Annuity 4-hour Best Interest Training

United Insurance Educators, Inc.
PO Box 1030
Eatonville, WA 98328
(253) 846-1155

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Annuity Best Interest Training

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NAIC Model Law Section 7. Producer Training

A. A producer shall not solicit the sale of an annuity product unless the producer has adequate knowledge of the product to recommend the annuity and the producer is in compliance with the insurer's standards for product training. A producer may rely on insurer-provided product-specific training standards and materials to comply with this subsection.

(6) A producer who has completed an annuity training course approved by the department of insurance prior to *[insert effective date of amended regulation]* shall, within six (6) months after *[insert effective date of amended regulation]*, complete either:

a) A new four (4) credit training course approved by the department of insurance after [insert effective date of amended regulation]; or

b) An additional one-time one (1) credit training course approved by the department of insurance and provided by the department of insurance-approved education provider on appropriate sales practices, replacement and disclosure requirements under this amended regulation.

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PO Box 1030
Eatonville, Washington 98328
(253) 846-1155

Email: mail@uiece.com

Website: www.uiece.com

Annuity Best Interest Training

Annuity Best Interest Training Course

Changing Times

Most states require insurance producers to complete specified training in annuities prior to selling annuities. Variable annuities come under securities in most cases, which may be regulated differently, requiring securities education requirements be met. Equity indexed annuities are fixed rate contract, so they are covered by the requirements of the traditional fixed rate products.

Annuities may be categorized in various ways, depending upon who is doing it and what their goals are, but primarily they are categorized as:

1. fixed or variable,
2. immediate or deferred, and
3. flexible or single premium contracts.

Fixed and variable annuities relate to the risk in each type. Fixed rate annuities provide fixed earning guarantees, so their risk is low. Variable annuities invest policyholder's premiums in riskier vehicles that may move up or down (thus, the name of 'variable') so their earnings are not fixed.

Immediate annuities and deferred annuities describe when income is available. Immediate products immediately allow benefits to be paid out, while deferred vehicles defers income to a future date.

Flexible annuities allow future premium deposits while single premium contracts, as the name indicates, allows only a single premium to be made. Individuals who are saving for retirement or some other future goal are likely to select deferred annuities because they need to make continual deposits to reach their goal. Individuals who select single premium products have already amassed their funds, reaching a financial goal. Now they need a vehicle to hold their money, perhaps immediately beginning payout too. Only a single deposit is needed to do that, so a single premium vehicle is chosen.

Split annuities combine two products: a single premium deferred annuity and a single premium immediate annuity. One annuity pays the annuitant a set sum of money each month over a specified time. The other annuity is left to grow on a fixed interest basis. The goal is to maximize the length of time funds are paid to the investor. By the time the funds in the annuity owner's immediate annuity are depleted, the single premium deferred annuity will be able to provide income. The amount of income depends on how much money has accumulated, of course.

Annuity Best Interest Training

Annuities can be simple to understand or they can be complex, depending on the products used, how they are used, and the goals that are desired. The fixed rate annuities are the most commonly issued type of product and they are not complex.

Since 2003, state insurance regulators have overseen annuity sales, with the goal of protecting consumers. While annuities are traditionally safe investment vehicles, they are not right for every investor. They should only be placed after reviewing the buyer's consumer profile because annuities are long-term products, meaning it is not possible to remove funds without penalties prior to age 59½.

The Suitability in Annuity Transactions Model Regulation (#275) has served as a basis for the regulatory framework and sets standards and procedures for recommending and selling annuity products so that the consumer's financial objectives is compatible with buying an annuity product. Since the Model Regulations were first developed and adopted, the standards have been updated for consistency with the standards issued by the Financial Industry Regulatory Authority (FINRA), which regulates variable annuities. Many states have adopted the Annuity Suitability Standards.

In 2017 a group called the Annuity Suitability Working Group was appointed to review and revise Model #275. They wanted to promote greater uniformity across the NAIC (National Association of Insurance Commissioners) member jurisdictions. It was due to work being done at the federal level that prompted the interest in updating current standards.

In April 2016, the U.S. Department of Labor (DOL) had completed regulations broadening its definition of "fiduciary investment advice" under the federal Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC). However, the rule was vacated by the 5th U.S. Circuit Court of Appeals in March of 2018 before it could take effect.

The U.S. Securities and Exchange Commission (SEC) released a proposed rule package on April 18, 2018 updating the standard of care broker-dealers and investment advisers must provide to retail investors. The final rule became effective on June 30, 2020.

In 2018, the New York State Department of Financial Services proposed a new "best interest" criteria or standard for insurance producers and brokers licensed to sell life insurance and annuities in that state, which aligned with the "fiduciary rule" (even though it had been vacated) for retirement savings. Under this proposal, customer's interests over that of any sales commissions was required to be followed, or in other words, the customer's "best interests" were to be considered the primary objective. Insurance producers or brokers' compensation could not influence the products being recommended. This went into effect February 1, 2020.

Annuity Best Interest Training

The NAIC membership approved revisions to Model #275 in February 2020. It clarified that all recommendations by insurance producers and insurers must be in the best interest of the consumer. Insurance producers and insurers cannot consider commission earnings over the benefit of the consumer. Of course, most insurance producers and others associated with the industry have always placed the client's welfare before any commissions that were earned, but there are always the few who did not, affecting the majority who have been ethical.

Even for the majority of insurance professionals who have always been ethical, however, there is a positive outcome. Many insurance producers were not sufficiently trained to recognize a good annuity placement versus a bad annuity placement. The additional requirements that came to the states through "suitability" standards forced insurers or others to provide the necessary training. This requirement upgraded the quality of those recommending and selling annuity products. It had the additional result of causing some part-time insurance producers to drop their insurance licenses, but those individuals never intended to make insurance sales their primary focus.

As changes were made, what had traditionally been referred to as "annuity suitability" standards began to change to "client best interest" standards. Whichever term is used, the result is the same. Insurance producers must take the time to determine what is best for their clients and consumers. If an annuity is recommended, the selling producer will know it is a good choice based on the information he or she has gathered. This is good for both consumer and insurance producer. The consumer ends up with a quality product that meets his or her goals and the insurance producer is far less likely to be sued in the future for mistakes that were made due to their lack of knowledge.

Investment Objectives

There is no perfect investment vehicle, and each investment vehicle, including annuities, carries some type of risk. This is true of everything from stocks to saving at the local bank. In some cases, the risk has to do with the type of investment chosen, but in other cases it is inflation that robs savings and growth. The ideal investment vehicle would provide interest rates that are higher than the rate of inflation, without the risk of investment loss. Such "ideal" investment vehicles do not typically exist.

While there is no ideal investment, there is also no specific type of investment that is always wrong. Each investment vehicle has qualities that work well in some specific conditions and qualities that make it unsuitable in others. The goal is to identify the type of investment vehicle that best suits the investor's needs and goals.

Although this course deals with annuities in general, many industry professionals believe it was the emerging popularity of equity indexed products that caused the states to begin requiring annuity training and best interest (suitability) requirements. Just like other annuities, equity indexed annuity products are issued by insurers, but they have aspects that are not like traditional fixed rate annuities that most consumers are familiar with. Equity indexed annuities are *not* variable annuities. They are fixed rate annuities, but complicated fixed rate annuities.

What exactly is an annuity? The Suitability in Annuity Transactions Model Regulation defines an annuity as an *insurance product under state law that is individually solicited, whether the product is classified as an individual or group annuity.* Annuities are generally defined as a contract issued through an insurance company that allows money accumulation and distribution for life or some specified time period upon annuitization.

Annuities are One of the Oldest Known Investments

Annuities have been in existence for over two thousand years, although not necessarily all the types of annuities on the market today. Annuities are not right for every person in all situations, but they do have history on their side. Annuities are especially favored when safety is the goal.

In Roman times annuities were called "Annuas." Those issuing annuities were called financial speculators. Generally, only single premium annuities were available at that time. When an individual purchased a single premium "annua" the annuity dealer provided a yearly payment to his client, including interest earnings, for the investor's lifetime or for a pre-determined period of time, similar to our current annuities.

Common Annuity Objectives

Retirement Funding

Unlike life insurance products where policy issue and pricing are based largely on mortality risk, annuities are primarily investment products. Therefore, a typical objective when buying an annuity is growth, often with an end goal in mind, such as retirement funding. Since annuities are tax-deferred, growth happens quicker because there are not yearly deductions for taxation on the vehicle's growth.

Annuities may be funded with a single lump sum deposit or through a series of periodic payments. The insurer credits the annuity fund with a certain rate of interest, which is not currently taxable to the annuitant. The ultimate amount that is payable is, in part, a reflection of these factors. Most annuities guarantee a death benefit payable in the event the annuitant dies before payout begins. This death benefit is usually limited to the amount paid into the contract plus interest paid.

Wealth Accumulation

Investors who chose annuities generally want to accumulate funds for some future use. This is often referred to as *wealth accumulation*. Since annuity owners can make continued deposits into the annuity, they can accumulate wealth at their own pace and ability. Tax deferral aides in the wealth accumulation since interest earnings are not taxed until they are withdrawn at some future date.

Payout Options Such as Lifetime Income

Not all investors select a lifetime income from their annuities. Obviously, this works best when there are sufficient funds in the annuity. If there are insufficient funds, a lifetime payout option does not make sense because the monthly check would be too low. Since there are many ways to annuitize and begin receiving income from the annuity, it is important that investors understand their options before selecting how to receive their investment funds. The multiple benefit payments available are discussed later in this text.

One important objective when a lifetime payout option is selected is the realization that selecting a lifetime payout option eliminates beneficiary designations. In effect, the annuity owner is making the issuing insurance company their beneficiary.

Delay of Taxation (Tax-Deferred Earnings)

Insurance producers should never give tax advice unless they have the schooling and experience to do so. However, the general rule for pensions and annuities is that income from a non-qualified annuity plan is made up of two parts: tax free and taxable. The tax-free part is the return of the net cost for buying the annuity. The rest is taxable at whatever rate the annuity owner is at.

Annuity beneficiaries receive the annuity money as income (as opposed to withdrawals). Generally, the same rules apply whether the withdrawal is made by the contract owner or proceeds are received by a beneficiary. However, again we must stress that insurance producers should never offer tax advice unless they are qualified to do so.

Determining the Right Products

Americans, and really citizens around the world, have become dependent on the internet. We go to the internet for just about everything from household goods to investment products. However, it is important to realize that just about anyone can proclaim their views online; that does not necessarily mean the information is correct or even fairly stated. While we are not advocating discontinuing the use of the internet it is important that individuals verify the information they receive. Insurance producers may face obstacles created by the internet if prospective clients have done "research" on their own.

Perhaps the greatest failing of the internet is that it provides an incomplete picture of investing and investment vehicles. While there is some information provided it is seldom complete. It would take a book to completely explain any financial investment vehicle and most websites promote their particular products, so the information provided may be slanted to their preferred views. Consumers might still find useful information, but consumers should also view the information as a selling tool for the sponsoring company.

Wise insurance producers and brokers carry E&O insurance: errors and omissions coverage. Even a fully educated annuity specialist can make an error or forget to give a vital piece of information. Additionally, even if full disclosure was made, the consumer may claim otherwise. When it is the insurance producers' word against his or her client's, the outcome is uncertain. This is also a strong argument for the insurance producer to maintain sufficient documentation as will be explained in this course with regard to best interest requirements. When an annuity product is presented and recommended there can be consumer confusion. Poor choices can have adverse consequences. Even when principal is preserved a client who receives less growth than expected may become unhappy.

Fixed rate annuities are excellent and relatively safe as investments go but that still does not make them right for every person and every situation. The length of annuity *maturity* and the *age of the investor* are important. Annuities are designed to be long-term investments, so they are seldom wise choices for short-term goals. The Internal Revenue Service considers annuities a retirement vehicle, so they impose a 10 percent penalty on withdrawals made prior to age 59½ (it is an early withdrawal penalty).

Annuity Product Differences

There are important differences between different annuity products that must be considered when selecting a suitable annuity investment. Variable annuities are classified as securities just as stocks, bonds and mutual funds are. Although underwritten by insurance companies, variable annuities are offered through securities licensed registered representatives. Simply having an insurance license does not necessarily allow the insurance producer to market variable annuities. Variable annuities do not give the same safety, security and guarantees fixed rate annuities offer. Equity indexed annuities are not variable annuities; they are a more complicated form of traditional fixed rate annuities.

Annuities are Used for Several Financial Objectives

Most people having or seeking financial independence benefit from purchasing some type of annuity. Many professionals feel it makes sense to have both variable and fixed rate products in a financial portfolio, but this is always a personal choice.

Safety of Investment in Fixed Rate Annuities

There are many reasons fixed annuities offer safety of investment, but one of the reasons has to do with capital reserve issues. At times, the government has given funds to maintain banks following their poor lending practices and resulting money problems. Most experts felt at the time it was necessary to ease the credit markets, so our society could move forward. In most cases, the banks did not begin loaning again, as was desired, but instead used taxpayer money to improve or maintain their own capital reserve requirements.

Insurance companies have the same capital reserve requirements as banks, but fixed rate annuities must reserve the capital required to meet their financial obligations, which are contractually guaranteed to protect their policy holders. These reserves cover not only the rate guarantees but also minimum guarantees, income guarantees and living benefit guarantees. As a result, investors should not only be looking at potential lifetime income, but also at the safety of principal annuities offer.

Tax-Deferred Annuity Accumulation

Annuities are not tax-free, but they are tax-deferred. This means at some point, the investor will have to pay taxes, but not until funds are withdrawn from the annuity vehicle. In the meantime, the principal is allowed to grow without taxation on the interest earned.

Funding Retirement with an Annuity Income Stream

Although annuity funds may be used for any reason, retirement is a primary use. Since annuities are tax deferred vehicles, by depositing over a long period of time they are an excellent method of acquiring funds for retirement. Taxes will be due when funds are withdrawn, but annuitants can time those withdrawals with their current tax situation, thus minimizing taxes as much as possible. IRS penalizes early withdrawals, so annuitants should wait until age 59½ to access their retirement funds, but since most people do not retire prior to age 60 it works out well.

Accessing the funds during retirement may be accomplished through annuitization or by simply withdrawing funds periodically. If annuitization is selected it is extremely important to understand the various options. If maximization of funds is the goal the policy owner is likely to take a lifetime income option, but if there is also concern for the beneficiaries, this may not be a good choice. Insurance producers must carefully explain all options prior to the annuitant’s selection.

Structured Settlements

Annuities are often the financial vehicle of choice for structured settlements. These are often mandated by courts but need not be. Usually, it is court ordered or agreed to by two or more parties and then accepted by the presiding judge.

A structured settlement is a settlement amount that is structured to pay a specified sum over a specified time period or the lifetime of an individual. Annuities are typically used to guarantee that the payments will be made as agreed upon. They take the payment out of the hands of the liable party and place it with a legally disinterested third party. The amount of payment will depend upon the settlement amount placed with the insurer and the expected lifespan of the annuitant. Usually, the court is not concerned with the amount of periodic payment but rather with the total of principal deposited in the annuity since it is that premium that represents the legal settlement.

Insurance companies know how to analyze risk. Analyzing risk is part of their job and they do it every day. Not all insurers offer identical payouts derived from the same amount of principal, however. Some companies may charge more for their overhead or there may be other conditions that affect annuity payouts, including the amount of credited interest. Insurance producers are wise to represent more than one annuity company so he or she can compare rates and payout to give their clients the best opportunity possible.

Insurance producers must constantly check facts and figures since annuity companies can and do change how they formulate payout amounts on newly annuitized contracts. Previously annuitized contracts would seldom, if ever, be affected by changes. Once a product is annuitized, the payout amount and conditions become *contractual*.

Probate Avoidance

Annuities bypass probate procedures (although annuity values must still be listed during probate for taxation purposes). Most people are not wealthy enough for probate to be a severe issue, but if the investor believes probate may become slow or cumbersome, annuities may be a good investment choice. Since they have beneficiary designations, annuity funds go directly to the person or people named in the policy. The same is true for life insurance policies. Any type of investment vehicle that has beneficiary designations may be able to pass the assets on to the named individuals outside of probate.

Since individuals have unique circumstances, it is always important that an attorney be consulted. In many cases, both an attorney and a tax specialist should be part of the decision-making process. There are many mistakes that can be made in the attempt to protect assets; whatever it costs to involve these individuals may be well worth the cost.

Old Money; New Money

There is often a difference between older annuities and currently issued annuities, often referred to as old money and new money rates. It may depend upon multiple factors including current investments available to the issuing insurer. Newly issued policies may earn more or less than previously issued contracts. Some new contracts offer higher rates to be competitive if other insurers have come out with better contracts than previously offered. Like all types of businesses, insurers must attract new clients as well, so higher rates on new money may be a way of gaining new policyholders.

Annuity Participants

There are four annuity participants: the annuitant, the contract owner, the listed policy beneficiaries, and the issuing insurance company.

The annuity contract owner and the annuitant are often the same person. The **contract owner** is the individual who owns the “rights” to the annuity income. The **annuitant** is the person whose life was measured by the insurer when issuing the annuity. In a life insurance policy, he or she would be called the insured but in an annuity product the measuring life is called the annuitant.

Annuities offer the opportunity to list **beneficiaries**. If the contract is not annuitized, or if it is annuitized in a manner that allows unused funds to go to a listed beneficiary, the person or persons listed will receive funds after the contract owner's death.

The issuing **insurance company** is, of course, the insurer that underwrote the policy, accepted the risk, and issued the contract.

Types of Annuities

Although annuities are issued by life insurance companies, they do not insure against premature death as a life insurance policy would. Annuities do have beneficiary designations, but their intent is not to provide money for heirs; the intent is to provide income during the life of the contract owner.

As people continue to live longer lives, they are justified in fearing they might run out of money before they run out of life. In other words, people are at risk of having too little money set aside to last to the end of their lives. As people continue to have smaller families, they may not be able to count on their children to care for them both physically and financially in their last years. A major cost to the country's Medicaid system is the increasing use of nursing homes by people who have depleted their own savings. As our senior Americans spend all they have, they must turn to Medicaid for their health care needs. Few people are saving adequately for their retirement years so annuities, with lifetime annuitization options, make good sense.

Maturity Dates

Annuities have surrender penalties during which time the investor would be penalized if withdrawals are made. Annuities also have maturity dates, which is the date stated within the policy when the owner must select a settlement option and begin receiving payments. This is done by annuitizing the contract, receiving income in whichever way is selected upon annuitization. People think of annuities providing lifetime incomes, but that only happens if that is the payment method selected. People often select payout options that do not provide lifetime incomes, especially since lifetime options eliminate beneficiaries.

Contract maturity varies by annuity, but most require several years to mature. Surrender penalties can be anywhere from 12 months to ten years or even longer. When surrender penalties end, the contract has reached the contract's **term**. Withdrawals made prior to term might be subject to insurer penalties unless a provision allows partial withdrawals. Many annuity contracts allow the interest earnings or 10 percent of values to be withdrawn yearly without incurring penalties. Some annuities reward investors with bonus interest points if they do not withdraw funds within specified guidelines.

Annuity Income Options: Take Income Now or Later

Immediate Annuities

Individuals who receive a lump sum settlement or who have other sources of accumulated savings often choose to purchase an immediate annuity. It is called an "immediate" annuity because the buyer *immediately* begins to receive income from the investment vehicle.

> For example, Ruby has a Certificate of Deposit (CD) at her local bank that she wants to convert into continual lifetime income or income for a specified number of years (this depends upon the payout option Ruby selects). She withdraws the funds from her bank's Certificate of Deposit and buys an immediate annuity from her local insurance producer. The amount of income Ruby receives would, of course, depend upon the amount she puts into the annuity. The insurance company uses specific tables to determine the amount they will pay Ruby each month (she could have selected other payout time periods, such as quarterly). The insurer determines that, based on Ruby's expected longevity, she can receive $450 each month for her lifetime. Ruby could have received a higher monthly income if she selected a different payment option, but it would not have lasted for her lifetime, it would only pay based on the number of years she selected. Ruby chose lifetime income because that was her goal when she chose to buy an annuity. She will receive $450 each month no matter how long she lives, even beyond what her annuity purchase price, plus interest, actually paid for. If Ruby lives a very long time, she could come out thousands of dollars ahead. On the other hand, if Ruby dies prematurely the insurer will keep any unpaid funds since lifetime income options do not pay beneficiaries any left-over funds. In effect, the issuing insurer becomes Ruby's beneficiary.

Deferred Annuities

Deferred annuities may receive funds in any annuitization manner offered by the issuing insurer, including lifetime income or income for a specified period of time. Although deferred annuities may be used by anyone, they are commonly used by individuals who need to accumulate funds for use at a future date. Individuals deposit premium payments over a period of time, often many years. At some point they will have accumulated enough funds in their annuity to fund a specified event, usually retirement. Deferred annuities are likely one of the most common annuities since so many investors need to accumulate a pool of money to fund their retirement. This is especially true today with the decline in company-sponsored pension plans.

Split Annuities

Split annuities are considered tax efficient since they combine two different types of annuities: a single premium deferred annuity and a single premium immediate annuity. "Single premium" means one premium payment is made into each annuity versus multiple payments over a period of time.

One annuity portion pays the investor a set sum of money each and every month over a specified period of time. As in Ruby's case, the length of payments will depend upon the payout method selected by the investor upon annuitization of the annuity. The other annuity is left in place to grow on a fixed interest basis. The goal is to maximize the length of time funds will be paid back to the investor. By the time the funds in the investor's immediate annuity are depleted, the single premium deferred annuity will be restored to the investor's original starting principal. This allows him or her to then restart the process with new prevailing interest rates. Prevailing interest rates will hopefully be higher than they would have been when the first annuity was annuitized. Of course, there is no guarantee of that; historically, credited interest rates have risen higher than the guaranteed contract interest rate, but that is not promised. The guaranteed interest rate is always a protection, but there is no guarantee that the interest rate credited will be higher than the floor percentage guaranteed.

Premium Payment Methods

Single Premium Annuities

Single premium annuities are annuities purchased with a *single* premium payment, thus the name. These are often used when funds are being transferred from another type of investment vehicle, such as Certificates of Deposit.

Flexible Premium Annuities

Flexible premium annuities allow the investor to save over a period of time, often many years. *"Flexible"* means premium deposits are flexible allowing a young family to make premium payments either systematically, such as through payroll deductions, or as they find those elusive extra dollars. As previously stated, systematic saving into an annuity is likely better than depositing here and there, as able, but any amount of saving is better than none.

The contracts sold by insurance companies will offer different options; not all allow any amount to be deposited for example. In most cases, there is a minimum amount that can be deposited into a flexible premium annuity, such as no less than $50 per premium payment. Some contracts may require systematic deposits if the premium amounts are low. Most contracts allow premium payments to be monthly, quarterly, semiannually, or annually throughout the life of the policy holder, or for two or more people. Contracts can also be for a predetermined time period. In all cases, it is important for the consumer to select an annuity contract that suits their needs and saving abilities.

Flexible premium deferred annuities often accept ongoing small deposits as low as $50 per month. The interest rate guarantee period on each deposit is for one year; at the end of the guarantee period the depositor can benefit from competitive renewal rates, which are based on current market conditions.

Each type of annuity is an advantage for some investors, based on their goals. A primary advantage of flexible premium annuities (all annuities really) is the principal guarantee they offer; investors will not have to worry about losing their principal no matter what the general economy is experiencing. Annuities are considered conservative investments. They may not experience the growth that stocks might for example, but the guarantees of principal have become very important in recent years.

Annuity Type Based on Policyowner Risk

As we said, there is absolutely no investment without some type of risk, even if that risk is due to inflation. If the earning ability of the investment is too small, then inflation will not only erase the interest earnings but also the buying power of the principal itself. That being said, there are other more identifiable risks in many investments.

Each consumer has what is commonly referred to as *"risk tolerance."* This means the ability of the consumer to accept the risks of the investment and there are always risks. Some investors enjoy risk; there is something exciting in the possibility of making big returns and the risk that accompanies this excitement is not a deterrent for these individuals. As investors age, however, risk is seldom wise. Young investors have time on their side; if they lose big, they have time to make up their losses. Older people do not have time on their side. Older investors should always seek investment safety rather than excessive risk.

Some types of annuities have more risk than other types. The riskiest annuity is the variable annuity, since return is variable, not guaranteed.

Variable Annuities

Variable annuities are issued through insurance companies, just as other annuities are, but they are not like other annuities. There is no doubt that variable annuities involve investment risk and are not suitable for all investors. Between fixed annuities, equity-indexed annuities and variable annuities, variable annuities pose the highest degree of investment risk.

Variable annuities get their name from the fact that the rate of interest earned is *variable*, dependent upon the market index the contract is based on. The money deposited in a variable annuity is tagged with a portfolio of investments that earn based on what the market is doing. The risk in these annuities are generally at the maximum, just as stocks might be.

Variable annuities are complex (often described as mutual funds wrapped in an insurance policy). Variable annuities may be purchased as an immediate product or as a deferred contract. In other words, a single premium may be made or multiple premiums over a period of time.

Variable annuities offer a range of investment options, all of which contain investment risk. Like most annuity products, variable annuities are designed to be held for several years; they are long-term investments. Variable annuities have surrender fees, as do most annuities that may last ten years or more. Many investment professionals feel the insurer surrender penalties are not as worrisome, however, as the many other fees that might be in these products. That is because the surrender fees are clearly stated whereas some underlying fees may not be. For example, there may be underlying fund expenses that are imposed by the underlying mutual fund investment. These are often indirectly paid by the investors making it difficult to understand their investment impact.

Fixed Annuities

Both immediate annuities and deferred annuities are fixed annuities. A fixed annuity earns its name from the "fixed" aspect of the contract. It ensures a fixed rate of return on the investor's money. The rate may be less if compared to other types of annuities, but this form of annuity is the safest from a risk standpoint. Even during the saving period, the annuity earns the fixed rate of interest. Therefore, the amount of money that is with the insurance company keeps growing at the fixed rate of interest stated in the annuity contract. Fixed annuities have less investment risk than fixed equity-indexed annuities.

Annuities are tax deferred vehicles, but taxes will eventually be paid. Interest earnings in non-qualified contracts will be taxed in the year in which they are withdrawn.

Declared Rate Fixed Annuities

As we know, the principal in a fixed rate annuity is guaranteed but in declared rate fixed annuities the interest earnings may also have a guarantee. It may not necessarily be labeled as a declared rate fixed annuity, but the declared rate of interest will be posted in the contract or on an attachment to the contract. The declared rate of interest earnings is typically connected to the length of annuity commitment in some way. For example, a ten-year surrender term is likely to promise a higher rate of return than would a five-year surrender term product.

The contract will have a minimum guaranteed rate, but many contracts will also have a currently paid rate of interest that is higher than the minimum guaranteed rate (depending on current markets of course).

Fixed Equity Indexed Annuities (EIA)

An equity indexed annuity is first and foremost an annuity product. Indexed annuities are often thought to be a form of variable annuity, which they are *not*. Rather equity indexed annuities are a type of *fixed annuity* product. For this reason, equity indexed annuities are sometimes referred to as *fixed* equity-indexed annuities. Many investors consider them to be one of the best retirement tools developed in recent years, but they carry investment risk. Equity indexed annuities typically guarantee at least one year of initial premiums returned if the product is held past the surrender period. Since the indexed annuities have a link to a major stock index, there is the potential of growing faster than a traditional fixed annuity product. However, their complexity means they are not for all investors. Any person who does not fully and completely understand how the product works should neither sell equity indexed annuities nor buy them.

An equity indexed fixed annuity will experience variable returns because the annuity is linked to a market index, but it is not a variable annuity even though the earnings are variable. They are certainly more secure than variable annuities, but they are also complex. Equity indexed annuities (EIAs) are *not* regulated as securities even though they are linked to the stock market index. This means they are not regulated by either the Securities and Exchange Commission (SEC) or the National Association of Securities Dealers (NASD). As a result, salespeople are not required to have a securities license to market them whereas that is the case with variable annuities.

Two-Tiered Annuities

A two-tiered annuity is another method of creating interest. Many professionals consider them a poor use of annuities since they can be misleading. Some states have even outlawed them.

In 2008 the National Association of Insurance Commissioners defined two-tiered annuities as an annuity with two separate and independent values, usually called the **annuitization value** and the **cash value**. These values are calculated separately and frequently become further apart over time. In contrast, over time account values and cash values of a single-tier annuity becomes closer together rather than further apart.

The tier-one value is the value of the annuity bearing interest. The earnings are growing on a tax-deferred basis and it works just like a fixed annuity. The client will receive the full accumulated value of the annuity contract after the contract surrender term has been completed or when the contract is annuitized and placed on systematic payout.

The tier-two value is the cash that can be withdrawn by the contract owner. The cash value balance earns a minimal rate of interest that is set by the insurer. This rate of interest is less than that credited in the tier-one portion of the contract. Typically, on a two-tiered annuity only the annuitization value will be credited with any bonuses and index gain that the investor receives. Therefore, withdrawals greatly damage the total value of the product.

The surrender value only comes into play if the client decides to surrender the policy earlier than the intended time period. The surrender value is the contract value minus the surrender charge and may include the market value adjustment which will give the net surrender value.

These products are not suitable for many consumers, including those with short-term goals. Investors may have to wait a long time to access the tier two values outside of annuitization so in a way, these products require annuitization.

Consumers should make sure that these types of annuities are suitable for their situation. These annuities are not suitable of everyone and insurance producers should make sure their clients understand the different values of the contracts prior to purchasing a two-tier annuity.

The two-tiered approach credits the contract with a lower rate of interest if a partial or total surrender is made. Sometimes this is true for a specified time period; sometimes it is true for the life of the policy. They often have substantial charges for withdrawals, a charge that may never disappear, depending upon contract terms. Accounts may be credited with an artificially low rate if a minimal payout period is selected by the policy owner. Consumers may believe they are receiving a competitive rate of interest when, in fact, they are not due to charges in the contract.

A Closer Look at Fixed Rate Annuities

Fixed rate annuities are the opposite of variable annuities; the rate of return and payout is "fixed," not "variable." The *traditional fixed rate annuity* is easy to understand, which is probably one reason so many consumers buy them. Investors deposit money, the funds earn interest, and upon retirement benefits are paid out. Equity indexed fixed rate annuities are not as simple as traditional fixed rate annuities, however.

All fixed rate annuities typically have the following features:

- a guaranteed amount at the end of a specified time period,
- a free bailout option,
- the ability to add new contracts,
- ability to know the financial future of the product, and
- tax benefited annuitization.

The *guarantees* of a fixed annuity are guaranteed every day; investors often choose annuities for that reason. At the end of a specified period of time the investor is guaranteed to have the amount of earnings stated in their contract. Fixed rate annuities are conservative investments but also safe investments.

When an individual decides to invest in a fixed rate annuity a specified minimum guaranteed rate of return becomes contractual. The contract might pay more than the minimum guaranteed rate, but it will never pay less. Normally, the longer an investor is willing to commit, the higher the rate will be.

Whatever length of time the investor commits to, the minimum rate of return is guaranteed in the contract. If the person chose a nine-year option at 3.33 percent, he or she would be guaranteed 3.33 percent for the length of the contract, whether other aspects of the economy went up or down. Actual interest rates vary from company to company and even among annuity products within the same insurance company. Normally the minimum rates offered by annuity contracts are higher than those offered by Certificates of Deposit or money market accounts. Annuities may pay a *higher* interest rate each year than the stated minimum guaranteed percentage rate, but they will never pay *less* than the stated rate.

Annuities are often used with retirement income in mind. Since there are insurer penalties for early withdrawals during the surrender penalty phase, investors must decide how long to tie up their money. Some financial advisors feel the answer depends on what one believes will happen to interest rates in the future. If the investor believes rates will go up during the next several years, he or she may want to choose a shorter annuity contract. At the end of the surrender penalty phase, the investor could roll their annuity into a higher rate contract, whether they stay with that company's annuity or switch to another company’s. However, if the investor believes interest rates are going to fall, they may choose an annuity that offers the longest possible term (perhaps ten years). If the person is uncertain about the direction of the interest rates, they can opt for a term in the middle. Statistically, many annuities are never annuitized. Often funds are not used by the investor so in the end, they go to the designated beneficiaries. With the changes in the economy, this past trend may reverse. Today fewer retirees have sufficient monthly income, so they are more likely to access their annuities. Our parents and grandparents often had employer sponsored retirement plans that provided adequate income during retirement. Additionally, our parents and grandparents were less likely to spend at the levels current retirees do. They were less likely to travel, buy memberships to country clubs, or move into retirement communities. Today’s retirees spend much more freely than our parents or grandparents did. As a result, most economists believe annuity products will be accessed by today’s retirees, even though this was not true in the past.

The *free bailout option* is closely tied to the guaranteed interest rate provision of a fixed rate annuity. This can be very advantageous to the investor (contract owner). If, after the guaranteed interest rate period is over the renewal rate is ever less than one percent of the previously offered rate, the investor can liquidate all or part of the annuity - principal and interest - without cost, fee, or penalty. This gives the investor the security that he or she will always be receiving a competitive rate. If the investor wants to change, and the renewal interest rate is not less than one percent of the previously offered rate, the insurance company may charge a back-end penalty.

Normally if a person wants to *add to their annuity contract*, they must purchase another annuity contract. The fixed rate annuity is a contractual relationship. The insurance company is guaranteeing a minimum rate of return on the specific invested amount. Only a few insurance companies allow a person to add to an existing annuity contract.

The fixed rate annuity always allows the investor to know where he or she stands, so the *future of the investment is always known*. Investors know the exact amount of money that will be available at the end of the specified period. The annuity contract will spell out what a person can expect in the way of principal growth. Any penalties or fees that may exist will be specifically stated as well as the point they disappear, if applicable.

Annuitization provides an even distribution of both principal and interest over a period of time. The amount of each check can depend on several things, including the:

- competitiveness of the issuing insurance company,
- level of current interest rates,
- amount of principal that is to be annuitized, and
- duration of the withdrawals.

When an investor decides to annuitize, the dollar amount of each check paid out on a fixed rate annuity will depend on the current interest rates being credited. Under some contracts, the contract owner can decide to annuitize only a portion of the contract so that some of the investment left invested is still earning interest. Obviously, the amount of the check received depends on the amount of the investment annuitized. The larger the investment is, the larger the check received will be.

The time allotted to the annuitization will affect the size of the monthly or quarterly income received; the check will be larger if a shorter annuitization period is selected (such as ten years versus twenty years). Lifetime income options eliminate beneficiary designations, so that must also be taken into consideration.

Fixed rate annuities are among the safest and most conservative investments. People holding Certificates of Deposit often select fixed rate annuities to obtain additional advantages not offered by CDs. Since both are extremely safe, those who favor Certificates of Deposit are also likely to favor the traditional fixed rate annuities, but not necessarily fixed equity indexed annuity products since they are more complicated.

A Closer Look at Fixed Equity Indexed Annuities

Most equity-indexed annuities are declared rate fixed annuities, meaning the annuity’s rate of interest is re-set each anniversary date. For example, the first year might guarantee an interest rate of no less than three percent; the second year could adjust down or up, depending on current markets. Whatever subsequent years might be, the declared interest rate can never be a negative number. Like all annuities, as long as the investor holds the product to maturity, he or she will receive at least all they paid in; the investor will never lose principal, as can happen in stocks and mutual funds. For many investors, the absolute guarantee of principal is the major reason annuities are chosen for retirement investing. This might especially be true for those having experience in the stock market.

While annuity contracts are not all the same, generally equity indexed annuities do not have internal expenses, meaning there are no fees, or front-end or back-end loads that could hamper the product's performance. While we must always stress that contracts can and often do vary, most equity indexed annuities have clarity in that what is presented by the insurer is what is actually charged. This is different than variable annuities, mutual funds, and managed accounts that typically have various management fees and expenses.

Typically, equity-indexed annuities are *deferred* annuity vehicles because they do not begin providing income for several years. An annuity that begins paying income within a year of contract origin is considered an immediate annuity. The insurance companies need a period of time to earn a profit and the annuity needs a period of time to earn enough interest to adequately perform. The period of time during which the annuity is growing, earning interest, and perhaps receiving additional deposits from the investor is called the **accumulation phase**. Once systematic payments begin (upon annuitization), the contract moves into the **distribution phase**.

Equity-indexed annuities often allow free withdrawals during the accumulation phase without charging surrender penalties, but it is always necessary to read the contract for details. Depending on the contract, it may be possible to withdraw up to 10 percent of the account value during the accumulation phase. However, it is important that contract owners realize that any time funds are withdrawn there is less money in the account earning interest. Even so, this can help with occasional financial needs of the investor. If the investor is not yet age 59½ any withdrawals are probably subject to the 10 percent Internal Revenue Service early withdrawal penalty. As stated throughout this course, it is important to know that annuities are long-term investments and typically not suitable for short-term goals.

Once the distribution phase begins, the annuity's account value will be declining steadily, as monthly, or quarterly payments are made. Investors typically take distribution payments monthly or quarterly, but many contracts allow semi-annual or even annual payments through the annuitization process.

What we have been discussing is true of all fixed rate annuities so why would an indexed annuity be better than any other fixed rate annuity? If the stock market crashed or simply underperformed the equity-indexed annuity, like other fixed rate annuities, would simply continue to operate as they always do, paying the pre-set rate of interest on the investment exactly as the contract promises. However, with an indexed annuity, if the stock market is performing well, the fixed equity-indexed annuity will earn more than it otherwise would which would be a positive since would maybe balance out inflation risk.

All equity indexed annuities track some specified stock market index; commonly it is Standard & Poor's Index of the stock values in 500 of the largest corporations known as the S&P 500. The S&P 500 is a registered trademark of McGraw-Hill & Company. Whatever index is used if it substantially increases during the term of the equity-indexed annuity, the annuity's value will increase to the extent specified in the annuity contract. It would be unusual for the equity-indexed annuity to grow exactly as the index it is based upon grows. Most do not tract the index exactly and there are various methods used to correlate gains. It should surprise no one that some contracts are more generous to the investor than others. It is important to realize that this added value should be considered a "bonus" since there is no loss if the markets perform poorly. No investor should buy with the expectation that there will always be bonus earnings either. Equity indexed annuities are first and foremost a fixed annuity product, but there may be additional earnings if the markets are favorable.

While it may not be so prevalent today, at least initially, equity-indexed annuities were constantly compared to variable annuities. They are not and never were variable annuities. Critics of equity-indexed annuities may still try to compare them and that does a disservice to the product. More importantly, it confuses consumers.

A variable annuity tracks the stock market directly, so its values go up and down with the stock market. That is not the case with an equity-indexed annuity. Just like all fixed rate annuities they perform based on the contract with a bonus earning if the index it is based upon performs favorably. Variable annuity values are determined by a separate account that holds various investments, often similar to mutual funds, for each contract owner. Many allow contract owners to choose their own funds but, in most cases, it is important that the portfolio be professionally managed for maximum performance. Variable annuities experience full stock market risk while equity-indexed annuities do not. This distinction should not be taken lightly since it is a tremendous difference in product types. Just as stock market managers are unable to provide long-term financial guarantees variable annuities cannot give long term performance guarantees either. Experienced money managers may be able to forecast but it is just that: a forecast – not a guarantee. Some variable annuities do guarantee the investor's return of principal in the case of premature death or during a specified time following the contract's issue date. A variable annuity has the potential of total loss; that is, the investor could lose the entire amount he or she invested if the market takes a dive and remains down. A fixed equity indexed annuity would not be affected by a market dive; the investor simply would not earn any "bonus" earnings. As long as the investor holds the annuity contract past the surrender period (maturity date) he or she would receive all principal sums and any guaranteed interest earnings.

Another important difference between variable annuities and fixed equity-indexed annuities are the fees charged. While every contract can vary, typically variable annuities have several types of fees and expenses, many of which are tied to the buying and selling of stocks. Obviously, fees and expenses (often referred to in the contracts as management fees) will retard potential earnings. Equity-indexed annuities generally do not have internal fees and expenses beyond what is prominently stated in the contract. Any fees that do exist would be minimal, so the investor knows exactly what his or her contract earnings are.

A Closer Look at Variable Annuities

Variable annuities present the most risk among annuity types, but they also offer many investment opportunities. A variable annuity is (1) an investment company, (2) an entity that makes investments, and (3) institutions that share common financial goals.

A variable annuity is basically a tax-deferred investment vehicle that comes with an insurance contract designed to protect the investor from a loss in capital. Thanks to the insurance involvement, earnings inside the annuity grow tax-deferred and the account is not subject to annual contribution limits. In a variable annuity, the investor chooses from among a range of different investment options, typically mutual funds. The rate of return on the purchase payments, and the amount of the periodic payments eventually received will vary depending on the performance of the investment options the annuitant selected.

Generally, the investor chooses from a menu of mutual funds, known as "subaccounts." Withdrawals made after age 59½ are taxed as income. Like most annuities, earlier withdrawals are subject to tax and a 10 percent IRS penalty.

Variable annuities can be either immediate or deferred. With a deferred annuity the account grows until the investor chooses to begin withdrawals, which should be after age 59½ to avoid IRS penalties. The annuity may be annuitized, using one of the payout options, or the investor can withdraw money as he or she wishes (never annuitizing the contract).

Like most annuities, variable annuities are long term investments. The longer the policy owner allows their money to build, the more he or she is likely to gain from the investment. However, unlike fixed annuities (where the funds sit in an account from which payments provide a fixed income throughout a fixed time period), variable annuities give the investor more control over their investment but also gives the investor the burden of risk. There should be no mistake on this point: variable annuities have investment risk.

The money deposited into variable annuities can go into the investor's own account, separate from the investment portfolio of their broker or insurance company. The investment choices are, therefore, the investors to make.

As one nears retirement, it often wise to avoid riskier investments since the time to make up losses is not there. Younger investors are more likely to favor variable products since they do have time on their side, and they may actually enjoy involving themselves in the investment choices. These investors may want to play the money market, or invest in stocks, bonds, or equity funds. The variable annuity returns depend on the account's performance rather than just rising and falling with the fortunes of the firm that holds it.

Variable annuities often provide a wider spectrum of investment opportunities for retirement savings, while providing professionally managed fund options as well.

Variable Annuity Annual Expenses

The investor's broker or insurance company may guarantee the principal investment, minus withdrawals for any of the following annual expenses.

- **Annual annuity charge**. This fee is based on the total value of the variable annuity, plus the cost for the broker or insurer administering it and giving the investor the option of a lifetime's worth of annuity income. When the contract with the annuity broker provides for death benefits, annual annuity charges increase. This is generally computed by adding M&E (mortality and expense risk) to administration charges.

- **Maintenance fee**. This is simply a yearly fee for maintaining the contract. It pays for contract administration and communication services.

- **Underlying fund fees**. The broker holding the variable annuity will normally charge an annual fee for managing the investments.

- **Surrender charges**. If the investor withdraws their money within the first three to ten years from the date he or she took out their variable annuity, then he or she has to pay surrender charges based on a scale of declining charges. The exact percentage of the charge will depend upon the annuity contract and how long the surrender phase was.

Insurance producers should never assume that the percentages or costs that were listed in this text apply to all annuity products. Companies continue to change, add, or delete features as they try to gain additional clients, market shares, or correct faults within the products.

Funding Variable Annuities

Most investors choose to first maximize their retirement options as far as their individual retirement accounts (IRA) or employer-sponsored programs are concerned. If the investor still has some money they still wish to invest towards their retirement, then a variable annuity could be a good option. Since this is a risk vehicle, few professionals would recommend it as the only retirement investment since it would not fall under the care obligations that must be followed.

It is possible to either purchase a variable annuity outright or make regular deposits to it over time. The investor usually has the option of trading any current annuity for a variable annuity. However, transferring funds from an already tax-deferred plan, such as a 401(k) plan, into a variable annuity will not add value to the investment since the investor would just be paying their broker fees for tax deferral they already have.

Popularity is no indicator of practicality. Not everyone needs an annuity and certainly not everyone should buy a variable annuity due to the risk involved.

Variable annuities do have fees. Some financial planners feel the amount of fees are extravagant in some variable annuity products, so wise insurance producers will certainly shop around for the quality of products they want to represent.

Variable Annuity Death Benefit

The variable annuity death benefit basically guarantees the account will hold a certain value should the annuitant die prior to annuity payments beginning. With basic accounts, this typically means the beneficiary will at least receive the total amount invested even if the account has lost money. For an added fee, this figure can be periodically increased. If the investor decides not to annuitize the death benefit typically expires at a specified age, often around 75 years old.

Contract Provisions Affect Consumers

Whether the investment is gold or pork bellies, the investment performance will affect investor earnings. The same is true of annuities. Obviously, the primary way the investor is affected is by the amount of return or loss of principal but there are other effects as well.

Annuities have what might be referred to as "holding" periods. These holding periods might include the amount of time the investment is held by the investor or the time between the purchase and sale of a security. The *holding period* refers to the time between the asset's purchase and its sale or annuitization. In securities, it can have a different meaning. Sometimes the holding period of an investment is used to determine taxing of capital gains or losses.

When referring to annuities, it is likely the term would be regarding surrender penalty periods or sometimes even when referring to withdrawal allowances.

For example, Connie and Robert want to buy a house. Their Uncle Charlie tells them to buy an annuity because the gains are tax deferred. Uncle Charlie is 62 years old and retired and only knows how his annuity worked for him. He does not realize that there is an IRS early withdrawal penalty or that companies impose surrender charges if the annuity is not kept to maturity. Hopefully, Connie and Robert will discover this before they make a buying error.

Any investment considered by a consumer must meet their needs and goals. Just because a product suited one person perfectly is no guarantee that it will suit the next person just as well. Annuities have variations that work for some but not for others. Obtaining a complete customer profile will help both consumer and insurance producer to pick out the best options.

Traditional fixed rate annuities are typically suitable for the investor who is risk adverse and want guarantees in writing. Equity indexed annuities (which are fixed rate products) allow greater growth potential but they often do not guarantee growth. While principal may be guaranteed, it is possible that there will be no interest earnings, depending upon the market performance. On the other hand, they may earn higher rates than the traditional annuity – again depending upon market trends.

Variable annuities are suitable for investors who do not mind risk; some investors seek out risk because they have a high-risk tolerance, and they hope to make greater gains than possible in the more conservative annuity contracts.

Annuity Surrender Values and Penalties

Annuities have surrender penalties. The policy will state the terms of the surrender periods. This is an important part of the contract and should not be minimized.

Some contracts may refer to surrender penalties as withdrawal penalties, but whatever the term annuities will penalize the annuity contract owner for early withdrawals. It may be possible to take 10 percent withdrawals without penalty; refer to the annuity contract for details. Certainly, if the contract owner removes the full contract value before maturity there will be a penalty based on how long the contract has been held.

It would be unusual to see an annuity contract that did not have surrender fees. The length of the fees will vary, with seven to nine years being common. The reason insurers can guarantee interest rates is because they expect to have the funds for a specified period of time. To discourage early withdrawal of funds or a complete surrender of the contract, insurance companies impose early surrender fees. Surrender fees are a type of penalty for withdrawing money sooner than agreed upon at the time the contract was issued.

Surrender charges start off high and decrease a percentage point each year. For example, in a nine-year contract, the first year would experience a nine or ten percent penalty fee, and then decrease by one percentage point each year. It might look like the following:

Contract Year 1	9% surrender fee
Contract Year 2	8% surrender fee
Contract Year 3	7% surrender fee
Contract Year 4	6% surrender fee
Contract Year 5	5% surrender fee
Contract Year 6	4% surrender fee
Contract Year 7	3% surrender fee
Contract Year 8	2% surrender fee
Contract Year 9	1% surrender fee
Contract Year 10	Zero surrender fee

When there is no longer a contract surrender fee, the policy has reached what is called the **term** of the policy. Some people refer to this as policy **maturity**, but *actual maturity* is not the end of the surrender period; it is the latest date on which the owner can begin receiving payments from the annuity. Most contracts state a specific age for maturity, such as age 100.

Surrender penalties or fees do not apply if the contract is annuitized or when death benefits are paid due to the annuitant's death. If the contract is annuitized, an income stream begins, and the contract is then "locked in" based on the payout option selected. Once a payout option is selected and the first check has been cashed it is generally too late to make any changes; the contract owner cannot change their mind later. Whatever payout option was chosen determined length and amounts of systematic income.

Annuity critics seem to concentrate on commissions earned by insurance producers, an odd concern to say the least. This is odd because the rate of commission has no direct effect on the contract terms. If the consumer is aware of the guaranteed rate of interest and is content with the guaranteed rate stated, whether the insurance producer earns a commission has no direct effect on the product's performance. This is true of all fixed rate annuities, and the fixed equity-indexed annuity is no exception. Appendix form A was created to inform consumers of how the agent is paid.

Sometimes annuity critics argue the annuity product would pay a higher rate of return if the insurance producer received less commission and this may be true to some extent. However, the overall performance is stated in black-and-white for the investor to view. If he or she is happy with the contract terms, there should be no concern for the amount of commission his or her insurance producer receives. The first and primary obligation is simple: does the investment suit the investor's goals and requirements, including risk tolerance above any commissions earned?

The commissions paid to insurance producers may affect the bottom line since the more the insurer pays their insurance producer (or to any other operational expense for that matter) the less there is for other insurer costs. To this extent, commissions may affect interest rates that are guaranteed (it will not affect rates based on market performance in most cases), participation rates, caps, and the length of surrender periods. Since these terms are already set when the product is offered the consumer will not get a better contract by bargaining for lower commission rates. The consumer would be wise to shop the marketplace for the best product but that is wise regardless of commissions paid. Since commissions have already been built into each product commission differences may be hard to see. It would be foolish to get so sidetracked by what the representative earns that the important issues are overshadowed: safety of principal, insurer financial stability and satisfaction of investment goals.

Insurance producers have not just an ethical responsibility to represent and recommend suitable annuity products that meet the best interests (suitability standards) of the buyer but also a care obligation to always act in the best interest of the consumer. Many states already have suitability requirements, now referred to as the "best interest" requirements for consumers, for annuities because there has been fear that insurance producers might place unsuitable products, especially with older investors who do not have time on their side if a mistake is made.

The best interests of the consumer is always required. Since they are long-term investments any type of annuity product must meet the needs and circumstances, including goals, of the investor. For example, most professionals would feel it was unwise to place all an investor's funds into an annuity (no matter how good the product was). If the investor experienced an emergency need for cash, there would be no funds available unless the investor paid an early surrender penalty on the withdrawn funds. Therefore, insurance producers must understand the circumstances (consumer profile) of each consumer prior to making recommendations. Only if the consumer refuses to provide full information is the insurance producer released from his or her ethical obligation to determine the best interests of the buyer.

Guaranteed Rates of Return

Fixed rate annuities, including equity-indexed annuities, promise a guaranteed minimum rate of return. This may be referred to as the "floor" rate since it is the lowest rate that will be paid. The annuity might pay a higher rate than guaranteed, but never a lower rate. Higher rates might be paid when market conditions are or have been good. At each anniversary, the minimum rate is re-set, but that does not mean higher rates could not be credited if circumstances warranted it. In the case of equity indexed annuities, there is also the possibility of bonus earnings if the market index does well.

Especially regarding equity indexed annuities, investors must always pay attention to the guaranteed or floor rate since it is the only interest rate return that is promised. *Higher rates or bonus returns are not guaranteed.* Some contracts do not give more than a zero-percentage guaranteed rate of return. In these contracts, there is no guaranteed interest rate that will be earned, but the principal is still protected or guaranteed to remain intact. In other words, in the worst index situation investors would not lose their principal but they might not gain any interest earnings either and be subject to inflation risk. Generally, fixed rate annuities (that are not equity indexed vehicles) would guarantee at least a couple percentage points in interest earnings but equity indexed annuities do not necessarily do so. This is another good reason to compare products, although the guaranteed rate of return is only one element of the product and not always the most important one. In some cases, the investor is better off with a lower guaranteed rate since the contract may offer better participation in the index-linked return if the interest rate is lower, maybe even a zero floor. The goal is an index-linked return that out-performs the guaranteed rate of return.

Interest Crediting Methods

How returns are credited to the annuity contract can be important as well as the actual rate of return earned. Some contracts may credit guaranteed interest earnings quarterly while others do not credit them until the end of the surrender period (which could be ten years from the date of issue). If they are not credited until the end of the surrender period, then any penalty-free withdrawals will not have earned even a penny of interest. It will be as though the funds had never been deposited. Even if no funds are withdrawn, actual earnings are likely to be lower than a contract that deposits quarterly or even just yearly.

Insurance companies will make early withdrawals unattractive in many cases because the point of buying annuities is for long-term investing. Insurance producers should never recommend depositing funds the investor might need during the surrender term of the annuity contract. Annuities, including fixed equity indexed annuities, are not in the best interest of any investor who may need the funds prior to the end of the policy surrender period.

Most annuity owners and annuitants do not consider how rates are determined or credited; they largely prefer to have their insurance producer select and present an appropriate and advantageous product for them. Especially with EIAs, crediting of participation rates can be complicated even for insurance producers who work daily with the products. It might prove difficult to fully explain the process to consumers. Even though it can be complicated, how earnings are credited can significantly affect the end results, so it is an important consumer topic.

One might assume that each insurer will credit all their fixed annuity products the same but that is not always true. Even within the same insurer, different products might credit earnings differently.

Some EIA products will not apply the minimum guaranteed interest rate to 100 percent of the principal. It is possible that only 80 percent to 90 percent of the principal amount will be credited with earnings. Some equity indexed annuity (EIA) contracts give the insurer flexibility to even change its crediting rates, but most contracts specify certain minimum crediting rates that must be followed. As with all insurance matters, it is important that the selling producer be fully and completely aware of the products he or she is marketing. It does not matter how sincere the selling producer was; if a major error is made it is the producer’s fault since he or she had an ethical duty to know the products he or she represented.

Important Consideration

While most fixed annuity products guarantee against loss of premiums paid in, that is not always the case. Even though EIAs are fixed annuities, equity indexed annuities do not make this guarantee of the full amount, guaranteeing only a percentage, such as 90 percent *plus whatever minimum interest guarantees exist. In these cases, if the investor does not receive any index-linked interest there could be loss of premiums. Of course, if the equity indexed annuity were surrendered during the penalty period, that could also result in a loss.*

To know how interest earnings will be credited, it is necessary to understand how the insurer credits premiums for the purpose of calculating interest payments. Individuals must also know if the issuing insurer has contract limitations preventing them from changing crediting methods. It is necessary to see how the insurer credits premiums and secondly if crediting methods may be changed. This will be found in the policies.

Simple Versus Compound Interest

Every insurance producer knows (or should know) the great difference between simple and compound interest. Simple interest applies only to the principal payments whereas compound interest applies to both principal payments and accruing interest earnings. In a way, that means that the interest applied in previous periods begins to act like principal, also earning additional interest. It has been suggested to always seek compound interest products, never simple interest policies. In fact, a compound interest policy will often accrue more earnings even if it offers a lower rate than a simple interest product. It will depend on the point spread, but seldom do simple interest vehicles compete well with compound products.

According to NASD, the way an annuity company calculates interest earnings during the policy term will certainly make a difference in the product. Some contracts might pay simple interest during the term of the annuity but change after that point. Anytime there is no compounding, similar rates of return will mean that the compound interest vehicle did better than the simple interest vehicle.

Some equity indexed annuities might pay simple interest during an “index term,” when bonus points are possible. This means index-linked interest is added to the original premium amount, but it does not earn compounded interest during the term. Others may pay compound interest during a term, which means that index-linked interest that has already been credited also earns interest in the future. In either case, the interest earned in one term is typically compounded in the next.

Although most professionals feel it is best to stay with compound interest vehicles, there may be reasons to go with the simple interest vehicle. Perhaps the simple interest product has some feature the investor specifically wants, for example.

Some non-equity indexed annuities might offer bonus rates for one year, maybe even several years. Of course, if the investor surrenders his policy during the surrender period bonus rates seldom, if ever, apply. Alternately, some equity indexed annuity products might offer bonus rates to an older non- equity indexed annuity to draw in business for their equity indexed annuity products. If the bonus makes up for any early surrender penalties it may be worthwhile, but product replacement should never be considered without knowing all the facts.

Sometimes we may see a financial journalist suggest that any annuity bonus inducements are questionable. The journalist might suggest that the insurer has an inferior product and is using the bonus to entice in customers they would not otherwise get. We do not generally agree with these kind of generalities, although each product must be individually considered to give an adequate answer. Just as department stores have sales to attract customers, insurers offer bonus points to attract consumers. The cost of offering such bonus points is figured into overhead; insurers are typically good at analyzing profit and loss. After all, their business is based on risk factors. Although bonuses can give an annuity product a strong performance start, it is important to also look at any limitations on performance that might affect the final returns. In all cases, products must comply with state and federal requirements.

If withdrawals are made, even if there is no surrender fee applied, it is likely that the amount withdrawn will not be credited with interest, so this should always be considered prior to pulling money out of an annuity. Of course, withdrawals made prior to age 59½ will incur an early distribution charge from the IRS as well.

Equity Index Annuity Crediting

There are various fixed equity index annuity products. The differences can be important as they apply to crediting.

Interest crediting provides a minimum return; index crediting provides the potential of a maximum return at the end of the term because it is measured in some specified way with the chosen index. Although interest guarantees can be zero, it is likely that at least some amount of interest earnings may be guaranteed, even if only one percent. If an investor were only interested in the guaranteed rate of interest earnings there would probably be no point in depositing funds into an equity indexed annuity contract; a traditional fixed annuity product would be sufficient.

Like all annuities, equity indexed annuities are insurance products and are issued by insurance companies. *The buyers of these products are not directly purchasing stocks*.

There are two important aspects to equity indexed annuities: the indexing method and the participation rate.

Equity indexed annuities are fixed rate annuities, either immediate or deferred. They earn interest or provide benefits that are linked to an external equity reference or an equity index. The index value will be tied to some particular index, such as stocks, often the S&P 500 Composite Stock Price Index. This would be an equity index. The value of any index changes often, perhaps daily, or even hourly. The changes cannot be predicted, so there is growth risk involved, although the principal is not at risk.

The indexing method is the method used to measure the amount of change in the index. While there is not necessarily going to be change, change is likely. The most common indexing methods are annual reset, also called ratcheting, high-water mark, and point-to-point. The original EIA used only a single method, usually the S&P 500. There are now many ways to calculate contract values.

EIA Participation Rates

Participation rates can be a limitation on the base interest rate paid by the issuing insurance company. They can also limit the index-linked return. Since participation rates are primarily a function of equity indexed annuities consumers do not typically have experience with them and may lack understanding of an important product feature.

A participation rate will determine how much the gain in the index will be when credited to the annuity. How gains will be credited can be confusing. The annuity insurer may set their participation rate at various amounts (depending upon the product); for example, it may state a participation rate at 80 percent, which means the annuity would only credit the owner with 80 percent of the gain experienced by the selected index (the S&P 500 for example). If the calculated change in the index is 9 percent and the participation rate is 70 percent, the index-linked interest rate would be 6.3 percent. This is figured by multiplying 9 percent times 70 percent, equaling 6.3 percent.

Participation rates for newly issued annuities can change daily. As a result, initial participation rates will depend upon the date the insurance company issued the annuity. Participation rates are usually guaranteed for a specified period of time so additional deposits may receive the same rate as the initial deposit. When participation rates are guaranteed, they may range from one year on. It is always important to check the actual policy since products do vary.

Once the product period ends, the insurer will set a new participation rate for the next period. Some annuities guarantee that the participation rate will never be set lower than a specified minimum or higher than a specified maximum.

Participation rates offering less than full value (100 percent) protect the insurers in some situations and may allow them to offer higher interest rates or caps. It may surprise consumers to learn that sometimes it is better to select products with less than full value (80 percent to 90 percent perhaps) to earn higher rates of interest. Although critics may imply that less than full participation rates are a product disadvantage, in fact they are often beneficial.

EIA Averaging

Some equity-indexed annuities average the index (called averaging) based on the indexed-linked returns during the entire period rather than simply subtracting the beginning point from the end point. Averaging can protect consumers from index crashes or greatly fluctuating indexes. As is always the case in averaging, the highs and lows are smoothed out. While it does smooth out the peaks and valleys, there is the risk that some return will be lost, especially if highs outnumber lows. Averaging methods will vary. Some insurers average daily, while others average monthly. The National Association of Securities Dealers (NASD) warns that averaging could reduce earnings.

EIA Caps

Some equity indexed annuities will have caps. In other words, returns are capped or limited. Usually caps are stated as percentages; these are the highest rates of interest that can be earned. If the product's index gained five percent but the cap was set at two percent, then two percent would be the most the investor could earn. Not all equity indexed annuities will have a cap, but it is something that insurance producers and consumers must be aware of.

Caps absolutely do affect how these products perform but that does not necessarily mean investors must totally avoid them. Annuities with caps may have other features the investor wants, such as annual interest crediting or the ability to make penalty-free withdrawals. Caps often allow insurers to offer other benefits, such as higher interest rates. A professional insurance producer will help the investor to decide whether it is better for their particular situation to have higher participation rates or higher caps.

The most common caps are annual and monthly caps, but products vary, so insurance producers must view each contract individually. Some contracts allow the issuing insurer to change caps based on specific market conditions. If this is the case, investors need to be aware of the fact.

EIA Spreads, Margins, and Administrative Fees

Some equity indexed products will deduct a percentage from the gains in the form of various fees. The percentage could be in addition to or in lieu of participation rates or caps. The fees may come under different names, such as spread, margin or administrative fee. These are not the only names it may come under, but they are the most common. The fees may be in addition to or instead of a participation rate.

Withdrawing Annuity Funds

Most insurance producers are probably familiar with the income-for-life payout benefit of annuity products. Under this method, the investor can select to receive income for the duration of his or her life; they have an income that they cannot outlive. However, there is no guarantee as to the actual amount of lifetime income. Obviously, if the investor saves too little in the annuity product, the amount of income stream would be small (too little to support their income needs perhaps). Therefore, the first and most important aspect of saving is to save *adequately*. Still saving something is better than saving nothing, so even if the individual knows the money being set aside is inadequate that does not mean he or she should abandon saving altogether.

Annuity Benefit Payout Options

Annuities were designed to provide income, with payout beginning after age 59½ since the Internal Revenue Service considers annuities to be retirement designated vehicles. Annuities may still be used for other goals, but primarily they are considered retirement vehicles. Although annuities were designed for payout, they are often used primarily for wealth accumulation. In other words, most annuities were traditionally not annuitized (turned into an income stream). Instead, most investors accumulated funds in their annuities, and then simply withdrew the entire value or exchanged it tax-free for another annuity, with the accumulation process starting over again. Eventually, the annuities went to the listed heirs.

COVID-19 is also affecting insurance companies. The initially falling stock market had an impact on insurers. They had to contend with unprecedented volatility and extremely low interest rates. Insurers were not able to adjust their annuities fast enough, so many insurers simply removed annuity availability, meaning they simply removed the ability to apply for them. In other words, the products were suspended in the marketplace. Fixed indexed annuities were either pulled off the market entirely or versions of them were removed by insurers.

Because of such low interest rates, one might assume investors would lose interest in buying annuities, but COVID-19 prompted the opposite reaction from investors. With greater concern for their principal and less concern with interest earnings, insurance producers suddenly found great demand for annuities. Especially individuals nearing retirement wanted principal protection. A professor of retirement income with The American College said when people are panicking, it might be better to buy an annuity than to put their money into some other vehicles where risk might be high. Although annuities are not right for everyone, at least the investment would be safe.

The year 2019 was a record year for annuity sales according to the Secure Retirement Institute (SRI). It is difficult to know how they will fare through the pandemic, but all indications say insurers will have a good year, assuming insurers agree to sell annuities the same way they did before.

Some consumers have expressed concern regarding the strength of the insurance companies they have invested through. Of course, everyone should invest only through financially strong insurers with top financial ratings from the companies that do that. In most cases, insurers with top ratings are generally conservatively managed and properly positioned to meet obligations in the now and in the future. According to Ewanich, a person holding an annuity with a highly rated insurer is likely on solid footing and need not worry about their own annuities.

Because of the pandemic, some insurance companies are making it easier to access their money, sometimes even waiving fees. However, this is not guaranteed.

Even though most annuities were not annuitized for systematic payout in the past, it has always been important for insurance producers and their clients to understand the available payout options. When annuities were created the issuers assumed lifetime income would be primarily used. They were designed to pay a specified amount, based on the total dollars in the annuity, for the remainder of the annuitant's life, regardless of how long he or she lives. Under this arrangement, beneficiaries receive nothing even if the annuitant happens to die soon after annuitizing the contract.

> For example, Annie Annuitant and Alvin Annuitant each have an annuity in their name of equal value (for this example let's say each Annuitant has $50,000 in their annuity). Annie and Alvin both choose lifetime income when they annuitize their contract and each receives the same amount each month. Just to keep it simple, we will say that each Annuitant receives $1,000 per month (the actual figure might be far different, based on the age of each Annuitant and their "life" expectancy).
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> Alvin begins receiving his $1,000 per month on January 1. In June of that same year he becomes very ill, eventually dying three months later in September. Alvin received a total of nine annuity payments totaling $9,000. The remainder of his annuity ($41,000 plus accrued interest) will stay with the insurer that issued the policy; Alvin's heirs will receive nothing.
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> Annie also begins receiving $1,000 per month on January 1 just as Alvin did. However, Annie Annuitant lives to an old age. She eventually receives every penny of the $50,000 in her annuity, but she continues to receive the $1,000 monthly payment even though her own funds have been depleted (that is what "income for life" means). By the time Annie eventually dies she has received $75,000 from her annuity contract. As a result, the insurance company paid out $25,000 more than it received. However, the company also retained $41,000 from Alvin so the insurer still made a profit based on these two people.

Insurance companies use analysts to determine expected longevity of their policyholders because their goal is always to earn a profit. While it is not possible to know for sure how long each person might live, there are indicators that suggest the likelihood of longevity. Alvin's beneficiaries are likely to be unhappy about the loss of the remaining $41,000 but Annie's family will be happy to see how her annuity paid out.

Once an annuity contract is annuitized it cannot be changed; the annuitant or policy owner cannot change their mind down the road. Usually, the point of no return is when the first annuity payment is cashed, or if a direct deposit is used, the date the check is deposited. Each contract may vary so it is important to consult the actual policy for details. Since the payout option is locked in, insurance producers must be certain their clients understand the advantages and disadvantages of each payout option.

It is important to realize that all annuities may not necessarily offer all payout options. If a particular payout option is important to the buyer, he or she will want to specifically examine the available payout options listed in the policy. Any questions should be addressed prior to purchasing the annuity.

Nonhuman Payees Under a Settlement Option

Many contracts require the payee under a settlement option to be a human being, meaning they will not make payments to an entity such as a business. All settlement option payments during the life of the contract owner are typically made by check to the primary payee or by electronic transfer directly into their bank account.

Lifetime Income Payout Option

Different contracts may call lifetime income by different names, such as "Life only," "Annuitant Lifetime," "Straight Life," or other similar names. In each case, a definition will be in the annuity contract. As discussed, annuities were designed to provide a systematic income at some point in time. When a contract owner annuitizes their annuity, surrender penalties will not apply even if the contract is still in the early years of the surrender period. Annuitization is the process of beginning systematic payments to the annuitant. Some EIAs allow the investor to vary the frequency and amount of the payout to meet the investor's particular needs. Other than surrender charges, which are waived if the contract is annuitized, the only real limitation regarding payments applies to taxes. It is necessary to wait until the attained age of 59½ to avoid the 10 percent early distribution federal tax.

One of the most important benefits of deferred annuities is the ability to use the built-up values during the accumulation period to provide income during the payout period. Income payments are typically made monthly, but it is possible to choose some other systematic time period, such as quarterly or even annually. Annually may allow the investor the ability to pay debts that occur only once per year, such as property taxes or some types of insurance (long-term care insurance for nursing home coverage for example).

It is important that annuitants and annuity contract owners realize that the lifetime income option does not consider beneficiaries which is why the text repeats it over and over. However, since the insurer does not have to consider beneficiaries the payout option is often higher. In other words, the systematic payment to the annuitant will be higher because, as in Alvin's case, the insurer will keep any unused funds.

Life Annuity, Period Certain Payout Option

The Life-Annuity-Period-Certain option will pay the annuitant *less* in each systematic payment than would have been received under the Lifetime Option. That is because there is a specified time period involved (Period Certain). Under this payout option the annuitant is guaranteed to receive a specified amount, as determined at the time of annuitization, for his or her lifetime regardless of how long he or she lives. The annuitant is also guaranteed that if he or she dies prior to the stated time period his or her heirs will receive the remainder of the funds.

In Alvin's case, if he had chosen this option, he would have received less each month; he might have received $750 each month rather than $1,000 for example. If he chose a ten-year period certain his beneficiaries would have received the remaining $41,000 because he did not reach the selected ten-year time period. The time period does not have to be ten years of course; the period of time will depend upon what is selected at the time of annuitization. Many insurers will offer a variety of time periods, perhaps 5-, 10-, and 15-year periods. The amount of money received on a systematic basis will reflect the "period certain" selected. The longer the "period certain" the less the annuitant will receive as income each month. That makes sense since the insurer increases its risk when longer periods are selected that guarantee beneficiaries receive remaining funds. Once the guaranteed period (period certain) expires beneficiaries will no longer receive any remaining funds.

If the annuitant dies during the *period certain*, his or her beneficiaries will receive the remaining funds based on contract language. In other words, the contract may state that a lump sum will be paid to the beneficiaries or it may state that the beneficiaries will continue to receive funds as the annuitant would have based on his or her income selection. In Alvin's case he was receiving monthly income (the most common selection) so his beneficiaries would continue to receive monthly installments if that was the beneficiary terms of the contract. Many contracts allow the beneficiaries to make their own choice between two or three options, including a lump sum distribution.

Joint-and-Last-Survivor Payout Option

When there are two people in the household, such as husband and wife, the joint-and-last-survivor payout option is often selected since it pays an income to two named individuals. Of course, they are not required to be husband and wife, but that is commonly who uses this payout option. Since two people are guaranteed a lifetime income it is not surprising that the monthly installments are less for two people than they would be for a single individual. In some annuity contracts utilizing this payout option, the amount of systematic income is reduced upon the death of the first named individual; others continue paying the same amount. Some contracts offering this payout option would give a refund to heirs if both named individuals die within a stated time period. If this is the case, the payout option might be called Joint-and-Last-Survivor-Period-Certain. As with other payout options, there might be variances in the name the contract uses, but they will be similar enough to the name we have used that there should not be any confusion. As always, the contract definitions will also state how the payout option works so insurance producers and insureds should refer to their policy.

Required Distribution

Most annuities have some point in time when the contract must be annuitized or closed. The contract may be closed simply by withdrawing all funds. Mandatory distributions will be after the surrender period has expired, so such penalties will not apply. If the annuitant has not reached age 59½ the IRS early distribution penalty would apply on any funds that were withdrawn.

Annuitants and contract owners could choose to simply roll the annuity into a new contract, which would meet mandatory distribution requirements of the contract but avoid any IRS penalties. If the annuity were rolled into a new annuity contract new surrender periods would begin, since most annuities have them.

Unfortunately, some equity indexed annuities have mandatory annuitization, whether the investor wants to or not. Generally financial advisors recommend against buying these products.

Taxation

Annuitization works the same regardless of whether the annuitant or contract owner will owe taxes on their earnings. What will be different between a non-qualified annuity and a tax qualified annuity is the taxation. If the annuity is not a qualified annuity, taxes will be due as the growth is paid out. Under current tax status, the first money withdrawn is interest growth, with the last money withdrawn being principal. In a non-qualified annuity, the principal was taxed prior to deposit.

Annuity gains are taxed as ordinary income tax rates, which can be high for some people. In fact, it can be substantially higher than taxes on long-term mutual fund gains if withdrawals are not made during low-income years. The difference can eat up the advantage of an annuity's tax-free compounding. It may take 15 to 20 years before tax-deferred annuities become more tax efficient than a mutual fund, even though the mutual fund is not tax-deferred. However, many people keep their annuities for 15 to 20 years or even longer, so the taxation is less important from a financial standpoint. Additionally, many people are not looking at how the gains will be taxed because funds will be *gradually withdrawn* as lifetime income or because they will be in a lower tax bracket in retirement. A tax and retirement specialist should be consulted if annuities will be prematurely withdrawn.

Annuities are long-term investments, but at some point, funds are withdrawn, ideally in retirement which is what the IRS had in mind. Since annuities are tax deferred vehicles, withdrawals incur taxation on the amount not yet taxed.

Exclusion Ratio

When an annuity was funded with dollars that had already been taxed, when withdrawals occur, part of the withdrawal is not taxed because it was taxed previously. This concept is referred to as the exclusion ration, the amount that has already been taxed in other words.

Qualified and Non-qualified Annuity Annuitization

Annuities are used in all types of tax-favored retirement plans maintained by employers for the benefit of their employees. This is especially true of qualified plans such as 401(k) plans, tax-qualified defined benefit plans, 412(i) plans and employee stock ownership plans, governmental 457(b) plans and Section 403(b) arrangements. Individual retirement arrangements (IRAs) are also considered workplace retirement plans, such as SEPs and SIMPLEs.

The Internal Revenue Code allows preferential tax treatment for workplace retirement plans. Of course, there are requirements that must be met.

There are differences between the plans, but all tax-favored plans have limitations on the contributions or benefits that may be made on behalf of any plan participant. Primarily the use of benefits must be restricted to retirement purposes. In addition, some tax-favored plans require minimum coverage and nondiscrimination rules that are intended to ensure the plan covers a cross-section of employees (it cannot be discriminatory) and provides meaningful benefits to covered employees. The types of plans used by employers usually are attributable to their type of business.

Section 403(b) arrangements (tax-sheltered annuities) may only be maintained by employers that are exempt from income taxes, and state and local government schools. Governmental 457(b) plans may only be maintained by state and local governments and they differ from tax-exempt 457(b) plans. Tax exempt plans are a type of nonqualified deferred compensation plans maintained by non-governmental tax-exempt entities, most notably charities and private universities. Government 457(b) plans are a type of tax-favored retirement plans.

Tax-qualified plans can be sponsored by all employers as a general rule, but state and local governments cannot maintain 401(k) plans. A 401(k) plan is a qualified plan that permits employees to make pre-tax salary reduction contributions (the employee can elect to have salary reduced in exchange for an employer contribution which must be equal to the reduction in salary). Section 403(b) plan arrangements and governmental 457(b) plans are similar to 401(k) plans since they permit employees to make salary reduction contributions and all three plans receive the same preferential tax treatment.

Normally, contributions to a tax-qualified plan, Section 403(b) or governmental 457(b) plans are excluded from an employee's gross income and most state income tax laws if the contributions satisfy certain conditions and limits, and the earnings that are credited to the employee under the plan, accumulate on a pre-tax basis. Contributions and earnings become taxable only when they are distributed, but once distributed, these dollar amounts are taxable as ordinary income unless they are rolled over to an IRS qualified plan, a Section 403(b) program or governmental 457(b) plan.

As of 2006, a qualified plan or a Section 403(b) plan (not a governmental 457(b) plan) allows employees who make salary reduction contributions to designate some or all the contributions as Roth IRA contributions. This means that the earnings credited to the employee and attributed to the Roth contributions accumulate tax-free. A distribution of an amount attributable to the specified Roth contributions, which includes earnings, is entirely excluded from the employee's gross income under IRS Code and most state laws. Distributions that are attributable to Roth contributions are tax-free in most cases. If, for instance, the taxpayer is in the same tax bracket at all times and tax rates do not change, then there is no real difference between the tax treatment of a pre-tax contribution and a Roth contribution, with the exception that a Roth contribution produces a larger ultimate benefit than would a pre-tax contribution of the same amount.

NAIC Model Law Section 4. Exemptions
Unless otherwise specifically included, this regulation shall not apply to transactions involving:

A. Direct response solicitations where there is no recommendation based on information collected from the consumer pursuant to this regulation;

B. Contracts used to fund:

(1) An employee pension or welfare benefit plan that is covered by the Employee Retirement and Income Security Act (ERISA);

(2) A plan described by Sections 401(a), 401(k), 403(b), 408(k) or 408(p) of the Internal Revenue Code (IRC), as amended, if established or maintained by an employer;

(3) A government or church plan defined in section 414 of the IRC, a government or church welfare benefit plan, or a deferred compensation plan of a state or local government or tax-exempt organization under Section 457 of the IRC; or

(4) A nonqualified deferred compensation arrangement established or maintained by an employer or plan sponsor.

C. Settlements of or assumptions of liabilities associated with personal injury litigation or any dispute or claim resolution process; or

D. Formal prepaid funeral contracts.

ERISA and Tax Favored Retirement Plans

Primarily, the laws applicable to tax-favored retirement plans are part of the Employee Retirement Income Security Act of 1974 (ERISA) and the Tax Code. State laws do not usually apply to ERISA-covered employee benefit plans since ERISA does not preempt state insurance, banking, or securities laws, even if they relate to an ERISA plan. As a result, state laws apply to an annuity used in connection with an ERISA-covered retirement plan. ERISA-covered plans must comply with federal securities and bankruptcy prohibitions on employment discrimination and other such laws and restrictions. Governmental plans like 457(b) plans and Section 403(b) arrangements are not affected by ERISA, so governmental plans are regulated by state statutes and regulations.

Using Annuities in Tax Favored Retirement Plans

There are three primary ways that annuities can be used for tax-favored retirement plans, including:

1. funding a tax qualified plan, government 457(b) or Section 403(b) plan,
2. funding held as assets in trusteed retirement plans, and
3. annuities used to settle benefit obligations.

Annuities can be used to fund a tax-qualified plan, a governmental 457(b) plan or Section 403(b) arrangement. Usually the assets of tax-favored retirement plans must be held in trust by one or more trustees or in a custodial account with one or more custodians. However, an annuity issued by an insurer that is qualified to do business in the state may be used instead of a trust or custodial account. These plans are often called "non-trusteed plans."

Annuities may be held as an investment asset in a trusteed retirement plan. For example, the plan could purchase and then hold in trust a group annuity contract that would provide a method for offering and making life contingent annuity payments to participants. As a result, the trustee would be the owner of the annuity contract.

An annuity may be provided to the participant of a retirement plan with the participant as the named contract owner. The insurer would then assume the obligations of the plan.

Surprisingly, the tax code does not specifically define "annuity" although it does impose several requirements on annuity contracts. Generally, the tax law requirements for annuity contracts do not apply when annuities are used with a tax-favored retirement plan, in which case there are some specific requirements.

- The annuity contracts that are used in qualified tax-retirement plans are exempt from the diversification requirements that apply to variable annuities.
- Annuities used in tax-favored retirement plans are exempt from the IRS Code that states the annual increase in an annuity held by a non-natural person is taxable to the owners unless the contract is held as an insurance producer for an actual person. The effect of this is that the non-natural person owning the annuity is taxed on earnings from annuities under qualified plans unless there is an exception.

IRS Requirements for Annuity Funding

Annuity funding for tax-qualified plans must be nontransferable. The owner is not allowed to sell, assign, discount, or pledge as collateral for a loan, as security for the performance of an obligation, or for any other purpose, his interest in the contract to any person other than the issuer. Additionally, the annuity contract must specifically contain provisions making the contract nontransferable.

Other than the non-transferability of the contract, there are no other special requirements required for an annuity that funds a tax-qualified plan. There are numerous regulations and requirements for the plan itself but since the annuity funding the plan usually does not have the qualifications for the applicable plan, the same thing is accomplished by separate plan documentation kept by the employer.

Taxation of Qualified Annuity Distributions

When distributions are made from tax-qualified retirement plans it must first be determined if the plan was transferable. If it was transferable, then the fair market value of the contract is taxable to the person receiving the distribution.

If the annuity plan is nontransferable, and assuming the plan meets the qualification requirements applicable, the contract is tax deferred and tax is assessed only upon actual payments from the contract. The right of an individual to surrender a nontransferable contract for value does not affect the taxation. The cash surrender value is considered as income only when the contract is actually surrendered.

The principal requirement of a distributed annuity is determination of taxability at the time of distribution. If it is found to be taxable there are no particular requirements that apply to the contract, but if the distribution is not taxable because it is nontransferable, then the annuity is required to adhere to several tax-qualification requirements.

The IRS or the Treasury Department has provided no specific requirements for an annuity distributed from a tax-qualified plan to adhere to and there are several unanswered questions regarding the status of a distributed annuity contract. For example, it is unclear if loans are permitted from a distributed annuity contract or whether a distributed annuity can accept rollover contributions under IRS law. The answers seem to depend on whether a distributed annuity is considered as a continuation of the qualified plan. If it is, then probably the contract would have to satisfy all the requirements of qualification and would then be entitled to the benefits of qualified plan status.

It has been suggested that the distributed annuity contracts must satisfy some limited qualification requirements but are not subject to all the qualification requirements.

Most tax-qualified plans require the distributed annuity contract show the direct rollover requirements of Section 401(a)(31) and the spousal consent requirements of Section 401(a)(11) that requires the insurer to be responsible for obtaining spousal consent to certain distributions. Also, the distributed annuity must satisfy certain anti-cutback rules which specifies that benefits, which include some optional forms of payout, must be preserved in the distributed annuity to the same extent that they need to be preserved in a plan and minimum distribution rules of Section 401(a)(9).

Financially Sound Insurers

One of the first investment considerations must be the entity selected to deposit funds with. Whether the consumer is buying an annuity, a Certificate of Deposit, or simply opening a Christmas club account, the sponsoring organization's financial strength (or lack thereof) should be considered.

When selecting an annuity product, the sponsoring organization is always an insurance company. Whether the product is bought at the investor's local bank, from an insurance producer, or over the internet annuities are always issued by an insurance company.

Once the annuity product is past the surrender period, generally, the only way to lose money is if the sponsoring insurance company becomes insolvent. Obviously, no investor wants to be with an insolvent company. Guaranteed return is only as good as the entity sponsoring the investment; in the case of annuities that would be an insurer. Luckily, most annuity insurance companies do not become insolvent, but it can happen. Historically annuity companies seldom fail. Other investments are far more likely to experience insolvency than annuities. It is so rare for an annuity insurance company to become insolvent, even critics of annuities seldom mention this possibility. Even so, it is important to utilize only financially secure insurers because even a small chance of failure is important. COVID-19 has prompted renewed discussions of insurer financial health, although it is unlikely that COVID-19 will cause any company's failure.

There are distinct differences between variable annuities and fixed annuities. Fixed annuities are not backed by segregated reserves or specific assets, as variable annuities are. For the equity indexed fixed annuity investor he or she does not own the index, index shares, or stocks comprising the index. Equity indexed annuities are *contracts*. Equity indexed annuity investors own those contracts, which promise to pay money in the future from its general assets. Sound familiar? That is basically what life insurance policies are: contracts that promise to pay funds in the future if the insured dies during the term of the policy. Although equity indexed annuities are not life insurance contracts both contract types promise future payments. Annuities are backed by the assets of the annuity insurer (not just specific assets or specified pools of assets), which explains why it is important that only financially secure companies be selected. Equity income annuities are roughly comparable in their safety to money-market funds according to Jay D. Adkisson, JD, author of *Equity-Indexed Annuities: The Smart Consumer's Guide*.

Insurance companies must keep state-required reserves and other assets to satisfy their financial obligations, although the requirements may vary state by state. However, insurance producers should never use their state reserve requirements as a marketing tool; rather insurance producers should select financially secure annuity insurance companies to represent. The public is not likely to understand how state-mandated reserves work and usually rely on their insurance producers to select companies they can feel secure with. Although the states have an insurer guarantee fund (which each licensed company pays into) that never takes the place of due diligence. The wise producer will only consider financially top-rated companies to represent.

How does an insurance producer know which companies are financially strong? Although producers could perform their own due diligence most simply rely on the rating companies to do so. Companies whose primary function is to measure the financial strength of insurance companies generally do a good job of determining which company is weak and which is strong. They assign ratings to the insurers that tell insurance producers the company's financial strength. Several companies perform these ratings, so it is possible to look at more than one company's opinion of an insurer's financial strength.

Each rating company will have their own rating method, so insurance producers and investors must take time to understand how the ratings apply. Some professional financial planners have favorite rating companies, but generally it is recommended that insurance producers consult more than one company. Each rating company will give their interpretation of the insurer's strength and weakness.

The Insurance Company or Companies Utilized

Although insurance companies are traditionally stable, companies can experience financial difficulties. State life and health insurance guaranty associations provide a safety net for their state's policyholders, but the goal is to only use companies that are financially strong. Consumers are unlikely to realize the ramifications of financially weak insurers. It is the responsibility of the insurance producers to make sure only strong companies are used.

Agents Can Only Sell Products Allowed by Licensing Status

Depending upon the consumer's goals, needs, and financial situation, one insurer might be recommended by the producer, or multiple companies might be involved. This also depends upon how the insurance producer is licensed since he or she can only sell products that he or she is licensed and authorized to represent.

Some insurance producers are captive agents, meaning he or she can only sell the products that are available through a single insurer. The producer is contracted to represent and sell only that insurer's products, so he or she is a "captive" of that company.

In other cases, insurance producers are contracted with multiple companies. These insurance produces are typically referred to as "independent" because they are not tied to any one company. He or she may recommend a single insurer or multiple insurers, depending on the needs and goals of their customers.

Full Client Disclosure on Insurers

In all cases, it is required by best interest to specifically tell consumers what companies are involved in the recommendations that have been made. Producers should also state why one company or another has been recommended.

Best Interest Standards

Insurance producers are accustomed to what was previously termed "suitability" standards for annuities. The term now used by some states, as previously discussed, is "best interest standards." Many states have mandated best interest or suitability standards for annuities because there have been errors made in the past. Most insurance producers intend to do a good job for their clients but unfortunately some insurance producers did not understand whether the annuity was in the best interests of their clients and mistakes were made. By mandating best interest standards or suitability standards, the state insurance departments hoped to avoid errors that could cause financial harm to its citizens. Best interest or suitability standards provide guidelines for insurance producers who may not otherwise understand how to determine whether an annuity product sufficiently and adequately serve the buyer's needs and goals.

In the absence of state mandated criteria insurance product suitability could simply be a matter of opinion. For example, advocates of equity indexed annuities may feel that there is no bad equity indexed annuities while critics may feel there are no good equity indexed annuities. While there are no so-called good or bad products, there are certainly situations and products that are in the best interests of the consumer and products or situations that are not, based on the consumer's circumstances. The goal of the insurance producer is to determine if his or her client's situation would benefit from an annuity purchase and whether it would meet the consumer's goals. If it would not, then any type of annuity product might not be suitable or in the best the interest of the consumer. It is also possible that one type of annuity might meet the consumer's goals while another type of annuity would not.

NAIC Model Law Section 6. Duties of Insurers and Producers

A. Best Interest Obligations. A producer, when making a recommendation of an annuity, shall act in the best interest of the consumer under the circumstances known at the time the recommendation is made, without placing the producer's or the insurer's financial interest ahead of the consumer's interest. A producer has acted in the best interest of the consumer if they have satisfied the following obligations regarding care, disclosure, conflict of interest, and documentation:

(1) (a) **<u>Care Obligation</u>**. The producer, in making a recommendation shall exercise reasonable diligence, care, and skill to:

i. Know the consumer's financial situation, insurance needs, and financial objectives;

ii. Understand the available recommendation options after making a reasonable inquiry into options available to the producer;

iii. Have a reasonable basis to believe the recommended option effectively addresses the consumer's financial situation, insurance needs, and financial objectives over the life of the product, as evaluated in light of the consumer profile information; and

iv. Communicate the basis or bases of the recommendation.

(b) The requirements under Subparagraph (a) of this paragraph include making reasonable efforts to obtain consumer profile information from the consumer prior to the recommendation of an annuity.

(c) The requirements under Subparagraph (a) of this paragraph require a producer to consider the types of products the producer is authorized and licensed to recommend or sell that address the consumer's financial situation, insurance needs, and financial objectives. This does not require analysis or consideration of any products outside the authority and license of the producer or other possible alternative products or strategies available in the market at the time of the recommendation. Producers shall be held to standards applicable to producers with similar authority and licensure.

(d) The requirements under this subsection do not create a fiduciary obligation or relationship and only create a regulatory obligation as established in this regulation.

(e) The consumer profile information, characteristics of the insurer, and product costs, rates, benefits, and features are those factors generally relevant in making a determination whether an annuity effectively addresses the consumer's financial situation, insurance needs, and financial objectives, but the level of importance of each factor under the care obligation of this paragraph may vary depending on the facts and circumstances of a particular case. However, each factor may not be considered in isolation.

(f) The requirements under Subparagraph (a) of this paragraph include having a reasonable basis to believe the consumer would benefit from certain features of the annuity, such as annuitization, death or living benefit, or other insurance-related features.

(g) The requirements under Subparagraph (a) of this paragraph apply to the particular annuity as a whole and the underlying subaccounts to which funds are allocated at the time of purchase or exchange of an annuity, and riders and similar producer enhancements, if any.

(h) The requirements under Subparagraph (a) of this paragraph do not mean the annuity with the lowest one-time or multiple occurrence compensation structure shall necessarily be recommended.

(i) The requirements under Subparagraph (a) of this paragraph do not mean the producer has ongoing monitoring obligations under the care obligation under this paragraph, although such an obligation may be separately owed under the terms of a fiduciary, consulting, investment advising, or financial planning agreement between the consumer and the producer.

Determining the Best Interests of the Consumer

There are several elements that determine whether a product is suitable and in the best interests of the consumer, including the individual's risk tolerance, financial needs, cash reserves, and personal or financial goals. In some cases, it is obvious that an annuity does not match the consumer's best interests based on their financial situation or future goals. In some cases, *some types of annuities* do not meet the criteria, but another type of annuity might be in the consumer's best interests. As we know (or should know by now), there is no product that is always right for every investor. It is misleading to compare one annuity product to another if the features each offer is vastly different. We often hear this stated as "comparing apples to oranges." Each is a fruit, but the differences are great enough that they cannot be adequately compared. The same is true for some types of annuities.

Insurance producers must stress that it is not possible to predict how the markets will perform in the future. Even looking at past performance seldom offers guidelines, as producers and financial planners have witnessed over past years. Unfortunately, clients often blame their professionals when investments perform poorly, so it is in the insurance producer's best interests to have a written statement regarding the inability to make predictions. This statement should be signed at the time an annuity is purchased and kept by the insurance producer in the consumer's file. Consider this signed statement future protection if the client or his or her family becomes dissatisfied with the investment's performance.

A consumer profile will emerge from the information that is gathered by the insurance producer.

NAIC Model Law Section 5. Definitions

"**Consumer profile information**" means information that is reasonably appropriate to determine whether a recommendation addresses the consumer's financial situation, insurance needs and financial objectives, including, at a minimum, the following:

(1) Age;

(2) Annual income;

(3) Financial situation and needs, including debts and other obligations;

(4) Financial experience;

(5) Insurance needs;

(6) Financial objectives;

(7) Intended use of the annuity;

(8) Financial time horizon;

(9) Existing assets or financial products, including investment, annuity and insurance holdings;

(10) Liquidity needs;

(11) Liquid net worth;

(12) Risk tolerance, including but not limited to, willingness to accept non-guaranteed elements in the annuity;

(13) Financial resources used to fund the annuity; and

(14) Tax status.

Asking the Right Questions to Develop a Consumer Profile

Insurance producers must ask their clients to consider several questions when considering the appropriateness of an annuity product, especially if that product is an indexed or variable contract. The product must be in the best interests of the consumer. The following questions are not inclusive, but they are likely to be among the necessary questions to ask:

1. What is the soonest date the investment money will be needed? In other words, when will the money need to be withdrawn for daily living requirements?
2. Will annuitization be an option or does the investor think he or she will want to withdraw the investment as a lump sum?
3. Depending upon the date of withdrawal, could the surrender penalties be imposed if funds were withdrawn and the policy surrendered (not annuitized)?
4. Does it seem likely that withdrawals will be needed that are larger than any “free withdrawals” allowed under the annuity contract? This relates to any insurer-imposed surrender penalties.
5. How old does the investor expect to be when funds are withdrawn? This relates to the IRS penalty if funds are withdrawn prior to age 59½.
6. What is the intended use of the annuity investment?
7. Is the investor more interested in the highest possible gains or in preservation of principal? This relates to risk tolerance.
8. It is not possible to have both the highest rate of return and little or no investment risk. Does the annuity client understand this?

When insurance producers ask these and similar questions of the consumer, their focus should be on the most *adverse* possibilities. For example, if the consumer thinks he or she may need large withdrawals during the surrender phase of the contract it is likely that an annuity of any type may not be suitable for their personal circumstances. Even if it is only a possibility that money may be needed it would be foolish to tie up all available funds in a non-liquid investment.

Investors and insurance producers should never simply assume liquidity will be available somewhere outside of the annuity, such as home equity or amazing investment growth. Taking the optimistic view does not comply with product best interest requirements. Any consumer that does not have sufficient liquidity for the surprises in life should not invest everything in an annuity; enough cash reserves should be retained in a liquid account of some kind. This is true for all consumers of all ages. We all need an emergency account that can be easily accessed.

Annuities are often used to pass wealth on to heirs, such as children and grandchildren, but many financial managers feel that goal is better served with a life insurance policy. This might be true even if the money in the annuity will not be needed at any future date. The life insurance policy should be held outside of the estate to minimize delays in distributing funds. These issues should be discussed with a qualified financial planner or attorney of course, so that the best avenues are utilized.

Annuities are considered long-term investments. Never should excessive funds be tied up in long-term vehicles. Even when the investor does not expect to need the funds it is impossible to predict future circumstances. The investor could lose their job, experience an uncovered medical emergency, or simply need a new refrigerator. All adults need an emergency cash fund that is easily accessible on short notice.

When a Recommendation is Not Possible Due to Lack of Information

Not all consumers will provide personal and financial information. This is simply a fact. When insurance producers are not able to obtain information with which to make a recommendation, there is a form typically used, signed by the consumer, stating that he or she refused to provide requested information. The consumer can typically still buy the product if he or she wants to, but it will not have been purchased based on a producer's recommendation.

Even if personal and financial information has been provided, the consumer still has a right to make his or her own decisions about any product purchased. For example, if the producer recommends product A, but the consumer wants product B, it is the consumer's right to buy the product they want, even if it is not the recommended annuity. As before, there is likely to be a form for the consumer to sign releasing liability of the insurance producer and issuing insurer. Neither wants to be sued in the future when it was the consumer that made the poor decision.

Everyone from state regulating authorities to insurance companies knew that some consumers would not provide personal or financial information. There are various liability waivers that are used. We are providing a copy of the one created by the NAIC Model Laws, labeled Appendix B.

NAIC Model Law

Appendix B

CONSUMER REFUSAL TO PROVIDE INFORMATION

Do Not Sign Unless You Have Read and Understand the Information in this Form

<u>Why are you being given this form?</u>

<u>You are buying a financial product – an annuity.</u>

To recommend a product that effectively meets your needs, objectives and situation, the insurance producer, broker, or company needs information about you. Your financial situation, insurance needs, and financial objectives.

If you sign this form, it means you have not given the insurance producer, broker, or company some or all the information needed to decide if the annuity effectively meets your needs, objectives, and situation. You may lose protections under the Insurance Code of [insert state] if you sign this form or provide inaccurate information.

Statement of Purchaser:
☐ I **REFUSE** to provide this information at this time.
☐ I have chosen to provide LIMITED information at this time.

Customer signature and date of signature:____________________________________

Ramifications of Refusing to Provide Personal Information

Producers should take care to explain what the ramifications are of refusing to provide information that would allow insurance producers to provide annuity purchase recommendations. There are even ramifications when only partial information is provided since a complete financial picture of the goals cannot be ascertained.

There are certainly ramifications when false or misleading financial information is given. In that case, the insurance producer could provide a recommendation that is actually harmful for the consumer. The insurance producer would likely not be aware that his or her annuity purchase recommendation was harmful unless he or she realized they were working with incorrect information.

Sales Practices

Insurance producers know they are required by every state to be honest in the course of practicing their profession, but appropriate sales practices go beyond that. Insurance producers could adopt the medical profession's code of "do no harm." The first step in any financial transaction is acknowledging that wrong choices could financially affect the buyer. Unfortunately, consumers are often unaware that they have been adversely affected until years later when they reach retirement or some other pre-planned goal.

In an effort to mandate ethical behavior many states now require a certain number of ethics, annuity and/or partnership LTC hours, but there is concern that mandating education does not necessarily translate into the expected behavior. It is a difficult situation for lawmakers and others who have the burden of protecting consumers. On the plus side, when producers have taken courses on best interest or ethical behavior, they cannot use the *"I didn't know"* excuse for their behavior.

Sales practices include everything from first contact to the final delivery of the policy. As it relates to annuity products, establishing the best interests of the client and product suitability are closely tied to ethical practices. An ethical insurance producer would not place a product that is not in the best interests of the buyer.

Appropriate sales practices would dictate that each item be given adequate consideration prior to placing the annuity product. There must be reasonable grounds to believe the annuity meets the best interests of the client and is suitable for the buyer's needs and goals.

NAIC Model Law Section 6. Duties of Insurers and Producers

(4) **Documentation obligation.** A producer shall at the time of recommendation or sale:

(a) Make a written record of any recommendation and the basis for the recommendation subject to this regulation;

(b) Obtain a consumer signed statement on a form substantially similar to Appendix B documenting:

(i) A customer's refusal to provide the consumer profile information, if any; and

(ii) A customer's understanding of the ramifications of not providing his or her consumer profile information or providing insufficient consumer profile information; and

(c) Obtain a consumer signed statement on a form substantially similar to Appendix C acknowledging the annuity transaction is not recommended if a customer decides to enter into an annuity transaction that is not based on the producer's recommendation.

(5) Application of the best interest obligation. Any requirement applicable to a producer under this subsection shall apply to every producer who has exercised material control or influence in the making of a recommendation and has received direct compensation as a result of the recommendation or sale, regardless of whether the producer has had any direct contact with the consumer. Activities such as providing or delivering marketing or educational materials, product wholesaling or other back office product support, and general supervision of a producer do not, in and of themselves, constitute material control or influence.

APPENDIX C

Consumer Decision to Purchase an Annuity NOT Based on a Recommendation

Do Not Sign This Form Unless You Have Read and Understand It.

Why are You being given this form? You are buying a financial product – an annuity.

To recommend a product that effectively meets your needs, objectives and situation, the agent, broker, or company has the responsibility to learn about You, your financial situation, insurance needs and financial objectives.

If You sign this form, it means You know that you're buying an annuity that was not recommended.

Statement of Purchaser:

I understand that I am buying an annuity, but the agent, broker or company did not recommend that I buy it. If I buy it **without a recommendation**, I understand I may lose protections under the Insurance Code of [this state].

____
Customer Signature

____
Date

____
Agent/Producer Signature

____
Date

Deceptive Sales Practices Forbidden

Some insurance producer practices are considered deceptive. These would include high-pressure sales, quick change tactics, or anything that is less than an honest presentation of the product facts. Just as insurance producers must correctly and honestly present their own products, they must also correctly and honestly present other products, such as the policy the insurance producer is attempting to replace.

All of us have been exposed to a salesperson that puts pressure to “buy now.” As insurance producers, we would probably like all buyers to buy the first time around, but when decisions can greatly affect an individual’s financial future, they must be made wisely. Pressuring a consumer to “buy now” is not only unwise, but if it is determined to be high-pressure sales tactics, it may have legal consequences.

Quick-change tactics involves discussing one type of product with the client but placing something else. The buyer may not realize that the old-fashioned fixed rate annuity he thought he was buying is actually an equity indexed annuity, for example. While the equity indexed annuity is a fixed rate product, it is not the fixed rate product that most consumers are familiar with.

Every state has specific forbidden practices but having a state or federal law should never be the reason an insurance producer is honest.

Most laws develop due to need. Annuity best interest laws for consumers are no exception. The need developed as multiple forms of annuities were developed by insurers. Not only could consumers become confused about some of the aspects of these new products; insurance producers could also be confused. Even very honest insurance producers were making errors that could potentially harm their clients. Unfortunately, consumers are harmed when mistakes are made, whether the mistake is due to insurance producer greed or insurance producer error; either way it is the buyer that suffers financially. Therefore, annuity requirements regarding the best interests of the buyers will hopefully prevent buying errors. Both the selling insurance producers and the issuing insurers now have responsibilities to the consumers to ensure that the recommended product does what the buyer expects the product to do.

NAIC Model Law Section 6. Duties of Insurers and Producers

D. Prohibited Practices. Neither a producer nor an insurer shall dissuade, or attempt to dissuade, a consumer from:

(1) Truthfully responding to an insurer’s request for confirmation of the consumer profile information;

(2) Filing a complaint; or

(3) Cooperating with the investigation of a complaint.

As insurance producers are required to jump through more hoops, they could believe that the new annuity requirements to establish the best interests of the consumer are a hindrance to them. Nothing could be farther from the truth. Best interest standards not only protect the consumer; they also protect the insurance producers selling annuities.

Avoiding *conflicts of interest* is also important. Typically, agents would not have a conflict since typically they would have had no previous relationship causing one. However, if there appears there could be a conflict of interest, this must be disclosed to the consumer. In some cases, it would be best for the producer to make no annuity recommendations.

NAIC Model Law Section 6. Duties of Insurers and Producers

(3) Conflict of interest obligation. A producer shall identify and avoid or reasonably manage and disclose material conflicts of interest, including material conflicts of interest related to an ownership interest.

Recordkeeping

Recordkeeping is important for many reasons. Recommendations for annuity purchases should be kept as protection in case an insurance producer's judgment is called into question in the future. We cannot predict the performance of many products; keeping records is both a requirement and protection against future lawsuits.

NAIC Model Law Section 9. Recordkeeping

A. Insurers, general agents, independent agencies and producers shall maintain or be able to make available to the commissioner records of the information collected from the consumer, disclosures made to the consumer, including summaries of oral disclosures, and other information used in making the recommendations that were the basis for insurance transactions for [insert number] years after the insurance transaction is completed by the insurer. An insurer is permitted, but shall not be required, to maintain documentation on behalf of a producer.

B. Records required to be maintained by this regulation may be maintained in paper, photographic, micro-process, magnetic, mechanical or electronic media or by any process that accurately reproduces the actual document.

Full Disclosure

As we know some products are more complex than others. A criticism of equity indexed annuities, for example, is their complexity. Many insurance producers even avoid presenting them purely due to lack of product understanding. Only when the producer understands the product will he or she be able to adequately communicate all aspects of the investment to their clients.

It is always important to fully disclose all product characteristics, including product limitations. Consumers will make better decisions when they understand the various products and are able to make an informed decision. More importantly for the insurance producer's commission is the fact that buyers will *keep the product* when they are satisfied that an informed decision was made.

When recommending an annuity purchase, whether the consumer buys the recommended product often hinges on the information the consumers receive. It must also involve the best interests of the client, which should have been established prior to the recommendation. If the insurance producer does not request adequate information, he or she cannot make an adequate recommendation.

NAIC Model Law Section 6. Duties of Insurers and Producers

(2) **Disclosure obligation.**

(a) *Prior to the recommendation or sale of an annuity*, the producer shall prominently disclose to the consumer on a form substantially similar to Appendix A:

(i) A description of the scope and terms of the relationship with the consumer and the role of the producer in the transaction;

(ii) An affirmative statement on whether the producer is licensed and authorized to sell the following products:

(I) Fixed annuities;

(II) Fixed indexed annuities;

(III) Variable annuities;

(IV) Life insurance;

(V) Mutual funds;

(VI) Stocks and bonds; and

(VII) Certificates of deposit;

(iii) An affirmative statement describing the insurers the producer is authorized, contracted (or appointed), or otherwise able to sell insurance products for, using the following descriptions:

(I) From one insurer;

(II) From two or more insurers; or

(III) From two or more insurers although primarily contracted with one insurer.

(iv) A description of the sources and types of cash compensation and non-cash compensation to be received by the producer, including whether the producer is to be compensated for the sale of a recommended annuity by commission as part of premium or other remuneration received from the insurer, intermediary or other producer or by fee as a result of a contract for advice or consulting services; and

(v) A notice of the consumer's right to request additional information regarding cash compensation described in Subparagraph (b) of this paragraph;

(b) Upon request of the consumer or the consumer's designated representative, the producer shall disclose:

(i) A reasonable estimate of the amount of cash compensation to be received by the producer, which may be stated as a range of amounts or percentages; and

(ii) Whether the cash compensation is a one-time or multiple occurrence amount, and if a multiple occurrence amount, the frequency and amount of the occurrence, which may be stated as a range of amounts or percentages; and

(c) Prior to or at the time of the recommendation or sale of an annuity, the producer shall have a reasonable basis to believe the consumer has been informed of various features of the annuity, such as the potential surrender period and surrender charge, potential tax penalty if the consumer sells, exchanges, surrenders or annuitizes the annuity, mortality and expense fees, investment advisory fees, any annual fees, potential charges for and features of riders or other options of the annuity, limitations on interest returns, potential changes in non-guaranteed elements of the annuity, insurance and investment components and market risk.

Identifying Best-Interest Issues

Best-Interest and suitability is essentially the same thing, so if the state uses either best-interest or suitability, it means what is best for the consumer to meet the goals and criteria they are seeking. Best-interest issues seem to arise for some basic reasons, including (though not limited to) the following.

1. The insurance producer believes he or she understands the annuity product but does not know how to convey the terms and limitations to their clients, so they adopt a "trust me" mythology when selling them.
2. The insurance producer realizes he or she does not understand the "details" of the product but believes the details are not important enough to worry about and markets the product anyway.
3. The insurance producer mistakenly believes he or she understands the product they are selling. Even though it may result in an unintentional insurance producer error, the result can cause great financial harm to the investors. Financial harm often results in lawsuits.
4. When investors clearly misunderstand how a product works, only a fool will sell the product anyway. When insurance producers know their clients have misunderstood the proposed investment under no circumstances should the product be placed until the investor's error is corrected.

The states have a difficult job. They must attempt to eliminate use of the *"trust me"* technique used by insurance producers to place annuity products regardless of the client's best interests or product suitability. It is doubtful that the states will ever be able to completely eliminate unethical insurance producers but with required product recommendation standards the states at least have an avenue to punish those who refuse to act ethically.

Every product has advantages in the right circumstances and disadvantages in the wrong situations. The goal is to place products where they are most likely to be advantageous for the consumers.

Emergency Situations Not Foreseen by the Consumer

Anyone can end up with an emergency that was not expected. Ideally everyone would have sufficient liquid assets available, but as COVID-19 demonstrated too few people have an emergency fund to access.

Crisis Waivers

Crisis waivers are annuity features allowing the annuity owner to withdraw money from the annuity without triggering surrender charges that would normally apply. In some cases, crisis waivers are riders on the policy, but in other cases they are provisions within the policy or contract. These riders or provisions are not necessarily the same in how they work.

Waivers are likely to permit access to funds for qualifying life events, such as entering a nursing home or the onset of a disability. Retirement age often means having a strategy for the unexpected events in life, so waivers are important when annuity funds are needed sooner than expected. Waivers often incur an additional insurer fee, which is typically stated in the policy.

Riders are not necessarily the same as waivers. Crisis waivers "waive" the surrender fees that would otherwise apply for early withdrawal of funds. Riders usually provide benefits to cover a range of financial or estate planning issues. Riders make annuities attractive to a larger group of people if they can address liquidity concerns through use of additional features. In effect, these riders allow annuity buyers to extend the basic coverage of the contract, solving possible shortcomings that would otherwise exist.

There are different types of waivers and all types may not be in all contracts, so it is important that people know what they are getting. Waivers and riders might cover premature death, hospital expenses not covered by other policies or government programs, nursing home care, terminal illness, disability, or even unemployment.

There are typically requirements to access cash while also waiving early surrender charges. For example, while long-term care riders and waivers are intended to cover care in a nursing home, there are likely to be qualifications required before the annuity cash is available. Annuity owners must be aware of these.

As always, it is necessary to consult the policy to see if the contract being considered has crisis features or riders. If it does, there may be specific conditions that must first be met. The policy might have a heading of "Extended Care Waiver" or wording that is substantially the same. While there may be variations it is likely to say something like the following:

> *"Upon your written request, we will waive the early withdrawal charges that may otherwise apply under your contract to a withdrawal, surrender, or annuitization if at the time of such withdrawal, surrender, or annuitization or within the immediately preceding ninety days of all the following conditions are met:*
>
> 1. *the insured is confined to an extended care facility or hospital,*
> 2. *the confinement is prescribed by a physician as being medically necessary,*
> 3. *the first day of the confinement was at least one year or more after the effective date of the contract, and*
> 4. *the confinement has continued for a period of time that is at least ninety consecutive days."*

It is Not a Liquidity Issue but Rather a Best Interest Issue

Annuities are *not* liquid investments, so when criticisms are levied against annuities for their lack of cash access, the critic is not understanding the product. Annuities are not intended to be a vehicle providing cash prior to annuitization. A "liquid" investment is one that can be easily accessed when cash is needed or wanted. Annuities of all kinds are typically long-term investments, so the issue is never about liquidity (there is none) but rather about meeting the needs and goals of the product buyer. It is about making sure the recommended product is in the best interest of the buyer. When the topic seems to snag on liquidity it is usually a sure sign that the insurance producer should *not* place an annuity with the investor. In most cases annuities are only suitable for those who will not need to withdraw significant sums during the contract term. *Withdrawals prior to the end of the annuity term* should never be a goal – period.

Although annuities may have crisis waivers or riders, if the investor has failed to set aside sufficient liquid assets for emergencies, an annuity is never the solution. Insurance producers and financial planners should assess liquid reserves prior to determining the best interests of the annuity buyer – prior to suggesting buyers consider an annuity of any kind.

The Care Obligation

The Application

Every insurance contract purchase begins with the insurance application for coverage. Unless the application is completed without a licensed insurance producer such as might be done for online products, the insurance producer exercises material control or influence during the process. He or she will be asking questions related to underwriting, so of course, there must be high ethical standards exercised during this process.

Placing the Consumer’s Needs Before the Producer’s Needs

The care obligation is a consumer best-interest obligation. To achieve the best interest of the consumer, knowledge is required. We know that insurance producers are required to put the buyer’s needs and goals first, and certainly before those of the producer. Sound recommendations cannot be made unless sufficient information is obtained.

The Care Obligation specifically requires obtaining knowledge of the consumer’s financial situation, insurance needs, and financial objectives. Obviously, the producer cannot make a recommendation option unless he or she can carry out the recommendation that is made. The producer must exercise reasonable diligence, care, and skill to understand what the consumer wants, then look at the available options the producer has that might meet the consumer’s needs and goals.

Of course, the producer must have a reasonable basis to believe the recommended options he or she makes effectively address the consumer’s financial situation, insurance needs, and financial objectives during the life of the products. The producer’s view will be based on the consumer profile information that was gathered prior to the recommendations that were made. The producer will communicate why he or she feels the recommendation meets the consumer’s needs and goals. By the end of the recommendation process both the producer and the consumer should feel comfortable with the solutions that were offered.

Product Exchanges and Replacements

If an annuity product is being exchanged or replaced, the producer must continue to exercise sufficient best interest standards and care obligations. This means he or she must consider the entire transaction, taking into consideration whether the consumer will incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits under the existing annuity, such as death, living or other contractual benefits, or be subject to increased fees, investment advisory fees or charges for any riders or similar product enhancements.

The replacing product should substantially benefit the consumer in comparison to the product being replaced over the life of the contract. In other words, it must be in the best interest of the consumer, and not simply take place for the sake of an earned commission.

Product Replacement with Best Interest in Mind

There are situations that call for replacing one existing product with a newer insurance product, but this is not true in every case. insurance producers should never replace an existing product with another product unless there are specific reasons for doing so and those reasons are sensible, meaning the client’s best interest has been considered. Especially when an annuity is the investment tool involved, there are times when replacement might be unwise. This would especially be true if the annuity owner’s contract were past the surrender period. Putting the buyer into a new annuity with a new surrender period should not be done without serious thought.

Obviously, insurance producers must observe all state-mandated replacement procedures. Most states have specific replacement procedures, which must be followed.

What does this mean? It all comes down to one question: *does the buyer benefit from the product replacement?* It could also be asked another way: *would the insurance producer recommend the same replacement if the product in question belonged to him or her instead of someone else?* Would the insurance producer make the same product choice for themselves that they are advising others to make?

Exchanges or Replacements Within the Preceding 60 Months

Annuities are not typically a replacement product. When annuities seem to be replaced too often, it is an immediate concern. The producer must consider the entire transaction, as we said, and that includes consideration of previous annuity replacements. If the consumer has had another annuity exchange or replacement within the preceding 60 months, it may be best not to proceed with another one.

NAIC Model Law Section 6. Duties of Insurers and Producers

> (j) In the case of an exchange or replacement of an annuity, the producer shall consider the whole transaction, which includes taking into consideration whether:

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

ii. The replacing product would substantially benefit the consumer in comparison to the replaced product over the life of the product; and

iii. The consumer has had another annuity exchange or replacement and, in particular, an exchange or replacement within the preceding 60 months.

(k) Nothing in this regulation should be construed to require a producer to obtain any license other than a producer license with the appropriate line of authority to sell, solicit or negotiate insurance in this state, including but not limited to any securities license, in order to fulfill the duties and obligations contained in this regulation; provided the producer does not give advice or provide services that are otherwise subject to securities laws or engage in any other activity requiring other professional licenses.

Annuity Replacement in General

Replacement of products is always considered by the issuing insurance companies. The insurers watch for the reasons why the consumer wants to purchase a new annuity product. If it appears to be inconsistent with the death benefit, lifetime income or raise liquidity issues, the insurer will investigate further before issuing any policy. In many cases, the only reason an insurer will consider issuing a policy that replaces an existing annuity contract would be for better growth potential or better policy rates. In many cases, replacement activity requires additional information beyond what is routinely gathered for annuity purchases. Of course, there must also be realistic and complete policy comparisons before one annuity may replace another.

Many annuity buyers are retired, but if the applicant is still considered to be a member of the working class, then if he or she is unemployed or disabled, insurers might require additional information in many cases prior to issuing a policy.

In all cases where the application and supporting documents seem to raise questions, the insurance company is likely to request additional information. Insurers typically have what is referred to as a suitability review team. These individuals are highly trained and experienced. They review new applications to ensure the sales of products are appropriate and have documentation that recommends the sale. The suitability team's review process aims to meet or exceed compliance with state regulations by documenting the recommendations made by their sales staff.

Insurance companies have a difficult job since their review teams are not present when applications are taken. The companies issue guidelines for their sales staff, but it would be difficult to guarantee that mistakes are never made. To avoid situations that may harm consumers, there will be situations where the insurer may decline applicants because the annuity sale is deemed to be unsuitable based on the information provided by the applicant and insurance producer. Lack of sufficient applicant information is the most likely reason an application will be denied.

Insurance producers can prevent unnecessary denials by providing complete applicant information that is consistent with insurance company requirements. Insurers are generally willing to work with agents, when necessary, to obtain necessary information. Inconsistent information on an application will always raise questions, so all applications should be reviewed with the buyer before submission.

The Annuitant's Death

How annuity funds are treated when the annuitant dies depends, in part, on whether he or she had annuitized the contract. If the contract is intact, never having been annuitized, then the funds flow to listed beneficiaries outside of probate, although the asset must still be listed during the probate process in most cases.

If the annuity contract has been annuitized, listed beneficiaries may or may not receive remaining contract funds. It all depends upon the annuitization option that was chosen at the time of annuitization. If a lifetime income was chosen, there are no beneficiary funds to disperse because that annuitization option makes the issuing insurer the beneficiary. It does not matter whether the annuitant received a single payment or payments for many years. No remaining funds will be dispersed.

If a payout option other than lifetime income was chosen at annuitization, the amount beneficiaries might receive depends upon the option chosen. Some annuitization options provide continued income for the surviving spouse or other people, but this depends on how the policy was annuitized.

Refer to the benefit payout options in this course for detailed information of annuitization and benefit payouts.

Annuity Tax Deferred Status and Other Taxation Issues

As every insurance producer knows, annuities enjoy tax deferred status on interest earnings. Taxes are eventually paid, but not during the accumulation phase. When funds are withdrawn, taxes will be due in the year the funds are withdrawn. Basically, taxation will occur when gains are withdrawn, payments begin (annuitization), or the annuitant dies, with the annuity then being distributed to heirs, such as a spouse.

Annuities are tax deferred so during the accumulation phase no taxes are due on the interest earnings. As previously stated, when partial withdrawals are taken, interest is always withdrawn first, and principal is withdrawn last under the law. Therefore, taxable gains are the first to be withdrawn and those gains are taxable upon withdrawal. This is called the "last-in-first-out" withdrawal method, often stated as LIFO.

When taxation is delayed, such as happens during the accumulation phase, it allows the financial vehicle to gain more growth because interest is earning additional interest (compound interest in other words). Tax deferral also allows the annuity owner to choose when taxes are paid by waiting until the right moment to make withdrawals. It would make sense to time those withdrawals with a year having lower income. In most cases it also makes sense to obtain tax advice from a tax specialist. He or she can help the annuitant time their withdrawals for the best taxing outcome, whether that happens to be a year with less income earnings or when significant deductions exist.

There is also an unfortunate side to the annuity's tax deferral status: when funds are finally withdrawn, they will be taxed as ordinary income (that is why Roth IRAs are so popular: no taxation upon withdrawal). If annuity growth were taxed as capital gains, taxation rates would be much lower. Of course, any funds withdrawn prior to age 59½ will also feel the pinch of the IRS 10 percent early withdrawal penalty.

Those who simply must find fault with annuities often bring up the fact that gains are taxed as ordinary income, which tend to have the highest taxing rates. It really is simply one of the prices investors pay for a secure, low-risk investment. It is important to note that investors should first make maximum payments to such things as Roth IRAs (if they qualify for one) and 401(k) Plans. These give tax deferral on gains, like annuities do, but the contributions also reduce the investor's current taxable income. Certainly, it makes sense to first contribute to investment vehicles that do that before investing in annuities.

As we have said, there is no perfect investment vehicle, but by utilizing several in proper order (first investing in IRAs and 401(k) plans, and then investing in such things as annuities) individuals have the opportunity to develop a well-rounded plan that will provide adequately during retirement. For tax purposes, fixed rate annuities can only be compared in terms of safety. That means comparing them to such things as government bonds or highly rated corporate bonds, which are also taxed as ordinary income tax rates – if held to maturity. If not held to maturity, they could be devaluated.

Lump sum withdrawals are taxed for the year in which they were withdrawn. When an annuity is annuitized, income is spread over a longer period of time, anywhere from five years to the annuitant's lifetime. Payments for lifetime options are based on anticipated life expectancy. The original premium payments, referred to as the "**basis**" for tax purposes, are calculated to last until the date of the investor's life expectancy. When annuity payments are received each month, part of it is a tax-free return of the original basis and part is the growth that is taxed to the investor as ordinary income. When the date of the investor's life expectancy is reached (as used for the basis) all the premiums have been exhausted. Therefore, from that point on, the entire systematic payment is taxable as ordinary income. That sounds like bad news but what it really means is that the investor is now receiving the insurance company's money rather than his or her own invested principal sums. In other words, he or she has lived beyond the amount they paid to the annuity company; from that point on, the investor has beat the odds and is collecting money that the investor did not personally save. Even though it is taxed as ordinary income, it could be viewed as "free" income. In that perspective, taxation does not seem so bad.

Tax-Deferral Exception

Not all annuities are tax-deferred, although most are. They must be held for a natural person or in trust for the benefit of a natural person. An annuity that is held in a corporation, limited partnership, LLC, or other business entity might not be able to grow tax deferred. Even placing an annuity into a family-limited-partnership might cost the investors their tax deferral status. In such cases, it really makes sense to consult with a tax specialist.

1035 Exchanges

It is often possible to exchange one annuity product for another, although there may be some limitations. When exchanges are properly executed there are no immediate tax consequences since the investor's hands do not touch the funds, so to speak. In some cases, it may even be possible to exchange a life insurance policy for an equity indexed annuity or some other annuity type. In the case of a life insurance policy, it only works one way: life insurance policy exchanged for an annuity. It is not typically possible to exchange an annuity for a life insurance policy without causing a taxable event. These tax-free exchanges are known as 1035 exchanges, for the tax code they come under. In some cases, the exchange may be partially tax free and partially taxable; this often happens when there is an outstanding loan against the policy.

Annuity Gifts

Investors must be careful when a gift is made of an annuity product. Most professionals strongly advise the investor to consult with a tax specialist in the transaction. The person who receives the gift may have to pay taxes on the gain on top of any gift taxes required. Even when annuities are gifted to trusts there could be taxable issues.

Investors often gift their annuities to charitable organizations. It is likely the investor will then have to pay taxes on the annuity gains, even though they were given to the charity. The charitable deduction may offset the taxes, but again a tax expert should be consulted.

Other Tax Issues

There may be other tax issues that relate to annuities. For example, estate taxes may apply in some cases. Since taxation, especially estate taxation, can be so complicated we will not try to address them in this continuing education course.

Annuities Are (Sometimes) Protected Assets

Generally, annuities are protected assets, which mean that others may not gain access to the accumulations in them. There are exceptions. An individual that owes child support, for example, may find him or herself having to give up the annuity values to pay the back-child support. The Internal Revenue Service may also have access to annuity values when back taxes are owed. Also, an investor that pledges his or her annuity as security for a loan has willingly and legally given access to their annuity values if they default on their loan.

Annuities only have protection from creditors if they were purchased under normal circumstances. For example, Tom Tardy knows he owes money all over town and those he owes the money to want to be paid. He receives a large sum of money from a relative and quickly buys an annuity to avoid paying his debts. This might be considered purchase under fraudulent conditions. If Tom Tardy gives false information on his annuity application, it could also be considered a purchase under fraudulent conditions. If Tom Tardy transfers money from an account that does not totally and completely belong to him into his personal annuity that could be considered a fraudulent transfer.

Sometimes annuities are placed in trusts for other reasons. For example, perhaps the investor's children have a poor financial history. He may place his annuities in trust purely for distribution reasons. The annuity could be directed, upon his death, to pay its proceeds to the trust rather than the beneficiaries. The trust would then pay out to the beneficiaries as directed by the testator.

Annuities typically bypass probate procedures (although annuity values must still be listed during probate in most cases). Most people are not wealthy enough for probate to be a severe issue, but if the investor believes probate may become slow or cumbersome, annuities may be a good investment choice. Since they have a beneficiary designation, they go directly to the person or people named in the policy. The same is true for life insurance policies. Any type of vehicle that has beneficiary designations may be able to pass the assets on to the named individuals outside of probate.

Since individuals have individual circumstances, it is always important that an attorney be consulted. In many cases, both an attorney and a tax specialist should be part of the decision-making process. There are many mistakes that can be made in the attempt to protect assets; whatever it costs to involve these individuals may be well worth the cost.

Insurance Producer Compensation Disclosure Forms

Insurance producers have not traditionally had to disclose how they are paid or the amount of compensation that will be received. Like so many things that develop, the need to disclose compensation emerged as legal issues became apparent.

The NAIC developed Appendix A which is an insurance producer disclosure for annuities. There is a section for the producer's information and a section for the consumer (called customer on the form) information. There is also a section titled: *How I'm Paid for My Work*. This section outlines three options: commissions, fees, and other. Under "other" the producer would fill in how he or she received compensation. This disclosure form may vary by state, but the intent is to alert consumers to the differences in being paid by the insurer through commissions or other insurer compensation or an hourly rate that would be paid by the consumer. Typically, a person who charges an hourly rate never sells a commissioned product. It states that consumers may request additional information.

NAIC Model Law

APPENDIX A

INSURANCE AGENT (PRODUCER) DISCLOSURE FOR ANNUITIES

Do Not Sign Unless You Have Read and Understand the Information in this Form

Date: ________________________

INSURANCE AGENT (PRODUCER) INFORMATION ("Me", "I", "My")

First Name: ______________________ Last Name: __________________________

Business\Agency Name: ____

Website: ____

Business Mailing Address:____

Business Telephone Number: ____

Email Address:____

National Producer Number in [state]:____

CUSTOMER INFORMATION ("You", "Your")

First Name: _____________________Last Name: ____________________________

What Types of Products Can I Sell You?

I am licensed to sell annuities to You in accordance with state law. <u>If I recommend that You buy an annuity, it means I believe that it effectively meets Your financial situation, insurance needs, and financial objectives. Other financial products, such as life insurance or stocks, bonds and mutual funds, also may meet Your needs.</u>

I offer the following products:

□ Fixed or Fixed Indexed Annuities

□ Variable Annuities
□ Life Insurance

I need a separate license to provide advice about or to sell non-insurance financial products. I have checked below any non-insurance financial products that I am licensed and authorized to provide advice about or to sell.

□ Mutual Funds
□ Stocks/Bonds
□ Certificates of Deposit

Whose Annuities Can I Sell to You?
I am authorized to sell:

□ Annuities from Only One (1) Insurer
□ Annuities from Two or More Insurers
□ Annuities from Two or More Insurers although I primarily sell annuities from: ____

How I'm Paid for My Work:
It's important for You to understand how I'm paid for my work. Depending on the particular annuity You purchase, I may be paid a commission or a fee. Commissions are generally paid to Me by the insurance company while fees are generally paid to Me by the consumer. If You have questions about how I'm paid, please ask Me.
Depending on the particular annuity You buy, I will or may be paid cash compensation as follows:

□ Commission, which is usually paid by the insurance company or other sources. If other sources, describe: ____.

□ Fees (such as a fixed amount, an hourly rate, or a percentage of your payment), which are usually paid directly by the customer.

□ Other (Describe):____.

If You have questions about the above compensation I will be paid for this transaction, please ask me.

I may also receive other indirect compensation resulting from this transaction (sometimes called "non-cash" compensation), such as health or retirement benefits, office rent and support, or other incentives from the insurance company or other sources.

By signing below, You acknowledge that You have read and understand the information provided to You in this document.

____
Customer Signature

____
Date

____
Agent (Producer) Signature

____
Date

Sometimes Recommendations are Not Possible

In all cases with all investments the consumer (buyer) must understand what he or she is purchasing. If the insurance producer is a good communicator, he or she is probably able to educate the buyer sufficiently. However, sometimes even good communicators are not able to explain a product in a manner the buyer understands.

Any time an insurance producer suspects the buyer does not understand the product caution should be used. A buyer who does not understand what they have purchased is likely to experience “buyer’s remorse.” Although annuities come with what is called a “free look period” during which he or she can return it for a full refund it is still dangerous for the insurance producer to place any product the buyer does not fully comprehend. Sometimes it can even result in lawsuits. Lawsuits are most likely to happen when the product does not perform as the buyer expected it to. Sometimes lawsuits are filed not by the buyer, but by his or her family members so it is important that the buyer fully appreciate their investment and relay why it was purchased if necessary.

Consumers buy things every day, but most purchases do not require the consumer to give a stranger personal information. If the consumer already knows the insurance producer, then perhaps this will not be an issue, but if the consumer just met the insurance producer, it could be.

Insurance producers want to make recommendations, they primarily want consumers to be happy with what they have bought, and annuities offer some very good features. However, that does not always mean the producer is able to make a sound recommendation.

Why would a producer not make an annuity purchase recommendation? There can be several reasons not to do so:

1. The consumer refused to provide adequate and complete financial information or refused to state what he or she wished to achieve through an annuity purchase.

2. The consumer gave inaccurate information, or even outright false information, so it was not possible to prepare a recommendation.

In some cases, it is simply best to make no recommendation at all. If sufficient information cannot be obtained or the information that was given was found to be false or incomplete an insurance producer might be wise to give no recommendation at all. The consumer still can purchase an annuity probably, but giving no recommendation frees the producer from legal liability.

When no recommendation is made due to lack of information, lack of complete information, or inaccurate information the insurance producer should use a form that states information was withheld. This text previously supplied a sample of such a form.

NAIC Model Law Section 6. Duties of Insurers and Producers
B. Transactions not based on a recommendation.

(1) Except as provided under Paragraph (2), a producer shall have <u>no obligation</u> to a consumer under Subsection A(1) related to any annuity transaction if:

(a) No recommendation is made;

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

(c) A consumer refuses to provide relevant consumer profile information and the annuity transaction is not recommended; or

(d) A consumer decides to enter into an annuity transaction that is not based on a recommendation of the producer.

Basic Insurer Information Requirements

There are elements of annuities that insurance producers must completely communicate prior to placing the product. Some basic information is always necessary the:

1. name and contact information of the issuing insurance company,
2. name and contact information of the selling insurance producer,
3. financial rating of the issuing insurance company,
4. length and amount of the surrender penalties (policy term), and
5. point at which the insured will reach age 59½ and no longer must be concerned with IRS early distribution penalties.

In addition to the basic information listed above, *equity index* annuity investors need to know:

1. the minimum guaranteed rate of interest gain,
2. the participation rate for interest crediting,
3. how the annuity is linked to the index,
4. the participation rate for index crediting,
5. any caps that exist in the contract,
6. how the insurer will treat the annuity if the insured dies (are surrender charges waived for example),
7. any exchange options (if so, what are they?),
8. can the insurer change some terms in the contract (often called the "moving parts")? If terms can be changed, specifically what may be changed? Insurers can typically change guaranteed interest rates at specified points, but there may be other terms that are changeable as well.
9. Tax consequences that may apply to the annuity, such as taxation as ordinary income when funds are withdrawn. There may be tax matters that are specific to an individual, so insurance producers are wise to suggest buyers consult their personal tax accountant.

There may be additional points the insurance producer feels are important to discuss with their clients.

Annuities are primarily regulated by the individual state insurance departments with some differences in regulation existing among the states. Even so, the states primarily have similar requirements. Equity indexed annuities are not subject to SEC regulation since they are not securities.

NAIC Model Law Section 6. Duties of Insurers and Producers
C. Supervision system.

(1) Except as permitted under Subsection B, an insurer may not issue an annuity recommended to a consumer unless there is a reasonable basis to believe the annuity would effectively address the particular consumer's financial situation, insurance needs and financial objectives based on the consumer's consumer profile information.

(2) An insurer shall establish and maintain a supervision system that is reasonably designed to achieve the insurer's and its producers' compliance with this regulation, including, but not limited to, the following:

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

(b) The insurer shall establish and maintain standards for producer product training and shall establish and maintain reasonable procedures to require its producers to comply with the requirements of Section 7 of this regulation;

(c) The insurer shall provide product-specific training and training materials which explain all material features of its annuity products to its producers;

(d) The insurer shall establish and maintain procedures for the review of each recommendation prior to issuance of an annuity that are designed to ensure there is a reasonable basis to determine that the recommended annuity would effectively address the particular consumer's financial situation, insurance needs and financial objectives. Such review procedures may apply a screening system for the purpose of identifying selected transactions for additional review and may be accomplished electronically or through other means including, but not limited to, physical review. Such an electronic or other system may be designed to require additional review only of those transactions identified for additional review by the selection criteria;

(e) The insurer shall establish and maintain reasonable procedures to detect recommendations that are not in compliance with Subsections A, B, D and E. This may include, but is not limited to, confirmation of the consumer's consumer profile information, systematic customer surveys, producer and consumer interviews, confirmation letters, producer statements or attestations and programs of internal monitoring. Nothing in this subparagraph prevents an insurer from complying with this subparagraph by applying sampling procedures, or by confirming the consumer profile information or other required information under this section after issuance or delivery of the annuity;

(f) The insurer shall establish and maintain reasonable procedures to assess, prior to or upon issuance or delivery of an annuity, whether a producer has provided to the consumer the information required to be provided under this section;

(g) The insurer shall establish and maintain reasonable procedures to identify and address suspicious consumer refusals to provide consumer profile information;

(h) The insurer shall establish and maintain reasonable procedures to identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific annuities within a limited period of time. The requirements of this subparagraph are not intended to prohibit the receipt of health insurance, office rent, office support, retirement benefits or other employee benefits by employees as long as those benefits are not based upon the volume of sales of a specific annuity within a limited period of time; and

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

(3) (a) Nothing in this subsection restricts an insurer from contracting for performance of a function (including maintenance of procedures) required under this subsection. An insurer is responsible for taking appropriate corrective action and may be subject to sanctions and penalties pursuant to Section 8 of this regulation regardless of whether the insurer contracts for performance of a function and regardless of the insurer's compliance with Subparagraph (b) of this paragraph.

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

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

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

(4) An insurer is not required to include in its system of supervision:

(a) A producer's recommendations to consumers of products other than the annuities offered by the insurer; or

(b) Consideration of or comparison to options available to the producer or compensation relating to those options other than annuities or other products offered by the insurer.

Definitions for Annuity Products under Model Law

Most agents are accustomed to specific product terminology and with adoption of the new model law, some definitions have been added that an insurance producer must know, and some have been added. The previous *Suitability Information* has been changed to *Customer Profile* and added two items to the list for insurance producers to know. Insurance needs and Financial resources to fun the annuity was added.

NAIC Model Law Section 5. Definitions

In any law, there are always definitions. Because law must be clearly understood, definitions allow the readers to recognize what is meant by the law. Definitions, in other words, give clarity to the law.

Annuity means an annuity that is an insurance product under state law, individual solicited, whether the product is classified as an individual or group annuity.

Cash compensation means any discount, concession, fee, service fee, commission, sales charge, loan, override, or cash benefit received by a producer in connection with the recommendation or sale of an annuity from an insurer, intermediary, or directly from the consumer.

"**Consumer profile information**" means information that is reasonably appropriate to determine whether a recommendation addresses the consumer's financial situation, insurance needs and financial objectives, including, at a minimum, the following:

1. Age;
2. Annual income;
3. Financial situation and needs, including debts and other obligations;
4. Financial experience;
5. Insurance needs;
6. Financial objectives;
7. Intended use of the annuity;
8. Financial time horizon;
9. Existing assets or financial products, including investment, annuity and insurance holdings;
10. Liquidity needs;
11. Liquid net worth;
12. Risk tolerance, including but not limited to, willingness to accept non-guaranteed elements in the annuity;
13. Financial resources used to fund the annuity; and
14. Tax status.

Continuing education credit or **CE credit** means one continuing education credit as defined by each state's regulations.

Continuing education provider or **CE provider** means an individual or entity that is approved to offer continuing education courses pursuant to each state's regulations.

FINRA means the Financial Industry Regulatory Authority or a succeeding agency.

Insurer means a company required to be licensed under the laws of this state to provide insurance products, including annuities.

Intermediary means an entity contracted directly with an insurer or with another entity contracted with an insurer to facilitate the sale of the insurer's annuities by producers.

(1) **Material conflict of interest** means a financial interest of the producer in the sale of an annuity that a reasonable person would expect to influence the impartiality of a recommendation.

(2) **Material conflict of interest** does not include cash compensation or non-cash compensation.

Non-cash compensation means any form of compensation that is not cash compensation, including, but not limited to, health insurance, office rent, office support, and retirement benefits.

Non-guaranteed elements mean the premiums, credited interest rates (including any bonus), benefits, values, dividends, non-interest based credits, charges, or elements of formulas used to determine any of these that are subject to company discretion and are not guaranteed at issue. An element is considered nonguaranteed if any of the underlying non-guaranteed elements are used in its calculation.

Producer means a person or entity required to be licensed under the laws of this state to sell, solicit, or negotiate insurance, including annuities. For purposes of this regulation, "producer" includes an insurer where no producer is involved.

(1) **Recommendation** means advice provided by a producer to an individual consumer that was intended to result or does result in a purchase, an exchange, or a replacement of an annuity in accordance with that advice.

(2) **Recommendation** does not include general communication to the public, generalized customer services assistance or administrative support, general educational information and tools, prospectuses, or other product and sales material.

Replacement means a transaction in which a new annuity is to be purchased, and it is known or should be known to the proposing producer, or to the proposing insurer whether or not a producer is involved, that by reason of the transaction, an existing annuity or other insurance policy has been or is to be any of the following:

1. Lapsed, forfeited, surrendered or partially surrendered, assigned to the replacing insurer or otherwise terminated;
2. Converted to reduced paid-up insurance, continued as extended term insurance, or otherwise reduced in value by the use of nonforfeiture benefits or other policy values;
3. Amended so as to effect either a reduction in benefits or in the term for which coverage would otherwise remain in force or for which benefits would be paid;
4. Reissued with any reduction in cash value; or
5. Used in a financed purchase.

SEC means the United States Securities and Exchange Commission.

The law quoted in this course is not the complete law. We encourage readers to look up the full law and become acquainted with it.
https://content.naic.org/sites/default/files/inline-files/MDL-275.pdf

United Insurance Educators, Inc.

PO Box 1030

Eatonville, WA 98328

Email: mail@uiece.com Website:
www.uiece.com