Other information to be gathered includes the individual's **financial concerns** with respect to:

- **Social Security**…how much income does the individual expect to replace with Social Security payments?
- **Retirement plan distributions**…will they be paid in a lump sum or in installments?
- **Investing retirement assets**…should the money be placed in a "safe" place? Invested? Rolled over?

All of these considerations help form a "snapshot" of the individual's potential retirement situation, and again help to make a suitable recommendation.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need to Gather & Use Information before Recommendations

Other Information: Health

The individual's **health** is another important consideration. Of course, if health is very poor, life insurance might not be an option at any cost. On the other hand, given a long enough time horizon, an annuity might be able to ensure that money will be available to help cover costs associated with health care as the individual grows older.

Key Ideas

- **Life insurance unlikely when health is very poor**
- **Annuities might provide needed cash for future health care costs**
- **Deferred annuity not suitable if there are immediate cash needs**
- **Immediate annuity might be suitable**

However, if such cash is needed immediately for health care, a deferred annuity is not suitable, considering the surrender period and accompanying charges if cash is needed soon. An immediate annuity might be suitable depending on the circumstances.

Of course, it's also important to determine whether the individual has long-term care insurance in place. Long-term care insurance lessens the risk that an individual would need immediate cash to pay for the cost of nursing home care. If a potential buyer has neither long-term care insurance nor an emergency fund or other liquid assets (available to pay the costs of long-term care), an annuity purchase is not advisable.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need to Gather & Use Information before Recommendations

Other Information: Access to Account Value

Producers should be prepared to discuss with the potential buyer how he or she may gain access to account values. If these options are not satisfactory to the prospect, the product may not be suitable.

We have previously discussed the following ways to access account values. You can refer to the sections below to review.

- **Required minimum distributions…**
  Click here to view discussion in Annuity Advantages & Disadvantages
- **Free withdrawals…**
  Click here to view discussion in Annuity Contract Provisions
- **Withdrawals in excess of free amount…**
  Click here to view discussion in Annuity Contract Provisions
- **Full surrender…**
  Click here to view discussion in Annuity Contract Provisions
- **Annuitization…**
  Click here to view discussion in Annuity Contract Provisions

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need for Full Contract Disclosure

Individual states typically require that certain **contract disclosures** must be made with respect to annuities. For example, one such law might state:

> **"The rules specify the minimum information which must be disclosed and the method for disclosing it in connection with the sale of annuity contracts. The goal of these rules is to ensure that purchasers of annuity contracts understand certain basic features of annuity contracts."**

Key Ideas

- **Code requires minimum disclosures**
- **Assist client understanding of annuities**
- **Help insurers, producers meet suitability requirements**

The intent to help consumers understand annuities is all part of the suitability issue and assisting clients in making good choices based on a producer's good recommendations.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need for Full Contract Disclosure

Disclosure Contents

Most states also require, at a minimum, that the following information must be included in the disclosure document:

1. The generic name of the contract, the company product name (if different) and form number, and the fact that it is an annuity
2. The insurer's name and address
3. A description of the contract and its benefits, emphasizing its long-term nature, including examples where appropriate
4. Specific dollar amount or percentage charges and fees, listed with an explanation of how they apply
5. Information about the current guaranteed rate for new contracts that contains a clear notice that the rate is subject to change

The law requires the insurer to define terms used in the disclosure in "language that facilitates understanding by a typical individual within the segment of the public to which the disclosure statement is directed."

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need for Full Contract Disclosure

Disclosure Contents

The third item includes specific information that must be included at a minimum. This item calls for a description of the contract and its benefits, emphasizing its long-term nature, including examples where appropriate, including but not limited to these items as quoted from the rules:

“**a)** The guaranteed, non-guaranteed and determinable elements of the contract, and the limitations of those elements, if any, and an explanation of how the elements and limitations operate;

b) An explanation of the initial crediting rate, specifying any bonus or introductory portion, the duration of the rate and the fact that rates may change from time to time and are not guaranteed;

c) Periodic income options both on a guaranteed and non-guaranteed basis;

d) Any value reductions caused by withdrawals from or surrender of the contract;

e) How values in the contract can be accessed;

f) The death benefit, if available, and how it will be calculated;

g) A summary of the federal tax status of the contract and any penalties applicable on withdrawal of values from the contract; and

h) Impact of any rider, such as a long-term care rider”

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need for Full Contract Disclosure

Disclosure Contents

The suitability guidelines are intended to ensure that producers make careful recommendations and individuals understand exactly what they're buying when they make an annuity purchase. To that end, it is also necessary to provide full disclosure of all the various features of any annuity recommended for purchase, including:

- The surrender period and applicable surrender charges
- The tax penalty if the consumer sells, replaces, surrenders, or annuitizes the annuity
- Mortality and expense fees associated with the contract
- Investment advisory fees
- Features of all selected riders
- Limitations that apply to interest returns
- All insurance and investment components
- Market risk that is associated with the annuity

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need for Full Contract Disclosure

Delivery Standards

Insurers or producers must deliver the required disclosures to annuity applicants in a timely fashion, typically before or at the time the application is made. If the application isn't taken by a producer in a face-to-face interview, the insurer must send the disclosures no later than five business days after the insurer receives the application.

Key Ideas

- **Delivered at or before application in face-to-face interview**
- **Delivered within five business days of application receipt by insurer**
- **Direct mail requires mailing to include disclosures**
- **Internet applications require disclosures to be made available on web site**

Applications resulting from a direct mail solicitation require the insurer to include disclosures with the mailing soliciting annuity applications. When an application is received by the insurer through the Internet, compliance requires the insurer to make the disclosures available on the insurer's web site.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need for Full Contract Disclosure

Buyer's Guide

A Buyer's Guide to Fixed Deferred Annuities must also be included with the disclosures. The National Association of Insurance Commissioners (NAIC) provides the required format, or the Buyer's Guide may be in language the insurance commissioner has approved.

Key Ideas

- **Buyer's Guide included with disclosures**
- **Free-look period may be required**

If the required documents are not provided to the applicant before or at the time the application is made, the applicant must be allowed a free look period of at least 15 days to examine the documents and the annuity and return the annuity if desired.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Need for Complete Record Keeping

The law requires records to be kept with respect to any insurance transaction, and **complete record keeping** is especially pertinent with indexed products, which are subject to many structural factors. In addition, records of questions asked and answered (or answers refused by the applicant) are important in the suitability determination and potentially in defense of the agent's recommendations.

Key Ideas

- **Record keeping required by law**
- **Important in recording suitability decisions**
- **Records kept for 10 years**
- **Insurers may maintain producer records**

States typically require that information used in making insurance transactions be kept for a specific number of years, perhaps 10, after the transaction was completed. Insurers, general agents, independent agencies and producers must keep records, but insurers are allowed if desired to maintain records for producers.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Replacements and Exchanges

Definitions

Key Ideas

- Exchange or replacement may ensure better benefits
- Exchange or replacement may offer lower costs

A **replacement** involves the purchase of a new policy where the producer knows or should know that the purchase involves the surrender, partial surrender, forfeit, lapse or termination of an old policy. Replacement also encompasses the reissue of a policy with a reduction in cash value, or a financed annuity purchase (where the new policy is purchased using funds obtained by withdrawing or surrendering the values in an existing policy, or by borrowing against these values).

An **exchange** is the tax-free exchange of one annuity contract for another, also known as a 1035 exchange. The owner and annuitant must remain the same if the exchange is to remain tax free.

A new contract may be beneficial if it offers more investment options or higher rates of return at less expense than the consumer's current contract. The new contract might also offer enhanced death or living benefits.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Replacements and Exchanges

Determining Suitability

While there are potential benefits to a new policy, some agents have made a practice of recommending unsuitable or unnecessary replacements or exchanges simply to generate additional commissions. Because of these abuses, replacement and exchange transactions are now subject to a higher level of scrutiny. Therefore, it is very important for producers to **determine client suitability** for any replacement or exchange of an annuity.

The producer must consider whether the exchange or replacement will subject the consumer to:

- a surrender charge,
- commencement of a new surrender period,
- loss of existing benefits, or
- increased fees, investment advisory fees, or charges for riders and similar product enhancements.

The producer must weigh all of these negatives against real benefits that the consumer would gain through product enhancements and improvements in the new annuity contract. In light of new acquisition costs, even a clearly superior new policy may not be financially better for a client until many, many years have passed.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Replacements and Exchanges

Suitability Information

To determine client suitability for any exchange or replacement of an annuity (as with the purchase of any annuity), the producer is required to make reasonable efforts to obtain and review the consumer's **suitability information**.

Key Ideas

- **Obtain and review consumer suitability information**
- **Look at previous exchanges or replacements**
- **Determine if replacement or exchange is in the consumer's best**

The producer must obtain a signed statement from the applicant stating whether or not the applicant has existing policies or contracts. The producer must also sign this statement. If there are other policies or contracts, the producer must determine whether the consumer has exchanged or replaced another annuity (in particular, "has another exchange or replacement transaction taken place" in the preceding 36 months).

Producers may only recommend a replacement or exchange if, after evaluating the consumer's finances, needs, and risk tolerance, the producer determines such a replacement or exchange is in the consumer's best interest.

Suitability & Marketing Practices

Importance of Determining Client Suitability for Annuity Products

Replacements and Exchanges

Disclosure

In states that have adopted replacement regulations, producers are required by those regulations to provide **disclosure** to all applicants in the form of the “Notice Regarding Replacement.” This notice must be:

- Read aloud, if the consumer wishes
- Signed by both the applicant and the producer
- Left with the applicant (or a copy mailed to the applicant, in the case of an electronic Notice)

In most states, this Notice must (1) list all life insurance policies or annuities the producer intends to replace, and (2) indicate whether the producer intends to use cash values in existing contract(s) as a source of financing for the new policy or contract.

In the case of a replacement transaction, the producer must also leave all sales material with the applicant at the time of application. All required statements and notices must be submitted to the insurer with the appropriate signatures.

An insurer or producer who fails to comply with any of the regulations regarding replacement or exchange is subject to sanctions and penalties.

Suitability & Marketing Practices

Appropriate Sales Practices

Guaranty Association

Each state has a guaranty association. Every insurer licensed to sell life, accident or health insurance or annuities in the state is a member of the association. If one member becomes insolvent and the court orders a liquidation, the guaranty association provides protection for the affected policyholders.

Key Ideas

- **Each state has a guaranty association with all licensed insurers as members**
- **Guaranty associations protect policyholders in the event of an insurer insolvency**
- **Producers may not use this information as part of the sale**

Covered policies generally include individual or direct group life and health insurance policies and individual annuity contracts, within the limits that are spelled out by individual state guaranty associations. For example, the non-guaranteed portion of a variable annuity or variable life insurance contract, where the policyholder bears the risk, is not usually covered by the guaranty association.

This information would certainly ease the mind of a prospect who expressed concerns about the future financial stability of an insurer. However, be aware that in most states, you may not use this information as part of the sale. Read on for more details.

Suitability & Marketing Practices

Appropriate Sales Practices

Guaranty Association

Many states have laws prohibiting insurers and producers from using the existence of the guaranty association in their advertising, or in any attempt to induce someone to purchase a life insurance or annuity contract.

Key Ideas

- **Guaranty association provides emergency-only protection**
- **Consumers must select insurers carefully without counting on back-up protection**

Regardless of your state's laws, the existence of this emergency-only protection is not intended to be a substitute for the careful selection of a strong and financially stable insurance company.

Suitability & Marketing Practices

Appropriate Sales Practices

Misrepresentation

It is unfair and deceptive to make or issue an estimate, illustration, circular or other statement that misrepresents:

- The terms of a policy or contract
- The promised benefits or advantages of a policy or contract
- The dividends or share of surplus to be received (or the dividends or share of surplus received on a similar policy or contract)
- The financial condition of the insurer offering the policy or contract

Key Ideas

- **Do not misrepresent terms, benefits or dividends**
- **Do not misrepresent the financial condition of the insurer**

The name, title or class of a policy must also fairly represent the true nature of the policy.

Producers may not present an application to an insurer knowing that it contains false or misleading information. Producers also may not misrepresent any facts with the intention of inducing a policyholder to allow an existing policy to lapse or to forfeit or surrender a policy.

Suitability & Marketing Practices

Appropriate Sales Practices

Other Illegal Sales Practices

Other illegal sales practices include:

- False advertising
- Defamation of another insurer
- Boycott, coercion or intimidation
- False financial statements
- Prohibited rebates and inducements
- Unfair discrimination between individuals of the same class and equal life expectancy
- Deceptive names, symbols or slogans
- Unfair settlement practices

It is **not** illegal for a life insurance or life annuity contract to pay a bonus to a policyholder or otherwise reduce the policyholder's premiums out of the insurer's surplus, as long as the bonus or abatement is fair and equitable and in the best interests of both policyholders and the insurer.

It is **not** illegal for a life annuity contract to waive surrender charges when the contract holder exchanges the contract for another contract issued by the same insurer.

Suitability & Marketing Practices

Needs-Based Selling for Life Insurance

Key Ideas

- **Life insurance need is primary**
- **Need is the primary purpose of life insurance**

Whether indexed or not, life insurance should never be sold unless the producer has determined there is actually a need for life insurance.

Needs-based selling means that, no matter what financial expectations an individual might have for an indexed life insurance policy, the primary purpose of the policy is to provide life insurance to fill a need. If there is no demonstrable need for life insurance, it is probably not appropriate.

Suitability & Marketing Practices

Needs-Based Selling for Life Insurance

Two important elements of needs-based selling that every producer must examine are:

- **Financial underwriting issues**…does the individual have unmet financial needs that can be satisfied by the purchase of a life insurance policy and does the individual have discretionary income to purchase the policy?
- **Insurable interest**…does the individual purchasing the policy have an insurable interest in the life of the person to be insured, that is, will the individual suffer a loss if the insured person should die prematurely?

Answering these questions will help establish the need for the life insurance protection being recommended and whether or not the policy is suitable for the individual involved.

Special Issues for Senior Consumers

Product Complexity

As the life expectancies of seniors in the U.S. continue to expand, the **complexity of insurance products** being offered to older consumers has come under close scrutiny by insurance regulators.

Key Ideas

- **Complex products scrutinized**
- **Seniors want to understand the product**

While not strictly a concern for older people, there is some evidence that seniors, more than the younger population, need and want a full explanation of any product being considered. They want—and are entitled to—a clear understanding of the advantages and disadvantages before they make a purchasing decision.

Special Issues for Senior Consumers

Product Complexity

Because insurance products have become quite complex—and indexed products are certainly an example of that complexity—seniors must look to insurance professionals for information. Producers must, therefore, be prepared to explain the many facts included in this training course, and ask the proper questions to be certain prospective purchasers understand.

Key Ideas

- **Producers must help seniors understand complex products**
- **Prospective purchasers must indicate understanding**
- **Downsides must be explained as clearly as advantages**

For example, on the surface, the idea supporting an indexed annuity seems fairly simple: Instead of settling for a conservative declared interest rate, the owner can link to an equity index that has a greater chance of earning at an increased rate. On this basis, there is essentially no downside—no chance of losing principal as would be the case with the actual purchase of equities.

However, you've learned that there is nothing simple about indexed products. They include numerous moving parts and structural elements that can greatly impact the interest crediting for indexed products. Prematurely withdrawing money or surrendering all or part of an indexed annuity or a life insurance policy can trigger substantial penalties.

It is elements such as these that producers must pay special attention to when explaining how products work and in making the required disclosures to consumers.

Special Issues for Senior Consumers

Buyer Competence

Buyer competence is an issue that is more likely to arise with elderly consumers. People joke about short-term memory loss, and it is a demonstrated fact that memory can suffer as people age. However, dramatic memory loss is not a normal consequence of aging—it is typically associated with disease such as Alzheimer's disease and dementia. Often, people who recognize they have memory loss compensate for it in some way but do not necessarily have a disease.

Key Ideas

- **Memory may suffer with aging**
- **Short-term memory loss may not be serious**
- **Use indicators to help judge competence**

While you should not make a medical diagnosis regarding the buyer's competence, you can watch for signs of mental impairment, such as the following indicators:

- Memory lapses, especially regarding the individual's own property or estate plan
- Extreme disorganization beyond usual norms
- Mistakes in basic math calculations
- General confusion, or confusion related to the understanding of basic terms and concepts, especially after repeated explanations
- Difficulty concentrating or following the conversation

If you have any doubt about an individual's ability to understand what you are selling, do not recommend the sale without consulting the insurer.

Special Issues for Senior Consumers

Ethics & Compliance Issues

Key Ideas

- **State law and court cases establish requirements**
- **Vital issues in fiduciary relationships**
- **Many states have producer ethics requirements**
- **Seniors more vulnerable to unethical treatment**
- **Severe penalties can apply**

Insurers and producers have become accustomed to dealing with both **ethics and compliance issues** with respect to marketing their products. State legislatures and the courts increasingly require certain minimum requirements to be met in relationships such as insurance transactions, where fiduciary responsibilities are significant.

The letter of the law, of course, is not the only consideration. Again, state insurance departments have increasingly recognized the need to deal specifically with the ethical aspects of insurance transactions. Many states now have a separate ethics study requirement for insurance producers.

While these issues are important in any transaction, insurance producers should be very careful in transactions with older consumers that their ethics are never questionable. Older people are more vulnerable to being taken advantage of by unethical agents. In most cases, such agents have been found not only to have behaved unethically but also illegally. The penalties can be severe, including large monetary fines and imprisonment.

New Developments in Indexed Products

Both indexed annuities and indexed life insurance have undergone numerous changes since the indexed elements were first added to these products. It is likely new features will continue to be developed. Recent innovations include:

- New methods of applying participation and cap rates
- Guaranteed minimums on participation rates
- Guarantees that the participation rate will never change during the life of the product
- Special inflation protection features
- An annuity that's been characterized as a cross between a variable annuity and an indexed annuity purchased with a single premium that is allocated between a fixed account and an indexed account
- Potential for increasing annuity income with higher interest rates when a certain benchmark index reaches a specified level at a time specified in the contract
- New commission structures for producers and brokers

The insurance industry has repeatedly demonstrated it is responsive to needs expressed by consumers with respect to insurance products. The innovations that may appear in the future will be driven by both consumer requests and insurer creativity.

Final Exam

REMEMBER:

1. To fulfill Sagicor's company-mandated training requirement, please complete the exam and your results will be sent to our Agent Training Department. If you have any questions regarding this or any other Sagicor training requirements, please call us at 888-SAGICOR (724-4267). WARNING: **PRINT, SIGN & DATE YOUR RESULTS PAGE AT THE CONCLUSION OF THIS EXAM… Your printout will serve as the ONLY proof of completion in the event our automated notification system fails.**
2. Active X and/or Flash add-on may be required. Depending on your browser and security settings, you may see a Security Warning dialogue box. If so, click "Install" or "Allow" to install the appropriate add-on.
3. This course may also be used for Continuing Education credit in some states. (Please note: CE credit is available in your resident state only. Not applicable to non-resident licenses.) If you are a resident of a state that requires a monitored exam, STOP: Your monitor must complete an affidavit of personal responsibility before you access the exam. (Click here for a list of participating states, required forms and further instructions.)
4. **CO**, **CT**, **DC**, **IA**, **IL**, **IN**, **KY**, **MD**, **ND**, **OK**, **OR**, **RI**, **SC**, **TX**, **WI and WV PRODUCERS please note**: This course is approved to meet CE requirements, including the CE required in the new Suitability in Annuity Transaction Model Regulation. It can also be used for Indexed Products CE credit in **IOWA**. If you have not already met these CE requirements and want to use this course to do so, please specify which CE credits you are seeking through completion of this course.
5. For state Continuing Education, a $30 grading fee applies. Fax all required forms and payment information to 317-549-9470.

Click HERE to begin the Final Exam.