CHAPTER 10
ANNUITIES

Annuities are contracts sold by life insurance companies that pay monthly, quarterly, semiannual, or annual income benefits for the life of a person (the annuitant), for the lives of two or more persons, or for a specified period of time. They can be considered the flip side of insurance. Life insurance creates an immediate estate and annuities **liquidate an estate**. When a life policy is purchased, the policyowner makes premium payments and the insurer agrees to pay the face amount of the policy if the insured dies while the policy is in force. With an annuity the contract owner provides the insurance company with a sum of money that will be paid out to the annuitant for a lifetime or a specified period of time. With an annuity that pays a lifetime benefit, the annuitant cannot outlive the contract. Even if the sum used to purchase the annuity is depleted, the annuitant will continue to receive payments. Therefore, the function of the annuity is to provide the annuitant with a payment that he/she cannot outlive. Other assets may be exhausted through the years, but the annuity continues to pay and protects the annuitant from living too long. With an annuity no proof of insurability is required. After all, the insurer is counting on the annuitant not outliving the amount of principal and interest used to provide payments. Insurance companies are uniquely qualified to sell annuities as their experience with developing mortality tables puts them in a position to determine how long an annuitant may live and how long payments will have to be made.

An annuity contract is between the contract owner and the insurer. The contract owner may or may not be the annuitant (person to receive payments). The contract owner has the right to name a beneficiary to receive any survivor benefits payable under the annuity contract.

The two primary reasons to purchase an annuity contract are income and tax-deferred growth. While an annuity contract is being funded, it grows tax deferred. The period of time when the annuity contract is being funded is called the **accumulation period**. When the annuitant receives payments from the contract, it is referred to as the **annuity period**. The annuitant will pay tax on a portion of the annuity payment as discussed in Chapter 8.

The amount of an annuity payment is based on the following factors:

- Annuitant’s age—The older the annuitant, the greater the payment. If comparing a 50 year old and an 80 year old, the insurer knows that there is a much greater chance that it will have to pay the 50 year old for a longer period of time than the 80 year old.
- Annuitant’s sex—Females live longer than males. Therefore females pay more for annuity contracts as insurers know they will make payments to females for a longer period of time.

- Principal sum—The more money invested in the annuity contract, the greater the potential income.
- Credited interest—The higher the interest rate paid by an insurer, the more money accumulated for payment.
- Expenses—The expense charges of the insurer will effect the policy. The lower the expense charges, the greater the payment to the annuitant.

Annuities can be classified in the following ways:

- Premium method
- Annuity starting date
- Options available
- Investment characteristics—fixed or variable

FUNDING METHOD

The annuity principal can be funded either immediately or by periodic payment. An **immediate annuity** is funded with a single, lump-sum payment. A person at retirement age may wish to use a company bonus to purchase an annuity.

With a **periodic payment** annuity the contract owner makes a series of periodic payments to fund the annuity contract. The payments may be fixed and level throughout the years with payments made on an annual, semi-annual, quarterly, or monthly basis. The payments may be flexible giving the contract owner the ability to vary the amount of each payment as long as the payments fall within certain minimum and maximum amounts. Of course, with flexible payments, there is no way to determine the amount of the annuity benefit in advance as there is no way to know the total amount that will be paid for the annuity.

STARTING DATE

An annuity may be classified as either immediate or deferred. An **immediate annuity** will be funded with a single payment allowing the annuitant to start receiving benefits immediately (i.e. one payment interval from the date of purchase). Most annuitants choose to receive monthly payments. Therefore, the immediate annuity would pay its first payment to the annuitant one month from the date of purchase. Payments may be made annually, semi-annually, quarterly, or monthly. The longest payment interval is one year. Therefore, it stands to reason that an immediate annuity will begin to pay benefits no later than one year from the date of purchase.

A **deferred annuity** is a contract that will start making payments at some future date. A deferred annuity can be either a single premium deferred annuity or periodic payment deferred annuity. Insurers put restrictions on how long payments may be deferred. For instance the insurer may state that annuity benefits should start being received by age 75.

If an annuitant dies during the accumulation period of a deferred annuity, usually an amount at least equal to the amount accumulated will be paid to the beneficiary. If the contract owner cancels the contract, or takes some money out of it, there may be surrender charges deducted from the accumulation value.

A young person might inherit money and choose to purchase a single premium deferred annuity. The money will grow tax deferred and can provide a retirement benefit in the future.

ANNUITY INCOME OPTIONS

There are a number of options the contract owner may select. These options are straight life income, cash refund, installment refund, life with period certain, joint and survivor, joint life, and period certain. The choice will be made according to the recipient's needs.

Straight Life Income Option

A straight life income annuity option—also known as life only annuity, a life annuity, or pure life annuity—pays the annuitant for his/her lifetime. Upon the annuitant's death, no further payments are made to anyone. In other words, if the annuitant dies shortly after receiving annuity payments, the remainder of the unpaid principal is forfeited. Due to this risk of losing the principal, this option pays the highest income to the annuitant. This option should be picked only if the annuitant is convinced he/she will live long enough to beat the life expectancy tables. If there are survivors for whom some provisions need to be made, this is not the option to choose.

Cash Refund Option

The cash refund option pays the annuitant a payment for as long as he/she lives. If the annuitant dies prior to receiving payments equal to the entire premium paid, the insurer will refund the difference in one lump sum to a designated beneficiary. This option will appeal to someone who does not wish to risk losing any of the principal.

Installment Refund Option

This is very similar to the cash refund option. The difference is that, instead of paying the beneficiary in a lump sum, the funds remaining when the annuitant dies are paid in the form of continued annuity payments until the principal amount is exhausted. This option is a good choice when the annuitant wants to make sure all of the principal is paid but has some concern as to how the beneficiary manages money.

Life with Period Certain Option

This option also is known as life income with term certain option. This option will pay the annuitant for life, but it guarantees a minimum period of payments. If the annuitant has a life with a 10-year period option, there is a minimum guarantee that payments will be made for 120 months whether the annuitant is alive or not. If the annuitant lives beyond 10 years, his/her payments will continue. If the annuitant dies after the 10-year period, his/her beneficiary would receive nothing. This option mitigates the risk of the straight life annuity of losing the entire principal if the annuitant dies shortly after receiving annuity payments.

Joint and Survivor Option

This option frequently is picked by husband and wife. It is designed to pay an income for two lives. If either dies, income payments continue to the survivor for life. When the surviving annuitant dies, all payments cease. This option also may be structured as joint and two-thirds survivor or joint and one-half survivor. In these cases the survivor’s income will be reduced to either two-thirds of the original joint income or to one-half of the original joint income. In these latter cases, the assumption is that each annuitant consumes some of the income and, when one dies, the income needed is not as great.

Joint Life

This is an annuity plan in which income payments continue until the death of the first of two or more annuitants. The monthly income benefit is greater than with other annuities since income payments cease at the first death. This type of annuity option is not appropriate for a husband and wife since at the death of the first spouse payments will cease.

Period Certain

The period certain option does not provide a lifetime benefit. It is structured to pay benefits for a certain period of time—10, 15, 20 years—whether or not the annuitant is living. At the end of the specified number of years, payments end. A person who is retiring early may wish to use the period certain to provide a retirement income for a certain number of years until he/she receives other retirement benefits at a later date.

INVESTMENT CHARACTERISTICS—FIXED OR VARIABLE

Annuities can be classified as fixed or variable. The fixed annuity provides for a guaranteed payment while the variable annuity does not.

Fixed Annuities

Fixed Annuities pay a guaranteed fixed benefit to the annuitant. The benefit will be stated in a dollar amount per payment period (e.g. $600 per month). During the accumulation period when the contract owner is making payments to fund the annuity, the insurer will credit an established rate of interest to the annuity on a regular basis. This interest rate is guaranteed to be no less than a stipulated amount. Many companies pay greater amounts than they guarantee, but they do not promise to continue to do that indefinitely.

Fixed annuity payments are part of the insurance company's **general account** assets—the conservative investment portfolio for investing premium income. Consequently, fixed annuities can offer security and peace of mind. It should be remembered that the dollar amount paid to the annuitant may decrease in purchasing power through the years due to inflation.

Variable Annuities

Variable annuities shift the investment risk from the insurance company to the contract owner. **Variable annuities** invest the deferred payments in the insurer's **separate account**. Variable annuities typically offer a range of investment or funding options. These funding options may include stocks, bonds, and money market instruments. The return on these investments can go up or down. The principal and the return are not guaranteed; they strictly depend on the performance of the underlying funding options. If the funding options chosen do well, this type of contract may exceed the inflation rate. If they perform poorly, prior earnings and principal may be lost.

Variable annuities allow for the transfer of funds from one account to another without triggering a taxable event. Tax-free switching allows for the re-allocation of funds to suit changing market conditions. Many products put a limit on the number of transfers per year. The rationale is to cut down on administrative costs.

Since variable annuities are based on non-guaranteed equity investments, the sales representative who sells such products not only has to have a life insurance license but also must have registration with the Financial Industry Regulatory Authority in order to transact in California. The agent should provide the client with a prospectus describing the available investment alternatives.

During the accumulation period, payments made by the contract owner, less a deduction for expenses, are converted to **accumulation units**. The value of the accumulation unit varies depending on the value of the underlying investments. The value of the accumulation unit is determined by dividing the net value of the separate account by the number of accumulation units outstanding. As the value of the separate account increases and decreases, the value of the accumulation unit increases and decreases accordingly.

Annuity Units

When payments start to the annuitant, the accumulation units must be converted to **annuity units**. Once the number of annuity units has been determined, this number remains the same. It is the value of the annuity unit that fluctuates. Therefore, the amount of each payment is subject to change.

The following is an example of how to annuitize a variable annuity.

1. Determine the client's ownership of the separate account.

    A. Divide the value of the separate account by the number of accumulation units outstanding

    B. Multiply times the number of accumulation units owned by the client.

    C. This value is the client's ownership of the separate account.

    Assume the value of $10,000,000 for the portfolio held by the separate account. There are 5,000,000 accumulation units outstanding. The value of one unit is $10,000,000 divided by 5,000,000 units or $2.00.

    Assume the client has purchased and holds 25,000 accumulation units in his account. The client's ownership of the separate account is $50,000.

2. Consult the company's annuity tables to determine the amount of monthly income the company will pay per $1000 applied. The tables take into account the annuitant's age, sex, payout option chosen, and loading.

    For example, if the table shows a value of $5 per $1,000 applied, the client could receive $250 per month (50 x $5 = $250). If this were a fixed annuity the client would continue to receive this fixed amount. Variable annuities use this monthly amount to purchase annuity units on the day the client annuitizes his contract. The value of the annuity unit and the number of annuity units purchased that day determine the income paid to the client.

3. Divide the monthly income amount found in the company's annuity table by the value of one annuity unit on that day. This amount is the fixed number of annuity units the client always will own.

   Consider the following: Assume that on the day the client annuitizes the contract that an annuity unit is worth $2.50. The client's $250 monthly income from the annuity table will purchase 100 annuity units. If the value of the annuity unit is $2.55 next month the client will receive a monthly income of $255. If the value of the annuity unit decreases to $2.45 the following month, the payment will be $245.

EQUITY-INDEXED ANNUITIES

Equity-indexed annuities offer the guaranteed minimum interest rate of a fixed annuity and a guarantee against loss of principal if the annuity is held to term. However, interest credited in excess of the minimum guaranteed rate is linked to the upward movement of a particular index. Standard and Poor's 500 Composite Stock Price Index (S&P 500) is one of the most commonly used indices. If the index moves upward, the interest rate is based on some portion of the increase. If the index moves down, the equity-indexed annuity is credited the guaranteed minimum rate. As the return on equity-indexed annuities is linked to a market index and not to the actual performance of any individual stocks or mutual funds, this product is not presently considered an investment product and consequently not regulated by the SEC.

MARKET-VALUE ADJUSTED ANNUITIES

A market-value adjusted annuity is a fixed annuity that has a fixed interest rate. The market value feature only applies if the contract is surrendered before the contract period expires. There must be a disclosure on the first page that the non-forfeiture values may increase or decrease based on the market value formula stated in the contract. If the contract is surrendered early, a surrender charge and a market value adjustment will apply. If interest rates decrease during the period, the market value adjustment will be positive and may add to the surrender value of the contract. Conversely, if interest rates increased over the period, the market value adjustment will be negative which would cause an increase in the surrender charge.

RETIREMENT INCOME ANNUITIES

A retirement income annuity is a deferred annuity policy that includes a decreasing term life insurance rider. It is arranged that the decreasing term life insurance rider will terminate at retirement age, normally 65. The annuity contract then provides retirement income to the annuitant. However, if the insured dies prior to retirement age, the value of the deferred annuity and the term life insurance benefit are paid to a beneficiary. In this way, the ultimate goal of accumulating a certain amount of value in the annuity is accomplished. The beneficiary may use this combined benefit to select any settlement option.

ANNUITY RIDERS

Annuity riders normally come with an annual cost ranging from .1% to 1.0% of the annuity's value. The following are riders that some companies may offer on variable annuities:

- Guaranteed minimum accumulation benefit (GMAB) guarantees the growth of the annuity by a minimum specified amount over a period of time—regardless of how the account's investment portfolio performs.
- Guaranteed minimum death benefit guarantees the beneficiaries will receive a minimum benefit upon the annuitant's death—either the original or current value of the account, whichever is highest.
- Guaranteed minimum income benefit (GMIB) allows investors to receive a set amount of income per year even if the performance of the investments does not support it.
- Guaranteed minimum withdrawal benefit (GMWB) allows the annuitant to withdraw a set amount of money per year even if there is not enough money in the account to cover the withdrawal.

QUALIFIED AND NON-QUALIFIED ANNUITIES

Qualified annuities are funded with pre-tax dollars that reduce the taxpayer's taxable income in the year of contribution. Contributions grow on a tax-deferred basis. Upon withdrawal, both the original investment and the earnings are taxed as ordinary income.

Non-qualified annuities are funded with after-tax dollars. They do not reduce the taxpayer's taxable income in the year of contribution. Like qualified annuities, contributions grow tax deferred. Upon withdrawal only the earnings are taxed as ordinary income.

FREE LOOK

Every policy of individual life insurance or individual annuity contract delivered after January 1, 1990 must have a notice printed on the policy or attached to the policy stating that, after receipt of the policy by the owner, the policy may be returned by the owner for cancellation by delivering it or mailing it to the insurer or to the agent through whom it was purchased. The period of time set forth by the insurer for return of the policy by the insured shall not be less than 10 days nor more than 30 days. By delivering or mailing the policy during the cancellation period, the owner shall void the policy from the beginning. (CIC 10127.9)

Every policy of individual life insurance and individual annuity contract initially delivered or issued to a senior citizen in this state on and after July 1, 2004 must have a notice printed or attached to the policy stating that the policy may be retuned by the owner for cancellation by delivering it or mailing it to the insurer or agent from whom it was purchased. In this context, a senior citizen means an individual who is 60 years of age or older on the date of policy purchase. This period of free look shall not be less than 30 days.

During the free-look period, the premium for a variable annuity may be invested only in fixed-income investments and money market funds unless the investor specifically directs that the premium be invested in the mutual funds underlying the variable annuity contract. In the case of individual variable annuity contracts for which the owner did not direct that the premium be invested in the mutual fund underlying the contract, the owner is entitled to be refunded all premiums paid and any policy fee paid. In the case where the owner directed that the premium be invested in the mutual funds underlying the contract during the 30-day cancellation period, the owner will be entitled to a refund of the account value. In all cases, the insurer is to make the refund to the owner within 30 days. (CIC 10127.10)

After January 1, 1995 every insurer and life agent offering the sale of individual life insurance policies or individual annuity contracts to senior citizens in this state who uses non-preprinted illustrations of non-guaranteed values shall disclose on those illustrations or on an attached cover sheet, in a manner that makes the notice more prominent than the surrounding material, the following statement:

"THIS IS AN ILLUSTRATION ONLY. AN ILLUSTRATION IS NOT INTENDED TO PREDICT ACTUAL PERFORMANCE. INTEREST RATES, DIVIDENDS, OR VALUES THAT ARE SET FORTH IN THE ILLUSTRATION ARE NOT GUARANTEED, EXCEPT FOR THOSE ITEMS CLEARLY LABELED AS GUARANTEED."

All pre-printed policy illustrations must contain this **notice in 12-point bold print** on the illustration form itself or on an attached cover sheet in a conspicuous manner. All pre-printed illustrations containing non-guaranteed values shall show the **columns of guaranteed values in bold print**. All other columns used in the illustration shall be in standard print. "Values" includes cash value, surrender value, and death benefit. (CIC 10127.11)

RELEVANT INFORMATION IN MAKING RECOMMENDATIONS TO SENIORS

All of the following are important for the agent to obtain before making a recommendation to a senior consumer. They are:

1. Occupations and occupational status
2. Marital status
3. Age

4. Number and type of dependents
5. Sources of income
6. Yearly income
7. Consumer's existing insurance
8. Consumer's needs and objectives
9. The cost to the consumer and consumer's ability to pay
10. Source of funds to pay premiums
11. Investment savings
12. Liquid net worth
13. Tax status
14. Need for tax advantages
15. Investment experience of consumer
16. Consumer concern for preservation of principle
17. Product time horizon
18. Consumer's awareness of liquidity limitations or surrender charges

REVIEW QUESTIONS

1. A life annuity offers protection against the risk of:

   A. Death during the earning years.
   B. Disability during the earning years.
   C. Living longer than anticipated.
   D. Death after the age of retirement.

2. A difference between a variable annuity and a fixed annuity is:

   A. Fixed annuities have a duration of a specific number of years and may not last for the life of the annuitant.
   B. Variable annuities provide a series of fixed monthly payments for the life of the annuitant.
   C. Variable annuities are sold by life agents who also must have a securities license.
   D. Fixed annuities have the potential of keeping up with inflation.

3. All of the following statements about variable annuities are true **except**:

   A. The annuitant’s benefits after retirement are effected by the value of each annuity unit.
   B. Benefits are expressed in units rather than dollars.
   C. The annuitant’s benefits are guaranteed to maintain their purchasing power during inflationary periods.
   D. Assets supporting annuities are invested primarily in common stocks.

4. Todd Jones purchased a life annuity with a 10-year period certain option. He died after receiving payments for six years. His beneficiary would receive:

    A. Nothing
    B. Payments for life
    C. Payments for 10 years
    D. Payments for 4 years

5. Which of the following is *incorrect* about a variable annuity?

    A. A variable annuity pays a variable income to the annuitant.
    B. The number of annuity units will decrease as payments are made to the annuitant.
    C. The value of the annuity unit may vary.
    D. A variable annuity can provide a lifetime benefit to the annuitant.

6. Which of the following is true about an annuity?

    A. The annuitant's age when starting to receive payments has no effect on the amount of the payment.
    B. An annuity creates an immediate estate.
    C. Someone purchasing a deferred annuity is required to annuitize the contract.
    D. An annuity liquidates an estate over a period of time.

7. What type of annuity provides payments for life at regular intervals with no further payments at death?

    A. Installment refund
    B. Straight life
    C. Joint and survivor
    D. Life with period certain

8. How are annuities funded?

    A. Lump sum immediate
    B. Lump sum deferred
    C. Periodic payment deferred
    D. All the above

9. Which type of annuity accumulates funds in units that are tied to the value of an investment portfolio?

    A. Refund annuity
    B. Straight life annuity
    C. Variable annuity
    D. Pure life annuity

10. Systematic liquidation of accumulated funds is the basic function of which of the following?

    A. An annuity
    B. A family protection policy
    C. A multiple protection contract
    D. Decreasing term contract

11. Which of the following require a securities license to sell?

    A. Universal life policies
    B. All annuity contracts
    C. Adjustable life contracts
    D. Variable annuity contracts