The ABC's of Annuity Investing

www.uiece.com

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Introduction

Welcome to the course

This course is designed to provide information relating to your insurance license. It is not intended to be used as a selling device or to provide any type of legal information. Statutes vary from state to state and it is the legal responsibility of each agent to be aware of their particular state's requirements.

We are not responsible for your educational time requirements, so our advice is always the same: start early and finish early. Any questions relating to the renewal of your license should be directed to your state.

Each agent is legally required to complete his or her own continuing education requirements. *It is both unethical and illegal to copy a test someone else has completed. Turning in a test with answers that have been copied will result in state notification, which may result in a state audit and legal sanctions by your licensing department.* Your livelihood is never worth the few hours you will save.

We appreciate your business and hope you will consider us for all your educational needs.

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Retirement's Surprise

Finding Retirement Income

The most common problem in retirement is living longer than the money lasts. Of course, some of this is created by the retirees themselves. They make large purchases that should not be made from funds that must last throughout their retirement or over-spend in the early years. Many surveys show a major problem is under-estimating at age 65 how long they are likely to live. Many new retirees plan for twenty years of retirement living when they should be planning for 30 or more years.

Another error is failing to plan for the effects of inflation and rising costs of living. Today's costs will probably be only a fraction of what it costs to live tomorrow. Retirees must plan on needing progressively more money as the years go by to cover the same routine bills. Gasoline goes up, electricity goes up, and property taxes go up. Seldom do any of our routine expenses go down over time. Retirement can be golden but if the retiree fails to adequately plan ahead with enough savings and investments the final years may mean poverty.

Many retirees not only miscalculate the amount of money they will need during retirement, but also make investing errors. For retirees, the margin for error can be quite slim. Academic research shows investors can afford to withdraw only four to five percent of their savings annually if they want to be certain their savings will last the 30 years or more they will need supplemented income (beyond Social Security income).[1]

When stocks perform poorly, annuities gain favor. They are actually the same consistent performers whether the market is up or down, but when stocks are performing well annuities look like poor performers since interest rates may be lower than stock earnings. However, when stocks are down, the interest rates paid by annuities suddenly look very good to investors and those who advise them.

In 2005, for example, very few people moved their 401(k) funds, IRAs or private brokerage accounts into annuities at the point of retirement. The reasons vary. In some cases, it may be that investors think only of life insurance products when they hear annuities are issued by insurance companies. While annuities are underwritten and

[1] U.S. News & World Report 6/13/2005

issued by life insurance companies, they are not life insurance products. Annuities have the ability to guarantee a lifetime income, regardless of how long the insured lives. Of course the amount received will be based on the amount deposited prior to retirement. If the lifetime payout option is chosen (paying the lifetime income) any unused funds will belong to the issuing insurance company – not to heirs.

While many financial advisors strongly recommend the lifetime annuity payout option, investors can select other options so that their beneficiaries will receive any remaining funds (assuming the investor dies prior to using the total funds invested in the annuity). However, people are living longer these days. It would be foolish to think of one's heirs over the retirement income needs he or she will likely have.

Retirement security is not simply about saving adequately, although that is certainly a major requirement for a financially secure lifestyle until death. Retirement security is also about *managing the money* that was saved. Since many retirees spend too much in the early years of retirement it is necessary to take steps that will ensure their money lasts as long as they do. An annuity vehicle does that. By moving his or her savings into an annuity, annuitizing it for a lifetime income, the investor will receive a set amount of income each month. In theory this should prevent over-spending in the early years of retirement. It may also mean giving up the dream of traveling around the world, but in the end it will provide the security needed during the investor's *full lifetime*.

There is one drawback to the lifetime income option: inflation. No matter what happens in the economy or with inflation, the amount received each month will not vary when a fixed annuity vehicle is utilized. The monthly income will be the same from the annuity regardless of where costs go or what the rate of inflation is. Despite that fact, the knowledge that there will be a monthly income provides a great deal of comfort.

Everyone is Living Longer These Days

Statistics show nearly half of all retirees are unable to meet their regular living expenses at some point in their retirement. Those with incomes in the bottom 20 percent typically rely primarily on Social Security to meet their monthly living expenses. This often means going without needed prescriptions and medical care.

Both men and women are living longer. Individuals who reach age 60 have a very good chance of living into their eighties and nineties. In addition, the longevity gap between men and women is closing. Some 20 years ago, a woman aged 60 could expect to live for another 22 years, while a man of 60 could only expect to live for another 17 years. Now, a man who reaches age 60 can expect to live for another 21 years and a woman for another 25 years.

Although the gap is closing, currently the life industry expects women to live longer than men and so pays women a lower monthly pension amount. People who survive to

60 are living longer because of improved medical care, a greater willingness to go for check-ups and medical treatment, better screening for diseases, better education about diseases and how to treat them, and improved access to treatment. Many feel longer life is also a product of our increased willingness to stay physically active long into our retirement.

Coutts-Trotter and Peter Bond, the chief medical officer at Old Mutual Insurance, say the life expectancy of men has improved faster than women because:

- Men are now smoking less or not at all. In the past it was women who did not smoke. Women now smoke at nearly the same rates as men.
- Improved medical treatments for heart/circulatory and related illnesses have a bigger affect on men, who tend to die of these illnesses more than women do.
- Women are suffering from increased stress. More and more women are working in the formal sector, as well as having to manage the home. The added stress brought about by women's changing role in society has had an impact on their mortality and morbidity. On the other hand, the role of men in society has remained pretty much unchanged.
- There has been more room for improvement among men, who are now better educated about health, using preventative measures such as screening to detect problems at an early stage.[2]

Although the general population has recognized the fact that they can expect to live longer than their parents and grandparents did, they do not seem to relate that fact to their retirement expenses. Living longer means more money is needed to match those additional years of living.

Retirement Risks

There are many risks associated with retirement. First of all, even with all the advancements of modern science, we cannot say exactly how long any one of us will live. Therefore, each person who retires faces **"longevity risk."** We also cannot say for sure where prices will go in the future. We can be fairly sure that prices will go up, but we cannot say to what extent they will rise. As a result, retirees also face **"inflation risk."** Finally few people entering retirement could predict with accuracy the returns they will earn on their savings, which is called **"investment risk."**

Each retiree can make estimates regarding their longevity by looking at the averages published by those who study such things and examining their personal family history. If

[2] 1st quarter 2006 edition of *Personal Finance* magazine

Granddad and Dad all lived to be 90 there is the general expectation that the next generation of men will also reach age 90. In fact, it is likely that following generations will exceed previous generations since that seems to be the general trend in the United States and other developed countries. Merely looking at longevity averages would not tell the full story because averages hide the broad range of experiences. That is why family history also must be considered. When looking at national averages, about 11 percent of men and 7 percent of women who reach age 65 die prior to their 70th birthday. On the other end of the averages are those who live to 95 and beyond (6 percent of men and 14 percent of women). When planning for retirement, it is always wise to consider ourselves in the group living to age 95 or more since we certainly don't want to reach age 80 and realize that all our funds are gone. It is the uncertainty of our personal lifespan that creates *longevity risk*.

As for inflation risk, even modes price increases erode the value of a fixed income. A dollar's value is based on buying power. When a loaf of bread costs $3 upon retirement, but rises to $5 in five years, the person on a fixed income has, in effect, had their monthly income reduced. Inflation does not affect everyone equally. Those who want to eat bread daily have lost buying power but an individual who never eats bread will not notice its price increase. Some things affect everyone regardless of personal circumstances. For example, everyone uses electricity so rises in utilities is likely to hit all retirees equally.

Price increases of only 3 percent per year will make $100 of today's buying values worth only round $74 in ten years. After 25 years, the value would drop by more than half to just $45. Those who live to be 95 or more will, therefore, need at least twice as much income at age 90 than was needed when they retired at age 65. This is an obvious example of why spending too much too soon in retirement puts retirees into poverty.

When high, often unexpected, rates of inflation occur, those on fixed incomes are greatly affected. Even when there was planning for inflation unexpectedly high rates can cause severe poverty.

When sufficient funds were not set aside for retirement there is always the temptation to try to earn unusually high earnings to offset low saving levels. However, only the young who are still working should consider high investment risks. Those on fixed incomes or near retirement are seldom in a position to invest in high risk investments for a simple reason: there is no time available to make up losses that may occur. High risk investments are "high risk" for an obvious reason: the investor could lose much of their investment. This means principal as well as interest earnings. High risk investments offer the possibility of higher earnings to *compensate for the higher risk experienced*. Earnings are uncertain, and the principal is at risk.

Social Security was enacted to help those in retirement, but Social Security was never meant to completely support the individual. It was assumed that the individual would have personal savings, a pension, or some other means of added retirement income.

Annuities offer an excellent additional source of income to back up Social Security, but not all annuities could be classified as "life annuities" since that classification would depend upon the payout option selected by the annuitant. For purposes of extra retirement income, payout should be structured to last the entire life of the retiree. Anything less is risky since no individual can predict precisely how long he or she might live. Choosing a lifetime annuity payout option shifts the individual's longevity risk and investment risk from the retiree to the insurance company. Insurance companies pool longevity risk over a large group of annuitants, with the extra funds (from those who die sooner than expected) covering those who live beyond the funds they actually paid in (these investors live longer than the underwriters expected). The actual amount received each month is determined by underwriters who study life expectancies, based on national data, personal company experience, and information obtained at policy application.

Baby Boom Generation Reaches Retirement

The so-called Baby Boom Generation, those born between 1946 and 1964, began reaching retirement age (62 by Social Security standards) in 2008. By this point those in this age range generally realized that there was not likely to be a company pension like their fathers enjoyed. Hopefully they have 401(k) plans, 401(b) plans, Individual Retirement Accounts (IRA), or other types of self-created retirement money. Insurance agents are likely to be suggesting baby-boomers roll these funds into a fixed rate annuity. Some may suggest variable annuities, although these variable vehicles certainly carry higher risk than the more traditional fixed rate products.

By 2005, the average annuity buyer was 63 years old, so it is likely that many of the annuity funds came from self-funded pension plans of some sort. Half of those buyers were already retired with the majority saying they bought the annuities to supplement their retirement income. During the Great Depression, annuity sales exceeded life insurance sales because buyers at that time doubted the ability of their employers, if they were lucky enough to be employed, to fund a company pension plan. Many saw insurance companies as financially stronger than their banks as well.

Today we are again worried about receiving our pensions (for the few who have a company sponsored plans), Social Security's longevity, bank solvency, or our country's ability to provide medical care in the years to come. We are increasingly aware that we must depend upon ourselves if we want retirement security.

Annuities offer lifetime income but it is not a free ride. Like any profit-making organization, they must structure these in a manner that allows for continuing operation. Those who live beyond what the underwriters estimated will do well, but for those who die sooner than estimated the insurance company will claim all remaining funds (no beneficiary designations on lifetime payout options). Additionally, by many estimates, insurance companies pay out only about 85 percent of each dollar invested in a fixed rate annuity to the annuitants, using the remaining 15 percent for overhead, marketing expenses (such as agent commissions) and profit. When we buy a new car we would not be shocked to learn that the automobile manufacturer used 15 percent of the purchase price for these things, but consumers seldom look at insurance companies in the same light as other industries. Therefore, when such reports are published consumers often feel the insurers are somehow robbing the investors. Seldom do these same reports show figures on the 90 year old woman who received thousands of dollars when she lived beyond her estimated life expectancy. Annuity payout amounts are based on the underwriter's estimate of the individual's longevity.

Certainly, it makes sense to shop around. Agents as well as buyers need to do this. The lower the company's expenses, the more money will be passed on to annuitants. Just as automobile companies have variances in their efficiency, insurers also vary in their level of financial efficiency. No matter what is being purchased, shopping the marketplace simply makes sense.

Consumers may not know how to shop the marketplace for fixed rate annuities, so they often depend upon their agents to do so. Obviously, it is important to use only top rated companies. These are long-term investments; we want the insurer to last as long as the annuitant does. While there are no specific tables or charts that easily tell agents which company is best, he or she can look at such things as sales charges, annual expenses and other published data.

Some annuity shoppers look for maximization of earnings, but it is important to shop carefully. While variable annuities do allow owners to choose from among several mutual fund accounts, potentially earning higher returns than fixed rate products, there is also added risk involved. Variable annuities do not guarantee returns in most cases.

Most annuities do not consider health, but they may limit annuity purchase by age. In other words, an unhealthy 65 year old can easily buy most annuities, but an exceedingly healthy 85 year old may not be able to.

Putting Off Retirement

When the retirement accounts of many Americans dropped by up to 45 percent in 2008 and 2009 due to drops in the stock market many people who had planned to retire were forced to rethink their retirement date. Individuals lucky enough to have a guaranteed pension through their employers were suddenly the lucky few. Most people fund their own pension plans, whether through 401(k) plans, Individual Retirement Accounts, or by simply putting away a few dollars whenever possible. Those who are self-employed (as most insurance agents are) must especially be diligent in planning for their eventual retirement. The question is always the same: will I outlive the wealth I have accumulated?

Each person must personally be responsible for their own retirement. While any financial planner will gladly help a client figure out their future, none can guarantee that all will be fine. Ultimately it is always up to the worker to save adequately for retirement.

Retirees face uncertain life spans, inflation, uncertain interest rates, and for women, widowhood. Many women could not survive on their own retirement incomes; these individuals must rely on their spouse's pension incomes. Although Social Security helps to some degree, it is seldom adequate.

Gender Issues in Retirement

Theoretically each worker should be paid based on job title and job performance but we know that is not what actually happens. Women are especially vulnerable to lower pay. Often the lower pay is connected to a specific job title that is held primarily by women. When men enter the particular job title, the rate of pay often rises substantially, but it may take many years to equalize. A good example of this is the nursing field. While there were other factors that also helped raise the level of pay received, such as demand, it was not until men entered the nursing field in large quantities that pay became substantially higher. It is not fair or possible to say that this was due entirely to men entering the field in larger numbers, but the rising pay did coincide with this event. Perhaps men entered the field *because* pay had gone up – not the other way around.

Women receive less retirement income for several reasons, including:

- They primarily worked in lower paying jobs;
- Women often take time off from work for raising children or caring for elderly parents;
- Women tend to follow the husband's careers, moving around the country if necessary and making other sacrifices that men are less likely to make.

The Institute for Women's Policy Research published a 2008 report titled *Gender and Economic Security in Retirement*. They examined major sources of income for older Americans, including earnings, Social Security income, pensions, assets, and government assistance programs. They focused on individuals who were 50 years old and above. The report looked at sources and amounts of income before and after retirement among different groups of women and men. As we know, women tend to live longer than men and are more likely to live alone at older ages. The report focused on differences by marital status and living arrangements as well as gender and age. Although printed in 2008, data came from the 1999-2001 Current Population Survey (CPS), collected by the Census Bureau. There is evidence that some changes are occurring that will eventually affect these findings, but mostly in age groups well below 50. For example, young women are now more likely than young men to attend college. Eventually this will bring about changes in retirement status but unfortunately that is many years away.

Some highlights emerged from the Institute's study. The study found women more likely than men to be living in poverty during retirement. There are some reasons that have nothing to do with earnings of course. For example, the length of time outside the work force certainly affects retirement funding, including earned Social Security benefits.

Primarily the report found:

1. Women age 65 and older are more than twice as likely as men to be unmarried, whether that is due to being widowed, divorced, separated or never married. As a result they live alone. Nearly 40 percent were, for one reason or another, living alone compared with 16 percent of men in the same age group. One income versus two incomes makes a difference in how they live.
2. Older women are more likely to face poverty than older men; those living alone are especially likely to be poor.
3. In pre-retirement years earnings constitute the major source of income for both men and women. However, women are less likely than men to work full time and year round. The average woman will earn only two-thirds what men in the same pre-retirement years earn. This is due to many reasons, but often women do not feel the need to work a full schedule during the entire year, opting instead to work part time or seasonally.
4. Unfortunately, Social Security is often the major source of retirement income for both men and women because they have saved inadequately on their own. The study found that approximately 90 percent of both men and women who were 65 and older received Social Security, but women's median annual benefits reached only 70 percent of the benefits received by men.
5. Unmarried women living alone especially seem to depend on Social Security benefits during their retirement. More than two-thirds of unmarried women living alone live in poverty status.
6. Men receive pensions more often than women. Just 30 percent of women compared to 47 percent of men age 65 or older received company-sponsored pensions. Women's annual benefits were about half of that received by men so even when women earned a pension, they received less income. Since women live longer, even with equal earnings, their monthly pension income might be less if payouts were based on longevity rates.
7. Although 60 percent of women and 65 percent of men received some income from interest, dividends, or rent during their retirement, income from these sources were typically too small to provide any kind of security during retirement years.
8. Most individuals are eligible for Medicare at age 65 so nearly everyone has health insurance through this program. For those between the ages of 50 and 64, however, 14 percent of women and 11 percent of men carried no health insurance at all. As we know, rates become very high in this age range. Some could not

afford health insurance; others simply chose not to buy it even if they could afford the premiums.

America is deeply in debt. It is likely that our children and grandchildren will be burdened by very high taxes just to allow our country's government to stay even. Our debt has become so great that there is concern America's credit rating will fall drastically. Due to this situation, we cannot be certain how public programs will fare. Social Security and aid to those in poverty may be downsized out of necessity. People over the age of 65 receive far more government dollars than poor children receive, primarily due to the costs of nursing home care during an individual's final years.

The population of those aged 65 and over is expected to rise to 20 percent by 2030, when the youngest members of the baby-boom generation turns 65 years old.[3] Taxpayers will find themselves with an increasing number of elderly people needing health care, including prescription drug coverage, long-term care in nursing homes, assisted living facilities and community programs, and some feel we might see rising numbers of homeless in the older age categories.

Among those age 65 and older, women are more than twice as likely as men to be unmarried, whether widowed, divorced, separated, or never married. Nearly 80 percent of women living alone are widows compared to 56 percent of men who are widowers. Between the ages of 50 to 64 women living alone are more likely to be divorced or separated rather than widowed (56 percent).

Older people *who live alone* are more likely to live in poverty since there is only one income rather than two. The loss of even a small Social Security income can be financially devastating when older individuals are already having a difficult time making ends meet. Since women live longer and typically have less retirement income, the loss of a spouse (whether by divorce or death) is likely to plunge her into poverty.

The pattern of gender differences in those aged 50 and older are the same for all racial and ethnic groups, although some ethnic groups are more likely to live in larger family units than others. Families who routinely group together fare better financially than those that do not. Unmarried white men and women are far less likely to live with other family members than other ethnic cultures. As a result, older white men and women tend to have less support financially from their family members.

After age 50, poverty rates rise for both men and women, but women experience higher rates than men. Those who live with a spouse have lower poverty rates than those that live alone (again, two incomes are better than one). Unmarried women living alone show the highest poverty rate of all groups at all ages above 50.

[3] Federal Interagency Forum on Aging-Related Statistics 2000.

Up to the age of 60 nearly half of women and over two-thirds of men work full time. Earnings are their major source of income. Over age 50, however, women are less likely to be working compared to women in younger age groups. This is likely to change as younger women stay with careers they chose rather than working to supplement their spouse's income. Women who chose careers will likely continue working full time throughout their lives because they are working for different reasons than their mothers and grandmothers did. Hopefully these career women will also consider retirement differently than their mothers and grandmothers did, creating their own pensions.

When men and women reach age 62 and begin collecting Social Security benefits, work income drops dramatically. If collecting Social Security benefits is delayed, earned income is likely to continue. For those who continue working after age 50, women working full time year round earn about two-thirds of their male counterparts.

After age 65 both men and women rely on Social Security to meet their monthly bills. No other source of income comes close to the level of Social Security coverage and women are less likely than men to have other income sources in retirement.

The next income most likely to be received in retirement is income from assets, such as interest earnings, dividends or rent received. Sixty percent of women and 65 percent of men receive income from their pre-retirement assets. Most do not have company sponsored pensions. As, we said, of those lucky enough to have company pensions, men are far more likely to have pensions than women. Although it is becoming more common for older ages to continue working, only 12 percent of women and 22 percent of men continue working after age 65.

Most Americans realize that company pensions supported their grandparents and maybe even their parents, but they will not support those retiring today. Pensions became too expensive for employers, so other avenues have become popular to fund our retirement years. A "pension" does not necessarily mean funds supplied by an employer. People can create their own pensions through Individual Retirement Accounts (IRAs), annuities, and other sources that were used to accumulate funds during one's working years. Even a simple savings account at the local bank may be kept for use as retirement funds, although that would be an inefficient way of saving (accounts at the local bank will be taxed on their earnings).

Unmarried women living alone are the most likely to have earned or created a pension for her retirement. Perhaps because she has always had to fend for herself, she appears to have made arrangements for retirement that married women have not made. Forty percent of unmarried women have a pension at the end of their working careers. This figure includes widows. Some of the pensions come in the form of survivors' pensions from their deceased partners.

Interest, Dividends, and Rental Income

Interest, dividends, and rental income provides the second most common income in retirement. Of the three, interest income is the most common for both men and women. Married couples are most likely to have this type of income.

Supplementing Social Security with Lifetime Annuities

Investors that own annuities often do not use them effectively, according to many authorities, because they do not annuitize them for lifetime income. Perhaps people simply do not like knowing that the issuing company may keep unused annuity funds if the annuitant dies sooner than expected. In fact, even beneficiaries may try to sway annuitants away from lifetime incomes for this reason. Until the general population stops looking at annuities as a "savings account" and starts looking at them as a "personal pension" this attitude is unlikely to change.

In 2005 the National Academy of Social Insurance looked at the possibility of making lifetime annuities mandatory under specific circumstances. They were considering the possibility of automatically deducting wages similar to the way Social Security taxes are currently deducted from our paychecks. If 2 percent of wages were deducted (with 4.7 percent returns) after 40 years, those turning age 65 would receive about 1.7 times their annual earnings while working. Monthly income would, of course, be spread out over their expected lifetime so it would not be possible to take lump sum distributions.

In their considerations, lifetime payouts would be mandatory, so there would be no chance to bequeath unused funds to others, unless the annuity had some type of guarantee feature. Guarantees in payout options have always been popular even though financial experts believe it is best to select lifetime options.

Annuities always look better to financial planners when stocks are down, but even when they have not been down, annuities have always been used to some extent. Annuities got a famously bad rap in the 1990s because of their unfamiliar - and surprisingly steep - fees. Since then, the variety of annuity products have expanded and some of the fees declined. In recent years, annuities have offered so much personalization that just about everyone can find one they like. That does not mean that the annuitant will have saved adequately. While everyone agrees that saving something is better than saving nothing, inadequate savings is not a solution. We know by now that Social Security is not adequate to live on, yet fewer people are putting away money for their retirement. As a result, many older people are deciding to retire later than they otherwise might have. Unfortunately, job layoffs are affecting those who would have liked to continue working.

No matter how many bells and whistles are added to them, annuities still come in the two basic formats: fixed and variable. As we have said, fixed annuities yield a steady stream of income for a set number of years or the rest of the investor's life. Variable annuities can also provide regular checks, but they tie the amount of payouts to the performance of an investment portfolio. Both types allow the individual investor to choose whether to begin receiving payouts immediately (in monthly, quarterly, or annual installments) or at a later date; both varieties pay out partly taxable money - taxed only on gains, not the original investment - at regular income tax rates, an important fact to weigh when considering annuities for any financial plan.

Annuities are offering a wider variety of options, but they really are just that: options. Fixed annuities can be purchased with inflation protection added to the payouts; a death benefit can also be attached to the annuity. Some policies offer an option for long-term-care insurance, which raises the payouts if the investor becomes disabled. On certain variable annuities, the investor can opt to have their portfolio value (and therefore their payouts) reflect the performance only in neutral or good years.

All options typically come with a price tag. Clients should never be allowed to assume anything different. For fixed annuities, the price comparisons among different firms' offerings are relatively simple*: "It all comes down to how much money you put in and what initial payment that produces,"* says a T. Rowe Price senior financial advisor.

On variable annuities, the cost of a specific feature is usually expressed as percentage points deducted from your returns. Unfortunately, few clients would realize this so it is up to the agent to inform them. Only if the client actually wants a feature should it be included. Features that limit downside investment risk tend to cost anywhere from 1¼ to 1½ percentage points deducted from the annual portfolio returns. That is on top of annual investment-management fees, which vary among companies and even among products of the same company.

For fixed-annuity holders, financial planners often feel the most important extra to consider is inflation protection. Even modest price increases can damage purchasing power over time. For example, an individual retiring on $100,000 a year in 1980 would need $253,000 a year today to maintain the same lifestyle. Inflation protection in the form of annual adjustments to income from the annuity is costly. It will reduce about 30% from the first payout received. Even so, it may be worthwhile considering that the insurance company takes on a big unknown – namely, how long the investor will live.

Not everyone will be willing to reduce their initial fixed annuity payouts by 30 percent. Perhaps their level of savings was too low, for example, to permit such a reduction. If inflation protection seems too expensive, the investor could buy a policy with an escalation clause, stipulating a lower annual payout increase (in other words, less than the actual inflation rate). This still comes at a price however. It may reduce initial payouts by 25 percent - less than the 30 percent for actual inflation rates, but still pricey. Notes T. Rowe Price's advisor: *"I like this feature because it's more affordable, and it keeps you apace with inflation in all but the really bad years."*

Most of us purchase fire, health and car insurance, yet we fail to protect the most serious risk faced in retirement: living longer than our assets. Our second retirement failing is underestimating the cost to live decently in retirement. Guaranteeing a monthly income is not the same as guaranteeing an *adequate* monthly income during retirement. Agents cannot do this for their clients; if the client has saved inadequately, all their agent can do is provide *some income* – not necessarily adequate retirement income.

An annuity could be compared to a pension plan since it will provide income to the end of one's life (if a lifetime payout option is selected). The difference is important however since the *investor* must fund his or her annuity pension; there is no employer doing it for them. That's unfortunate since the employer would make sure the pension was funded each and every month. The private investor may not necessarily do so.

Of all the people in history that have reached 65 years of age, half of them are living right now. We are experiencing a larger "graying of America" than we could have ever imagined when Social Security benefits were enacted.

These millions of Americans must be able to financially survive their retirements. Far too many assumed the retirement money would simply be there for them – perhaps through the government's Social Security payments, perhaps through their employer, perhaps from a mysterious rich uncle; somehow the money would simply be there. Unfortunately for too many retirees there will only be poverty.

While this course is on all aspects of annuities, we cannot discuss saving through annuity investments until the need to save is established. Of course, nearly everyone will say *"Oh yes. I know I need to save and I certainly plan to."* Too often that "planning" statement is in the future tense. It needs to be in the present tense. We need to save for our retirement from the moment we earn a paycheck after age eighteen. That is not what happens of course. Most people begin saving for retirement in their forties.

Retirement is Expensive

It takes money to live. This is true at age 25 and at age 65; there are no free rides. Yes, the 65 year old retiree will receive Social Security benefits – assuming the age is not increased to age 67, which is certainly possible in the years to come. Many people feel retirement and government-sponsored programs will undergo some tremendous changes in the years to come; perhaps even reverting back to how life was before employers initiated company-sponsored retirement plans.

The first retirees utilizing Social Security benefits, which are funded not by the retiree but rather by current workers, collected funds that they never personally paid in. Even those that worked and funded Social Security often collect far more than they pay in. It is estimated that the first contributors collected from seven to twenty times more than they contributed, depending on the length of contributions, monthly Social Security income, and other factors.

Even those who attempt to financially prepare for retirement are often surprised to find they are under-funded when retirement arrives. Too many people assume retirement will not require the amount of income needed during their working years. What they may fail to anticipate are rising costs of living (especially in such areas as utilities and insurance) as well as higher medical needs, such as dental care, prescriptions and nursing home care. While work-related expenses may decrease the areas that increase will surpass those decreases in many cases.

It is estimated that around 40 percent of those facing retirement have made no financial plans at all. These individuals may need to continue working since government assistance is seldom adequate. Those who fund Social Security (meaning those still in the workforce) are having a difficult time making ends meet themselves and the thought of continually higher taxation to pay for the elderly is not well received.

Most taxpayers give approximately one-third of their income to Uncle Sam through various taxes. Even in retirement individuals can expect to pay taxes and those taxes may be more than anticipated.

Many people save inadequately for retirement. They may believe $100,000 will be adequate for retirement when combined with Social Security income. They simply failed to think it through. If they lived on $25,000 per year, for example, how could they believe that four years worth of income would cover twenty years of living?

Prior to World War II, most people worked until their death. Retirement, and the resulting leisure activity, was only for the wealthy. People expected to work until death. If failing health prevented working it was their family that took care of them – not the government. As author Gregory Salsbury points out in his book titled *"But What If I Live?"* retirement is to some extent an invention of our society. With the creation of Social Security, we began to want and anticipate a time in our life when we enjoyed leisure more than productivity.

Originally it was those who had more income than most that anticipated retiring. Individuals with a pension of some sort, whether from the military, an employer, or the sale of a business, could anticipate a leisurely retirement. Most other people still expected to work. Work had to continue because without work there was no income.

Today everyone expects to "retire" – with varying degrees of financial expectation. In fact, many people seem to set retirement as a primary life goal rather than work performance or some other achievement. These individuals may not have a clear idea of what retirement will hold for them but they know they want it. Ironically, many of these individuals also do no financial planning to achieve this final goal; they simply wait for the event to arrive.

Most of us make several assumptions about retirement: there will be sufficient income to support our current lifestyle (maybe even a better well-traveled lifestyle), our health will be good, and the world's events and financial situations will not affect retirement years. Many retirees will find their assumptions wrong on nearly every level. These assumptions are often made simply because their parents seemed to do well in their retirements. However, past generations often had an employer-sponsored pension that adequately supplemented their Social Security income and they often had a level of savings that their children never duplicated.

It is likely that those currently nearing retirement will find that their parent's retirement is no indication of what they will experience. First of all, few people today have a pension supplied by their company. In fact, most people today never stay with a company for 25 to 35 years like our parents did. We are much more likely to work for several companies, save far less than our parents did and expect far more possessions than our parents wished for. Our parents were more likely to pay cash for what they bought, set aside ten percent of their earnings, travel less than we expect to, and maybe even continue working part time into retirement.

We work harder today than our parents may have, or at least we think we do. It is true that Americans put in more on-the-job hours than ever before and we require two wage earners. There may be some question as to whether or not we are living better than our parents. Yes, we have more material things but our children no longer come home to a parent after school because both are working. We have become willing slaves to electronic gadgets that interrupt our family time, our sleep, and even our leisure activities.

Each generation has been more prosperous – until now. Today we may see many families going back to buying less, getting by on less, looking at smaller houses, and generally downsizing in multiple ways. Although our current economy is looking more worrisome than past years, Americans are still primarily optimistic about retirement. We expect things to get better and in many ways it is likely the economy will improve with time. Those improvements may not provide a better retirement however. If retirement funds are not available, continued employment will be the only solution.

How Much Money is Needed to Fund Retirement?

There are so many different ways to determine how much money will be needed in retirement. Not everyone needs the same amount either. Some people want so much more than others, buying every thing they see while others are easily satisfied with a simpler lifestyle. In every case, however, it is always best to have more than needed than too little.

When trying to determine how much will be needed in retirement the most difficult factor to determine is inflation. We can guess at the rate of inflation but it is not possible to know exactly how much buying power will be lost.

Inflation robs us of buying power. "Buying power" relates to the amount of goods and services that can be purchased. For example, we have heard our grandparents talk about buying a loaf of bread for ten cents or a quarter. Today bread costs anywhere from two dollars to five dollars, depending on the type and quality of bread purchased. That is loss of buying power. Where we could once buy four loaves of bread for a dollar, that same dollar now buys only part of a loaf. That's inflation.

As inflation relates to annual income, it means that we must save enough to maintain the same standard of living in future years. For example, an individual requiring $50,000 per year to live must earn approximately an additional $15,000 ($65,000) ten years later to maintain the same level of living. In 25 years, the same standard of living will require about $101,650. Since we can expect to be retired for 20 to 35 years it is easy to see why so many retirees run out of money before they run out of life.

Limiting Credit Card Use in Retirement

Unfortunately, many Americans live on credit. In the past it has been credit card use that often propelled our economy and frankly the government is glad we use them. It makes it easier to hide our many financial issues.

Heavy use of credit cards in retirement can be financially fatal since the interest and other credit card charges cuts into limited retirement income. Only when the charges can be paid off each month should credit cards be used; this is good advice for any person, but especially true for those who no longer have earned income. Unfortunately, retirees often fall into the credit card trap. When there is not sufficient income credit cards are used to make ends meet, but eventually it must be repaid. At one time older Americans were considered excellent credit risks by those who lend but this concept has changed in recent years as mounting numbers of retired individuals have defaulted on their credit cards.

There are no easy answers since retirees must be able to afford prescriptions, shelter, utilities, insurance, and numerous other expenses that are not luxuries. While there are no easy answers it obviously does not make sense to add costs to an already tight budget. If credit cards are not paid off each month, the mounting fees simply make the matter worse.

Social Security's Development

Most of us assume Social Security was developed to help older Americans. Actually, it had more to do with limited job availability. When older workers retired it made room for younger workers. The Great Depression was marked with high unemployment rates; it was hoped that Social Security would encourage older workers to leave the job market making way for younger workers. This was not the only solution considered at the time but it was the solution that eventually was adopted by the federal government.

It was really the development of Social Security that promoted the idea that everyone could, at some point, retire. That did not mean everyone was wealthy by any means, but it did provide consistent retirement income. Since retirement now seemed available to everyone, Americans now expected to join the ranks of the retired – something they never expected prior to Social Security. Of course, at that time many people lived on farms that were self-supporting and the work farms required didn't stop just because a monthly income came in. Still it gave opportunities that did not exist before.

Times have changed. What was at first a great gift to supplement a frugal lifestyle has now become an expectation of a retirement with all the trimmings. According to several surveys and studies (although it is obvious without such studies), we have become a nation of spenders that expect every gadget and every convenience. We expect someone – the government, our employer, somebody – to make sure we have what our neighbors have, to guarantee our retirement, our healthcare, and our way of life. Social Security is not doing well; it is estimated that in 2018 Social Security will begin paying out more than it is taking in. This is due in large part to our changing population. Workers are decreasing in numbers in comparison to those in retirement. In other words, the number of workers per retired person is changing. In the beginning when Social Security was enacted, about 42 workers contributed to Social Security for each person benefiting from the program. By 1945 there were around 16 workers for each retired person receiving benefits. There are currently only 3.25 workers for every retiree and eventually it will reduce to just two workers per retiree according to the Wall Street Journal, December 2005. Many economists say if the government had put the money into a fund drawing interest rather than into the general funds, the earnings may have prevented the problems we are seeing today, but that did not happen so we must live with the results.

When Social Security was enacted many people wanted the program to operate on a pay-as-you-go foundation. In 1939 when benefits were amended to include spousal, children's and survivor's benefits it began to change to that. By the 1940's the program became a fully pay-as-you-go program. This meant that there was no trust fund set aside to earn interest. Rather the government collects from current workers to pay current retirees. Funds collected beyond the amount immediately needed for retirees goes into the general revenue fund to be used in any way the government chooses.

The only solution to the Social Security dilemma may be to raise taxes paid by our working children and grandchildren. This is not a new idea. Social Security taxes have continually been raised over the years – out of necessity says our government – if current retirees are to receive their Social Security income. No one doubts that additional increases are inevitable. Of course, this means future workers may be so busy paying taxes that saving for their own retirements may become difficult.

Since Social Security was enacted to battle the high level of unemployment during the Great Depression, the program was not thought through in terms of future use. Social Security was structured to discourage working, which is why the program initially penalizes those who continue to work. That is also why it was set up to provide benefits to those who did not fully fund the program through their work deductions. In many cases people receive benefits even when they paid nothing in themselves. Those who did not contribute at all and those who contributed too little will receive far more than their work-time contributions. In that respect, Social Security could be considered a welfare program with a classier name.

Many economists feel that Social Security will absolutely have to address these issues if the program is to continue. Although we may want to support all elderly equally that is simply not possible. At some point it will have to be adjusted to reflect the amount actually paid in by the worker. There is little doubt that this program cannot continue on the same path, paying out many times more than the worker paid in through payroll taxes. Furthermore, it is unfair to current workers since high taxation is partially the reason current workers are not adequately saving for their own retirements.

Many Americans continue to believe that Social Security taxes are put into some kind of trust fund, earning interest, so it will be waiting for them as they retire. The reality is quite different. The taxes paid by current workers are paying Social Security benefits to our currently retired citizens receiving Social Security checks. The pay-as-you-go system previously mentioned reflects this. In effect, we are collecting taxes in one hand and passing the funds over to retirees with the other hand. We are collecting taxes from Walter Worker in one hand and passing those collected taxes over to Ralph Retiree with the other hand. If all the "Walter Workers" suddenly quit working and paying payroll taxes there would be nothing (zero!) to hand over to all the "Ralph Retirees" and the entire system would collapse. It is true that current payroll taxes (for now) are higher than the benefits being paid out so what happens to the little bit extra collected? Those dollars are simply put into the general revenue fund and spent any way the government wants to. There are absolutely zero dollars put into any kind of Social Security trust fund to earn interest for future retirees. In fact, our government owes Social Security trillions of dollars due to use of those funds for other purposes.

Most of us feel we are entitled to Social Security because we have paid into the system during our working years. Even though that is true, the government still has the right to reduce or change the program at any time in any way. The government could even legally end it entirely. In fact, the U.S. Supreme Court has ruled that workers have no valid legal claim to Social Security benefits, even though workers paid into it. That is because workers paid taxes; they did not actually deposit into a pension fund in their individual names. Taxes belong to the government – not to the taxpayers.

Every time a politician or other individual talks about privatizing Social Security fear runs high. For some reason, Americans believe privatization would mean the end of the "security" aspect of Social Security benefits. In reality there is no "security" involved. It is merely taxation which *might* be used to pay retirement benefits to retired workers.

Of course part of the fear about ending Social Security benefits has to do with the fact that most people receive back far more than they paid it. Like an annuity's lifetime annuitization option, the Social Security system promises to pay an income to retired workers for their lifetime, even past the amount they actually paid in taxes.

As bad as Social Security is from a financial standpoint, Medicare is far worse. As early as 2015, Medicare could be bankrupt, according to many economists. Of course, it is likely that the government will simply find a way to fund it, perhaps going even deeper in debt to do so.

We can expect current workers to pay between 25 percent and 40 percent of their earned income into Social Security and Medicare just to keep it going. The two programs have grown from a "jobs" program to an "entitlement" program that is draining American taxpayers. It may eventually rob current workers of their own financial future as paying taxes becomes such a great burden they are no longer able to save for their own secure retirement. Of course, high earners pay the most, yet receive less (percentage wise) of their taxes returned in the form of Social Security income. In other words, the Social Security program is designed to penalize high earners.

Social Security faces three major problems and bunches of smaller issues. The first major issue is the increasing longevity of our elderly. No one considered this when the program was created. In 1935 when the program was created the average worker could expect to live until age 76. That meant a person who retired at age 65 could expect to collect benefits for around 11 or 12 years. We now routinely see individuals living to be 100 years old, and many more living into their eighties.

The second major Social Security issue is the increasing numbers of retired Americans. We are becoming an elderly nation with the number of people who are age 65 and older rapidly expanding. We have 77 million so-called Baby Boomers coming into retirement swelling the numbers even more. We need sufficient workers paying into the system to support these retirees, but we don't have sufficient workers. On top of increasing numbers of retirees, those who are still in the work force have experienced loss of jobs across our nation. Our government is now faced with supporting – through Social Security benefits – an enlarging retired population and paying out unemployment to thousands of people who have lost their jobs. In short, taxpayers (those lucky enough to still have jobs) are supporting a growing segment of people who are not paying into the system.

Thirdly, the decreasing number of workers supporting the increasing number of retirees cannot continue. At some point workers will no longer be able to support themselves and their families adequately if the government continues to increase their taxation levels in order to support other segments of the population. The number of workers supporting those collecting Social Security is called the **"dependency ratio."** In the future we may find ourselves throwing open America's doors to younger workers willing to pay taxes in order to live in our country.

Changing the Age of Retirement

Most people currently plan to retire between the ages of 62 and 65, when they are eligible to begin collecting Social Security benefits. The age of receiving Social Security benefits may be changed out of necessity however. The retirement age is likely to increase to age 67 or 68 at some point. It is also likely that the American people will be upset when this happens. We have forgotten that our grandparents and great-grandparents (depending on the reader's age) did not expect to retire; they expected to work as long as they lived and we may be headed back in that direction out of necessity.

Financial Defense

Currently we seem to be a two-class retirement population: the *retirement savers* versus the *non-retirement savers*. Many professionals feel it is not just a matter of failing to save for an obvious future need; it is also a matter of overspending throughout our lives. We have listened to the advertisers of products and goods. We have been convinced that we must – absolutely must – have everything available today. Not tomorrow; not when we have saved adequately to buy it but today and probably purchased on credit.

Will the current economic downturn change our perception on saving for tomorrow, on waiting until we can afford luxuries to buy them? Only time will tell, but the past tells us that it will probably have only a momentary affect. Americans are an optimistic group of people. We like our luxuries; we like spending; we don't like to save and we do not like waiting for anything.

Historically people worried about living to the age of 65. There was a likelihood that an earlier death would prevent retirement but that is not the typical worry today. With our lifespans now often reaching age 100 the focus is no longer on living into retirement but rather living adequately *during* retirement. Will retirement mean baking cookies for grandchildren or will it mean skipping meals and visiting soup kitchens when the month's allotment of food runs out? These are serious issues and serious questions, yet few people are addressing them soon enough to prepare for retirement.

Taxation Affects Retirement

Everyone pays taxes and taxes seem to generally be accepted by the American people. We realize we would not have fire and police protection, good roads, and schools for our children and grandchildren if we did not pay taxes. Yes, taxes also fund some very ridiculous things, but most of us feel helpless to do much about it, so we pay our taxes and go on with the business of living our lives.

Most Americans do not actually keep any of their wages for themselves until May. January through April earnings is given to the various city, state, and federal governments in the form of taxes. In 1900 American workers paid just 5.9 percent of their total earnings to taxes. By 2000 it had risen to 33 percent of their total income. In subsequent years it did go down but by 2005 it was once again rising as the government required increased funding.

Not everyone pays the same amounts of taxes but people do pay the same general variety of taxes. This includes federal income taxes, in many cases state income taxes, property taxes for homeowners, sales tax, in some states inheritance and estate taxes, plus any number of school bonds, fire bonds, and police protection bonds. Even though many of us want to believe that the wealthiest do not pay their fair share, in truth the wealthiest pay the highest taxes. However, the wealthiest have more left over simply because they are wealthy. Middle income Americans have much less left over after taxes so it seems like they are paying the biggest chunk. It is no surprise that the poorest people pay the least because they have the least income. The very poor often pay no income taxes because they are so poor.

The wealthiest Americans, pay approximately 36 percent of our nation's total tax bill. Forty-nine percent – Middle America – pay around 60 percent of our nation's tax bill, leaving the poorest people paying the final 4 percent. Because there are more people in the middle than at the top or bottom, Middle America does in fact pay the majority of the taxes. From a mathematical standpoint the wealthiest are paying a much higher percentage of their income out in taxes. They are just lucky enough to have more left over that the average family of four.

The bad news is that the government is expanding their definition of "rich." Those who may not feel rich are classified as such from a taxation standpoint. It is this fact that makes investment vehicles with tax-deferral status so important to retirement planning. Deferring taxation to a later date (during retirement, for example) can make a great deal of difference to those trying to be good financial managers.

Tax Efficiency

The purchase of an annuity with qualified retirement savings, such as funds from a 401(k) plan or an IRA, can save the investor money on his or her taxes when compared to taking a lump sum payment. Qualified funds can be rolled into a qualified annuity without any tax penalties. The annuitant only pays taxes on the income the annuity provides.

An annuity, like all investments, is not perfect, but it is a great way to protect one’s quality of life in retirement. Retirement assets can be used to purchase guaranteed income for a specified time period or for the life of the investor and his or her spouse. Annuities provide many payout choices for the investor allowing the freedom to make individual income choices in retirement.

After Longevity, Health is a Major Retirement Concern

Everyone knows we are living longer. The next concern should relate to our health status. Living longer is only pleasurable if health is part of that longer life. We know obesity and related diabetes and heart disease are raising some health issues affecting retirees, but assuming we can maintain a reasonable degree of health, how will that longer life impact the amount of money we have for retirement? Even with good health we will need some measure of health care and health care is increasingly expensive. Few employers offer health insurance through our retirement years. Those that attempted to found it increasingly expensive in this economy and stopped providing health care for retirees.

Financial planners use a term called **longevity risk**. It is the risk of outliving one’s money. There is a 30 percent chance that one of a couple will live to age 95 or more. It is interesting that the Social Security Administration traditionally understates expected longevity since this severely impacts actual funding versus projected funding. For example, the administration projects a life expectancy in the year 2065 of just 80.5 years. When statistical information is incorrect it affects funding. Americans cannot afford to have funding severely limited due to vital errors as this may prove to be.

Medical treatment is probably one of the most expensive elements of growing older. Even relatively healthy people need increased medical care as they age. Prescriptions are sure to be an element of this increased care. At the same time, Americans seem to be retiring earlier as the years go by, with many retiring as early as age 50 or 55. Unfortunately this often means dipping into retirement savings, especially for medical care. Medicare’s doctor and hospital benefits do not begin until age 65, although Social Security may be taken at age 62. Following World War II the average retirement age was 70 so Americans had between fifteen and twenty more earning years than those who are now electing to retire in their fifties. The average retirement age is 62, when Social

Security benefits may be accessed. Eight additional work years (for someone retiring at age 70) may not seem critical but it can have an enormous affect, especially if retirement funds continue to grow during that time.

Physical health sometimes forces retirement prematurely. According to the Employee Benefit Research Institute, 45 percent of people who retire early do so because of illness or disability. For these individuals there is often no way to live well in retirement. Besides potentially being under-funded they are also likely to experience high medical bills.

Today most people realize that retirement will be difficult in some way, including financially funding the retirement years. Many people surveyed said they plan to work in some way during their retirement, although they may not realize that older Americans often earn less than younger workers. That is not necessarily due to discrimination; it is often due to the type of jobs available to older workers on a part-time basis. Financially, it is probably better to remain in a lifelong job than take an early retirement with the expectation of picking up a job somewhere part-time since pay in an established job will be much better.

The Disappearing Three-Legged Stool

Financial planners have used the "three-legged stool" example for many years. One leg of the stool was Social Security income; one leg represented pension income through an employer, and the final leg represented personal savings. Unfortunately, the pension leg has crumbled. How can the financial planner keep that stool upright? The only way to keep it standing is by additional savings in a vehicle that replaces what was once received through lifelong employment.

Social Security benefits will likely be the next leg of the stool to crumble, perhaps replaced by continued employment. Maintaining Social Security is a hot political topic, with those receiving benefits or about to receive them ready to fight to the death to maintain them. The reality is that the program will soon be under-funded; it is likely that will be remedied with higher employee and employer contributions. Since the working population is already taxed heavily (losing a third of each year's income to varied taxes) this additional taxation will probably not be well received.

Most people no longer believe that Social Security is intended to support them in their retirement; most of us realize it is merely a supplemental income to what we should have done for ourselves. Even so, many people retire with only Social Security benefits because they failed to personally save to supplement it. Taxpayers end up supporting this segment in one way or another through their taxes.

When Social Security was initiated it was intended to be self-supporting. The creators did not intend to use general tax revenues, except for the first years of the program. Taxes were supposed to be collected from workers and their employers and invested in a trust program that would then pay benefits from that point on.

While there are many opinions on what we can do, the first thing we certainly can do is better prepare ourselves for retirement. That is much easier said than done. It is more difficult to save when our day-to-day costs are rising and the job market is shrinking. Even so, it is the only avenue available if one wishes to retire.

Diversification

Investment diversification can mean many things: it might mean diversity among various annuity types. It might mean diversity between various stocks, bonds, and mutual fund accounts. It might mean diversity between types of investment products.

When a financial portfolio achieves appropriate diversification it is likely to have various types of investment vehicles, not just diversification among vehicles of the same type. Appropriate diversification will protect the investor in all kinds of markets, in good financial times and in bad financial times. When one investment vehicle suffers, another will prosper offsetting the product that is currently losing. Some types of investments will be appropriate for one age, but not appropriate for another age group. As we age, for example, our investment vehicles should move from high risk to low risk investments. Diversification must take all circumstances into consideration.

Before any person of any age begins buying investment vehicles their day-to-day financial picture must be considered. An individual who is having trouble meeting his or her mortgage payment each month should not, for example, try to also deposit monthly into an annuity, no matter how good that annuity product might be. First the individual must become financially secure in meeting monthly obligations, and then he or she must set aside a "rainy day" account that is sufficient to cover no less than three months living costs (today most professionals feel there should be sufficient funds to cover six months of living expenses).

Once the individual has enough income to cover monthly living costs, has established a budget to stay on track and avoid frivolous spending, has their emergency fund set aside and has maxed out other types of investments, then they may be ready to invest in an appropriate annuity. Note that we said he or she should first max out other types of investments; we are referring to such things as 401(k) investments that his or her employer may match. In other words, Eric Employee's company will match 50 percent of what he deposits (usually up to some specified maximum). If Eric deposits $10 each week, his employer will match that at 50 percent or $5. Obviously Eric should max out his opportunity, so if he is allowed to deposit $150 each week he should do so if at all possible since the matching $75 is essentially "free" money. Even if that means Eric delays some other types of spending or personal pleasures he should attempt to deposit the maximum allowed by his employer. It would be foolish to invest in an annuity and miss out on the free funds offered through his 401(k) plan or any other type of employer-sponsored fund that gives him money he would not otherwise have access to.

Age has a great impact on how investments should be made. During 2008 and 2009 it was not unusual for investors to have lost between 35 percent and 50 percent of their portfolio. Those between the ages of 18 and 45 are likely to recover over a period of time but older investors, especially those nearing retirement, have little chance of recovery. Time simply is not on their side. Those who lost 50 percent would need to make 100 percent return to recover which is not likely to happen even under the best of circumstances. Those who lost that much of their total financial portfolio likely had all their funds invested in stocks, bonds and mutual funds. While that may sound like diversification, it is far from diversified because all investments were in the same investment product-type. Even though the market is likely to recover at some time in the future, those near retirement do not have time on their side so that "somewhere in the future" thing just isn't going to work well for them.

Investors must realize the risks they take in their investments, especially as the investor ages. During 2008 and 2009 it became obvious that many near-retirement age investors were 100% invested in the stock market in one way or another. Did they not understand the risks? Chances are they had began saving for their retirement late and were trying to maximize their return but it was a foolish choice to attempt maximization in this manner. We are not advocating that older-age investors never use the stock market but it is important to diversify between risk and safety with the emphasis at older ages on safety.

Although opinions vary even among the best financial planners, generally speaking the rule of thumb says most individuals can afford to be aggressive up to the age of 50; after that age safety should be a primary investment goal. Between the ages of 50 and 60 there must be a balance between growth and income funds. After age 60 there should be every attempt to be conservative and preserve principal. By this age, it is better to realize zero percentage growth than lose principal.

Rule of 100

The Rule of 100 relates to investment risk. Take the investor's current age and subtract it from 100. The balance is the *maximum* percentage that should be subjected to market risk.

For example, Betsy is 60 years old. Subtract 60 from 100 for a resulting figure of 40. Therefore, no more than 40 percent of her investments should be subject to market risk.

Managing the Retirement Money

Relatively few people actually manage their retirement accounts. They are more likely to have a mix based on which salespeople knocked on their doors. If the investor is lucky there was at least one insurance agent who talked them into purchasing a fixed rate annuity or a fixed equity indexed annuity. If the investor is really lucky he will have at least one of each type. Fixed annuities will provide a guaranteed rate of return and fixed indexed annuities will provide maximization of return. Using both will hedge against deflationary interest rates and trends.

Few investors really know or understand how to determine their risk tolerance level although it is something that each investor should know. Risk tolerance is based upon both the person's personality and views towards risk and their total investment portfolio. Just about any sane person would say they do not want to lose any of their principal but that does not necessarily mean they are risk adverse. Most financial planners have a specific list of questions they ask a new investor to determine the amount of risk they can comfortably live with in their investment portfolio. Aside from age, which has specific risk criteria, individuals often say they want no risk yet are willing to buy stocks. Does that mean they do not understand the risks stock purchase automatically brings with it? Perhaps it simply means they hope not to lose any principal but are still willing to risk a loss. The financial planner or insurance producer must determine such things prior to placing their clients into a risk vehicle. Risk tolerance and asset allocation are intended to be very methodical but investments are often not viewed that way; instead they may bring an investor's emotional feelings with them. Bottom line: the investor must know how much of their principal they are willing to lose if everything goes wrong. If the seller has not established this prior to placing their clients into stocks, bonds or mutual funds or any other type of investment (including variable annuities) then he or she could be facing a future lawsuit.

Ideally the investor would review his or her investment portfolio at least twice each year and four times each year may be better in the current financial climate. Most people are now living longer and their money must last as long as they do. While part of that longer life means obtaining gains that will provide adequate income to the end of life, it also means providing a type of income that pays until death occurs, such as an annuity's lifetime annuitization offers. Of course, the annuity will only provide income based on the amount of money placed in the policy.

Most states have some type of product suitability requirements that insurance producers are required to use. The states hope to prevent loss of principal, which would severely impact senior investors, but really all investors should use some type of suitability standard before selecting their annuity investments.

There are very few restrictions on who can place the words "financial advisor" on a business card or office entry sign. Unfortunately for many insurance producers they do not realize the legal liability they immediately place on themselves by adding those words to a business card or on a door logo. According to author Cheryl Toman-Cubbage, the primary reason an agent is sued is for negligence. It takes only a few moments of searching the internet to see the number of advertisements by attorneys and their corporations offering to sue agents. Variable annuities are often specifically listed as potential lawsuit vehicles if any financial losses occurred. We are not suggesting that such financial investments never be sold; we are advocating that only those who can prove they are financial planners by virtue of schooling or experience advertise as such.

There are few standards specifically identifying who is and who is not a financial advisor. Part of this has to do with deregulation, especially since 2008. In 1999 President Bill Clinton signed the Gramm-Leach-Bliley Act, also referred to as the Bank Deregulation Bill. Prior to this bill banks were limited by the Glass-Steagall Act of 1933, which separated banks providing basic lending procedures from other banking institutions that offered riskier investments. This made insurers, banks and investment firms equal in many respects. The line between each entity was essentially erased with the Bank Deregulation Bill.

We are seeing many other types of entities joining financial planners as advisors. For example, it is not unusual to see Certified Public Accountants also selling annuities and other types of investments or at the very least, offering advice. He or she may now, in addition to filing your taxes and trying to stay current on tax laws, manage your investment portfolio, open bank accounts in your name, provide investments such as Certificates of Deposit or place an annuity.

It takes extensive time and experience to be an *effective* financial planner. While other industries, such as medicine and law, are specializing, the financial planning industry seems to be doing just the opposite. Effective financial planning is more than placing stocks or annuities for retirement. Professional planners (those that specialize in just that and nothing else) also look at future needs such as long-term medical care (nursing home insurance) and during the working years, disability coverage. Specialization requires knowledge and experience to cover all possible and probable risks.

Today banks still offer mortgage and automobile loans but in addition to that they may be selling term life insurance (perhaps online), various annuity products, and investment advice in other products. Security firms now offer online banking, variable insurance products, and advanced investments for those they feel are qualified. Insurance companies have a new role as well. They often partner now with other financial institutions, even administering retirement plans.

Who can say whether the changes are best for consumers or not? It will probably take many years to really know. We have seen the selling and buying of life and annuity contracts turning them into a different kind of investment for many firms. Debt has been sold for years as a type of investment.

Perhaps what all consumers really need to understand is that there is no longer any such thing as a financial advisor. We do have agents that are very proficient in annuities and life insurance; we have bankers who have a great understanding of the debt markets, and we have accountants who may understand how to leverage investments for the best tax circumstances. The term "financial planner" is really a general term applying to many different aspects of specialization.

There are companies who offer schooling for individuals who want to be specialized in insurance and related financial fields. We are referring to Certified Financial Planners™, Registered Investment Advisors, Registered Representatives, Chartered Life Underwriters, Chartered Financial Consultants, and other organizations that offer specialized training and ongoing continuing education in the financial fields. We recommend consumers seek out these specially trained individuals although it is unlikely that the general consumer is even aware they exist.

One area may have benefited from the deregulations; consumers can seek products from multiple sources to find the best competitive rates and vehicles. Generally, banks will still primarily be concerned with banking issues and accountants will still be primarily concerned with keeping abreast of current tax laws. Even so, there will be those who also try to do it all. Consumers need to become better educated to seek out the best individuals in the financial fields, but chances are that will not happen to the extent it needs to. Most consumers will continue going with whoever knocks on their door and seems to fill some need they believe they have.

Some individuals will always manage their personal affairs as they would a business and others will continue listening to every person who thinks they know something about money and investments. The rich get richer because they have learned how finances and investments work and they treat them as a professional money-manager would. They are seldom (and probably never) reckless with their money. They are not necessarily out to get the highest return but they are out to get a good return with acceptable levels of risk.

Supplementing Other Retirement Income

Most financial planners would probably urge employees to first max out their 401(k) plan, if such a plan is available. This is sound advice since employers often match in part or whole the funds contributed by the employee. At some point, if the employee is financially savvy, he or she may max out their 401(k) plan since, unlike an annuity, there are limitations. Once the 401(k) plan has been maxed out, an annuity becomes an excellent financial vehicle to contribute to. The earnings will be tax-deferred, meaning the interest earned does not affect current taxation. Earnings are not taxable until they are withdrawn. At one time, investors could claim they were first withdrawing the principal, which had already been taxed. Now the IRS says interest earnings are always withdrawn first, so taxes would be due on the interest portion. This is often called the "last-in-first-out" rule.

Annuity Purchase Advantages

There are many good reasons to buy an annuity including:

- The investment earnings are tax deferred as long as they remain in the annuity. Income taxes on the earnings are not paid until withdrawn or paid out by the insurer to the annuitant.
- An annuity is free from the claims of creditors in most states.
- If the annuitant dies, accumulated values will pass to the listed beneficiary without having to go through probate. If payout has already begun, whether or not the beneficiary receives anything will depend upon the payout option selected by the annuitant.
- The annuity can be a reliable source of retirement income, providing freedom to decide how that income will be received.
- There are no income tests or other criteria; anyone may invest in an annuity.
- There are no annual contribution limits like those imposed on IRAs and employer-sponsored plans. Individuals can contribute as much or as little as they like in any given year.
- The investor is not required to begin taking distributions from his or her annuity at age 72 (the required minimum distribution age for IRAs and employer-sponsored plans). The investor can typically postpone payments until the income is needed – or never do so if income is never needed.

Annuity Purchase is not Right for Everyone

No investment is right for every person. Annuities aren't right for everyone either. Some potential drawbacks include:

- Contributions to non-qualified annuities are made with after-tax dollars and are not tax deductible. The interest earnings are tax-deferred, meaning the interest earnings are not taxed until withdrawn from the annuity.
- Once the annuity is annuitized, payments are locked in. There's no flexibility to change the payment amount or make discretionary withdrawals over and above the payment amount.
- Annuities have insurer-imposed surrender fees besides the early withdrawal fee imposed by the IRS (10% if withdrawn prior to age 59½). Insurer fees usually start high and go down one percentage point each year. For example, in a 7-year surrender annuity, the first year would impose a 7 percent early withdrawal

penalty, dropping one point each year thereafter. After the seventh year, no withdrawal penalty would be imposed by the insurer.

- Some annuities may have out-of-pocket costs for such things as annual fees, investment management fees, or insurance expenses.
- Annuitants will be subject to a 10 percent federal penalty tax (in addition to any regular income tax) if money is withdrawn from the annuity prior to age 59½, unless the annuitant meets one of the exceptions to this rule.
- Investment gains are taxed at ordinary income tax rates, not at the lower capital gains rate. This is often one of the biggest disadvantages of an annuity.

Practical Application

Certainly, investing from a young age is an obvious retirement advantage, but most people fail to do this, even when they know they should. As with most talents, knowledge and application of facts are necessary to make wise investment choices.

Although having investment knowledge is certainly a good idea, there are no major secrets to becoming a smart investor or accumulating wealth. Perhaps the biggest secret of accumulating wealth is not really a secret at all. Instead it is simply a matter of dedication. It takes dedication to begin investing early and continuing to invest on a regular schedule. It also takes dedication to leave the money untouched, so it is available in retirement. For the individuals who are serious about their financial goals probably understanding the sacrifice, discipline, common sense and consistency to accumulate wealth is the real secret.

It could be said that we practice asset allocation in our lives every day. Each month families allocate a portion of their current assets to mortgage and utility payments. The immediate reward is the ability to remain in their home with lights and water. If they did not allocate assets to these payments, they run the risk of loss of service and a foreclosure. We could consider mortgage and utility payments as essential. The reward for continuing to pay these costs is clearly defined.

Most people understand basic financial planning skills, such as how bad credit cards are unless paid off monthly or that eating out consistently wastes money. These are all straightforward identifiable costs and easily understood. Investment contributions for retirement are also discretionary allocations. The primary difference is that investing, and savings are a **reallocation of assets**, not an expense. Many people miss the positive side of this: *the person keeps the asset as part of their net worth.*

It is equally important to understand the difference between:

- Required spending *and* discretionary spending.

- Short-term *and* long term-investing.

The goal should be to identify our potential client's discretionary assets available for investing to meet long-term objectives that would include retirement planning and wealth accumulation. Once these are identified, it is possible to move on to short-term goals (begin the saving process) and then to long term goals (a retirement fund, for example).

Probably even children know that we are supposed to save something for the proverbial rainy day. Knowing this and doing it is, unfortunately, not the same thing.

Annuity Types

The Test of Time

Although some variations of annuities are fairly recent, annuities themselves have been in existence for over two thousand years. That does not necessarily mean that annuities are right for every person in all situations, but it does mean that annuities have history on their side.

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.

Of course, just like our modern-day insurance companies, the financial speculators were betting they could get a better earning rate by combining the payments of many investors and investing in a higher yield investment. Additionally, if his client died early the annuity speculator kept all unpaid proceeds; in most cases beneficiaries were not part of the early annuities.

Unfortunately, many speculators did go broke. If the client died early, he made additional profit; if the client died as expected he could still plan on making some profit, but if the investor lived longer than expected the financial speculator may not be able to meet his financial obligations so he would go broke. As a result of the speculator's risk, mortality tables were created, with the first mortality table attributed to Domitius Ulpianus.

The first life expectancy tables were only based upon and applicable to Romans, but the creation of this table changed the way annuities were issued. Since that time actuaries have repeatedly modified and updated the tables we use but the importance of them has never been questioned.

Over the centuries wealthy people from royalty to warlords have used annuities to fund multiple projects, including but certainly not limited to retirement.

During America's Great Depression insurance companies were among the very few stable institutions. Although insurance companies, like other big businesses, can go broke relatively few have done so when compared to the total number of insurers in business. Even during our most recent financial upheaval (2008 and 2009) annuities remained stable when few other investments were able to remain so. During this time annuities exceeded $200 billion in annual sales. Of course, that was not surprising since many investors were fleeing higher risk investments in favor of those guaranteeing principal deposits. Although annuities are often the target of criticism from those who feel their guaranteed interest rates are too low, they have continued to withstand the test of time and financial turmoil. Will Rogers was quoted: "It is not so much the return on my principal that interests me, but rather the return *of* my principal." That may sum up the reason so many investors are moving their funds these days.

Hundreds of companies offer annuities with some specializing only in annuities and life products. Many of the companies are highly rated from a financial standpoint. Most Americans are only familiar with the companies they see advertising on television or radio but many more companies exist; many with high ratings and excellent products.

The Annuity's Investment Role

Most people seeking financial independence will benefit from purchasing some type of annuity, perhaps even more than one type. There will always be critics of the annuity industry just as there will always be critics of most things in this world. The critics often simply don't like the "big business" aspect of insurance companies. Educated financial analysts, however, understand the annuity's role in financial planning. Although it should not be the only financial vehicle used, it should be among those used.

There are many reasons annuities offer safety of investment, but one of the reasons has to do with capital reserve issues. Our government gave money to maintain many of the banks following their poor lending practices and resulting money problems. Most experts felt 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.

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 a presiding judge.

A structured settlement is a settlement amount that is structured to pay a specified sum over a specified time period or 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 analyze risk; it 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. Agents are wise to represent more than one company that issues annuities so he or she can compare rates and payouts to give their clients the best opportunity possible.

Agents 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.

Annuity Extras

Although many annuities are purchased without additional options, it is important to know that such options exist. Not everyone will be interested, but it should always be the agent's choice.

Principal Protection

Some payout options guarantee the annuitant or their beneficiaries will receive at least all the principal back. In other words, if the annuitant dies before collecting every last dollar he or she paid into the annuity; their named beneficiaries will receive the balance. Also called **premium protection**, the annuitant will continue to receive periodic annuity payments until the cumulative annuity payments equal the net investment. This is often stated as a type of annuity, but it is actually a payout option. As such, it will not provide as much monthly income as a straight life payout option will because the annuity company is accepting a higher level of risk.

Principal protection is an important feature of traditional fixed annuities and fixed rate equity indexed annuities, something agents may want to stress. Most annuities guarantee a minimal amount of interest earnings. In the past, the amount of interest paid was usually higher than minimum guarantees, but when stock market performance became very dismal, those minimum guarantees provided more earnings than many stocks were able to do. Depending on the payout option chosen, it is also possible to guarantee that the annuitant or their heirs will receive back at least as much money as was invested in the annuity.

Annuity Cost of Living Protection

It is possible to choose an annuity with automatic cost-of-living adjustments. When an annuity is purchased it is often for the purpose of receiving a certain amount of monthly income during retirement. As we know, inflation can dramatically decrease the buying power of income over time. An annuity with "cost of living adjustments" (COLA) protects the value of the annuity income stream by adjusting the payments along with inflation or the cost of living. Inflation protection or cost of living adjustments can be very important in maintaining accustomed lifestyle during retirement. Nothing is free however. This feature comes with a price tag, usually in the form of lower monthly income than a straight life annuity payout.

Annuities go in and out of favor, usually depending on how the stock market is currently performing. When stocks are performing well, financial planners may condemn annuities as too conservative, providing low returns. When the stock market is performing poorly, however, annuities suddenly gain popularity due to their guarantees of principal and some amount of guaranteed interest earning. Annuities have always offered specific benefits over other kinds of retirement products, especially for those not able or willing to risk losing a portion of their retirement savings.

Premium Methods

There are many reasons an investor might select one type of annuity over another, including how premiums may be made. A young family is unlikely to have a lump sum of money to invest in an annuity but time is on their side. Someone just retiring may have a lump sum, but no time on their side. Therefore, the young family would likely want an investment vehicle that allows them to deposit funds monthly (perhaps through payroll deduction). In some cases, the young family may not be able to make systematic premium payments (the annuity deposits) so they may need a vehicle that allows them to make payments as they are able to. Systematic payments are always recommended since individuals are less likely to save anything if it depends on having extra dollars available to save in an annuity. Most people never find those elusive "extra dollars." Only when saving for the future is considered in the same mind set as bills will money be saved in most cases.

Annuity Choices

Traditional annuities offer several choices. The combination of choices made affect the amount of funding available from the annuity at retirement. These choices include:

Joint and Survivorship Annuities

Under joint and survivorship annuities the income is paid until the last policy annuitant dies. Although the annuitants are typically a husband and wife, it does not necessarily have to be this relationship. It could be a parent and child, sisters and brothers, business partners or any number of relationships. There may also be more than two people listed as payees. Joint and Survivorship annuities are often used with married couples because retirement is a joint issue. Even though each partner may have saved separately when building up his or her capital anything that was jointly earned and saved is typically paid to both parties in retirement.

A joint and survivorship annuity can be an option with any traditional annuity. In many cases, it is also possible to select the level of income the surviving spouse will receive. These decisions determine how much income is received while both parties are alive. Most professionals feel the surviving partner's annuity should not drop below two-thirds of the joint annuity. It is generally estimated that the difference between supporting one person and two people is about one-third since many household costs are fixed, such as mortgages, home insurance, gasoline, and utilities.

Guaranteed and Life-Time-Certain Annuities

The guaranteed and life-time certain annuity is guaranteed for a predetermined number of years, whether the annuitant lives for the guaranteed period or not. If the annuitant dies before the guaranteed time period ends (often 10 years, but it can be much longer), the annuity continues to be paid to the person designated as beneficiary in the policy for the remainder of the guaranteed time period. Beneficiaries would not receive life time income; only the annuitant would receive income for their life time.

If the annuitant lives *beyond the guaranteed income period*, the income continues to the annuitant only. If the annuitant dies beyond the guaranteed period, any remaining capital reverts to the life insurance company; beneficiaries receive nothing. Only during the guaranteed period will beneficiaries receive any inheritance.

Level Annuities

Under level annuities, the annuitant receives the same amount of income each and every month for the period of the annuity. Inflation can reduce the buying power of the income since the amount the annuitant receives each month never changes. Once the annuity is annuitized the income begins, but it is never adjusted for inflation or cost-of-living increases unless the investor has purchased a cost-of-living feature.

When the annuitant first begins receiving the annuity income, it will be comparable or higher than what might be drawn from other annuity types. However, within a few years, due to inflation, it could be significantly less than what would have been received if another annuity type had been chosen. The drawing point is longevity since the contract owner continues to receive income the end of his or her life, potentially paying out far more than he or she actually saved or would have earned in interest elsewhere. Therefore, it may be wise to use this type of annuity but have other types of assets as well that make up for lost value resulting from inflation and rising costs of living.

Capital-Back Guaranteed Annuities

Capital-back guaranteed annuities have two parts: an annuity and a life insurance policy. The annuity provides the annuitant with income and pays the premiums on the life insurance policy. This allows the annuitant to fully use the funds from the annuity (less the cost of life premiums) for their lifetime, but still provides something for beneficiaries.

There may be double commissions if a commission is paid for the annuity and another for the life insurance policy. Usually it is possible to find such an arrangement with a single commission rather than two. While the agent is not likely to worry about double-paid commissions, consumers may prefer the lower commission base of a single commission payment.

Escalating Annuities

The escalating annuity increases at a predetermined fixed amount each year. The annuity may track, lead or lag inflation, depending upon its structure. With these annuities, the annuitant receives less initially compared with a level rate annuity, but the increases in annuity income will help maintain the same standard of living for the duration of the annuity. It is designed to battle lost purchasing power due to inflation.

Most life companies will permit increases of no more than 20 percent each year on an annuity with a 10-year income guarantee. Increases of 15 percent per year may be permitted on a life annuity. It takes about nine years for an annuity linked to an inflation rate of 10 percent to catch up with a level annuity. Most professionals feel this is not too bad considering how long people are now living.

Inflation-Linked Annuities

Inflation-linked annuities are linked directly to the inflation rate, increasing annually in line with the rate of inflation. Where escalating annuities have predetermined increases in income, this annuity actually tracks the rate of inflation.

Enhanced Annuities

These annuities are offered by a few life insurance companies to people who can prove they are in poor health. While this concept goes against what insurance companies normally do, it actually makes sense for the insurer. If the annuitant is likely to die soon or has bad habits such as smoking heavily, the life insurance company is less likely to pay out benefits for a long period of time. While no one can say positively how long or short their life may be, there are factors that are strong indicators of longevity. The details of these policies vary so it is very important to see what the annuitant is gaining by purchasing such a policy.

The Roth and Education IRA

The **Roth IRA** is named after Senator Roth of Delaware. The Roth IRA is a nondeductible IRA and qualified contributions are not subject to either income tax or penalty. The maximum contribution is phased out for individuals with adjusted gross income (AGI) that is between specified amounts (depending upon the year) and for joint IRAs with adjusted gross incomes that qualify. As a result, some taxpayers who have the money to contribute will not be able to participate due to income levels.

The Roth IRA lets investors withdraw their contributions and earnings in the first tax year, five years after first being contributed without taxes or penalties under certain stipulations:

- The owner is over age 59½,
- The owner dies or is disabled, or
- The owner uses the money (up to $10,000) to buy a first home.

The **Education IRA** was developed to combat the higher education expenses of the taxpayer's designated beneficiary. Contributions to the account are nondeductible and limited to currently specified amounts per year per child. No contributions are allowed to be made after the beneficiary reaches age 18. There are no taxes or penalties on contributions or earnings that are withdrawn from the account to pay qualified college expenses.

Major advantages include:

- Tax-deferred Accumulation

- Flexibility
- Reallocation of Assets
- No Sales Charges
- Surrender Penalties versus Free Withdrawals
- Guaranteed Death Benefit
- Avoids Probate
- Distribution Options
- Safety
- Liquidity
- Inflation Protection
- No Investment Ceiling

Tax-Deferred Accumulation

As we know, annuity earnings accumulate on a tax-deferred basis so contributions and earnings (money ordinarily taken by taxes) remains in the account and continues to grow without current federal, state, or local taxation. Obviously this is an advantage over a taxable financial vehicle.

This triple compounding through tax deferral produces returns on all invested money. Triple compounding means a client could earn:

- Capital gains and interest on the principal,
- Capital gains and interest on the earnings, and
- Capital gains and interest on the money that is normally lost to taxes.

Flexibility

Fixed annuity investments are straightforward and generally easy to understand. There are two primary decisions: selecting the product's term and its interest rate. As with certificates of deposit (CDs), the fixed annuity interest rates are a function of the fixed-income markets. Fixed annuities offer either one year guaranteed rates with annual renewals or interest rate guarantee periods from one to ten years, depending on the insurer.

Variable annuity options are much more diverse. Annuity contracts offering 10 to 20 sub-accounts, from aggressive growth to money markets, are very common. One may be able to find a variable annuity that offers a fixed sub-account similar to fixed annuities however.

Annuity History

It would be easy to assume the annuity is a modern day financial device, but they have been around for a very long time in one form or another. During the 1800s annuities even played a big role in Native Americans losing their lands to the US Government. During this period the government enticed the Indians into trading their vast lands for trinkets and guaranteed annuities, often at rates that constituted gross underpayment. The tribes were forced into smaller areas, where their only real income was from government annuities. When the Native Americans needed additional money to purchase food and clothing, they could only buy from certain Government-approved traders, who would extend credit to the Indians. As the Indians' debts to these traders increased, the tribes were forced to sell more land to cover their loans. In one instance, the Governor of Indiana, which was then a territory, settled seven treaties in four years with First Nations in southern Indiana, Wisconsin, Missouri, and Illinois. The natives sold their land for what amounted to two cents an acre (in some cases less), paid to them in guaranteed annuities. Historians generally agree that the First Nations Tribe in this and many other cases were deceived in order to get them to sell at this price.[1]

Land treaties signed by the First Nations are, technically speaking, legitimate legal documents. They received goods, annuities, or a sum of money in return for a parcel of land. Of course, these “legitimate” (though certainly not fair) exchanges left many native people upset and confused, as they had never truly understood what they were selling. The tribes did not understand the transactions since they did not live by or use the concept of *property ownership*. It is likely the tribe was unaware that they would no longer be able to use the land after they sold it. To make matters worse, the treaties were often negotiated under duress. Native leaders were bribed and softened up with alcohol, and when that didn't work, threats were often made to stop payments on annuities from past treaties. Whenever these strategies failed, the US government was also not averse to sanctioning militant efforts to force the Native Americans off their lands.

As time went on, a number of Native American tribes became increasingly dependent on annuity payments and so were compelled to sell more and more land to the federal government. In a span of fourteen years the Potawatomi tribe, for example, signed six land treaties, which resulted in the tribe giving up large swaths of land in Illinois, Michigan, Wisconsin, and Indiana. Instead of turning against the government, this tribe from the Chicago area became so reliant on annuities that they would do anything to protect their flow of payments. This included acting as peacemakers on behalf of the government in 1827 when their kindred Winnebago tribe from southern Wisconsin threatened to rise up against white settlers.

Annuities have been used in many ways. In the United States, all railroad employees and their families are entitled to a number of benefits under the Railroad Retirement Act

[1] The History Collection

and the Railroad Unemployment Insurance Act. These include unemployment insurance as well as retirement-survivor benefits, the latter of which is paid through an annuity that is administered by the Railroad Retirement Board (RRB), an independent agency of the US Government.

Like traditional insurance companies, the RRB has field representatives to help railroad workers and their families file claims for benefits. There are adjusters who determine the validity of the claims. Calculation of benefits and processing of payments is highly automated, and the RRB also employs information technology staff to manage the various electronic systems.

The Great Depression brought about the RRB to a great extent. The railroads were ahead of other industries in introducing private pension plans. The first American railroad pension plan dates back to 1874. During the 1930s, however, serious defects in early private pension plans became magnified by the Depression, and a more suitable solution had to be found. Legislation was passed, creating a national retirement benefit annuity program for railroad staff.

The Depression highlighted how many elderly citizens had either insufficient retirement income or none at all. It was the Great Depression that gave birth to the idea of Social Security, although it did not become a reality until 1935. Railroad workers saw an immediate need for retirement benefits during the early thirties. Rather than stand around waiting for the government to offer a solution, they expanded upon and unified the existing private plans under one umbrella.

Beginning in 1934 the entire RRB system was implemented by 1937. Social Security was a reality by now, but the RRB began delivering benefits before Social Security did. The railroad retirement system still remains separate from Social Security, although the two are closely linked. A retiring railroad worker is entitled to a railroad annuity that is greater than the amount he or she would receive from Social Security. The portion corresponding to that which he or she would receive from Social Security is partially reinsured by the Social Security system. In this way, the funds are in the same position they would be in if the worker were covered by Social Security instead of the railroad program.

At one time employers wanted to provide retirement benefits to workers but this has gradually changed as costs became burdensome. Group annuities have been offered as a way to ensure the financial comfort of employees following retirement. Group annuities differ slightly from individual annuities in that the payout of a group annuity is dependent upon the life expectancy of all members of the group rather than on the individual. The administration costs of group annuity programs are usually absorbed by the employer.

Our annuity history includes use by our military. Not only were soldiers granted annuities, but their widows were often entitled to receive annuities as well. Widow's claims exist in the form of letters sent and received between their representative and the government office responsible for issuing them.

Annuities existed on both state and national levels. In some cases, annuities were even awarded to women that served an important personal role in military campaigns. The Annuity Museum[2] has a newspaper article discussing the granting of an annuity to Molly Macauley. She participated beside her husband on the battle field during the Revolutionary War. Military annuities were awarded for bravery and service and protected the survivors of fallen American soldiers.

When the Romans used annuities, just like today, the speculators intended to make a profit. As we previously said, in return for a lump sum payment, these contracts promised to pay the buyers a fixed yearly payment for life, or a specified period of time. Even though profit was the motive, the promise of lifetime income was enticing considering these participants would otherwise have had no income at some point.

During the Middle Ages lifetime annuities purchased with a single premium became a popular method of funding the nearly constant wars that characterized that period. There are records of a form of annuity called a **tontine**. This was an annuity pool in which participants purchased a share and received a life annuity in return. As participants died off, each survivor received a larger payment, until finally the last survivor received the remaining principal. Similar to our modern-day lottery, the tontine offered not only financial security but also a chance to win a jackpot.

During the 18th century, many European governments sold annuities providing lifetime income, which was guaranteed by the state. In England, Parliament enacted hundreds of laws regulating the sale of annuities to fund wars, provide a stipend to the royal family, and to reward those who were loyal. In the 1700s and 1800s annuities were popular with European high society. Their popularity is not surprising since annuities could shelter the investors from many of the ups and downs experienced in other markets.

Compared to other areas of the world, annuity use grew very slowly in the United States. Annuities were mainly purchased to provide income in situations where no other means of providing support could be found. Americans were more likely to rely on support from family members. Annuities were mostly purchased by lawyers or executors of estates who needed to provide income to a beneficiary as described in a last will and testament.

Annuities finally gained some popularity due to the spreading out of American families at the turn of the 20th century. There were fewer family members available to provide

[2] The Annuity Museum's offices are located at 8 Talmadge Drive, Monroe Township, New Jersey 08831 (USA). All original documents and artifacts exhibited are owned by the Annuity Museum and are available for viewing by appointment only. To schedule a visit, call 732-521-5110 (USA, Eastern Time zone).

care for other family members during illness or as they aged. The Great Depression was especially significant in the history of annuities. Until then, annuities represented just 1.5 percent of life insurance premiums collected between 1866 and 1920 in the U.S. During the Great Depression investors sought out more reliable investments in order to safeguard themselves from financial ruin. With an unstable economy, investors looked to insurance companies as a haven of stability when few other investments appeared to have any security at all.

Annuity Basics

There are many annuity products in the marketplace. Even agents may have difficulty discerning the differences; certainly it is difficult for the annuity buyers. There are many different products available under the fixed and variable annuity headings: tax-deferred, guaranteed, inherited, equity indexed, and more. While there are only two basic types of annuities (fixed and variable) each has many sub-types and marketing names. Insurers often market their products under company names making it difficult to compare apples to apples.

Annuities are *tax-deferred* investment vehicles. Investors deposit their money either in a lump sum or through a series of contributions. Although annuities are marketed by many different entities, they are always placed with a life insurance company that sells annuities (the annuity issuer). The period of time the annuity is being funded is known as the **accumulation phase**. In exchange for investing in the annuity, the insurer promises to make payments to the investor and possibly a named beneficiary at some point in the future. When the annuity vehicle begins paying the annuitant a monthly income it is known as the **distribution phase**. For many investors, the distribution phase begins at the point of retirement, but that is seldom mandatory. Many annuity investors never annuitize their contract, so the entire amount continues to grow. Upon the death of the annuitant, the annuity funds would then go to the named beneficiaries. *If no beneficiary was designated*, upon the annuitant's death, the un-annuitized accumulations would go to the annuitant's estate. Of course, a beneficiary should always be listed as well as a contingent beneficiary designation in case the primary beneficiary predeceased the annuitant.

These annuity terms generally refer to the different features that can be applied to the basic annuity product. Some of these features are great for retirees and are options recommended by the most respected financial planners in the country. Other annuity features are almost universally condemned by the same planners. Therefore, it is important to understand these options so you can determine which annuity is most appropriate for your clients.

Choosing Between Fixed and Variable Annuities

Perhaps the most important consideration to make when evaluating annuities is whether to choose a fixed or variable annuity. Each has its proper place, but neither is right for everyone and every situation.

Fixed annuities are typically based on fixed income products, such as bonds and once annuitized, pay a guaranteed stream of income. It is a fixed annuity because the income stream is "fixed." The annuitant knows how much income will be received each and every month once annuitization takes place. Of course, annuitization is not mandatory and many annuities are never annuitized. Even so, the insurer's intent when selling these products is to provide a stream of income – for the annuitant's life if that is the payout option selected.

The fixed annuity guarantees the investor a specified income – no matter what – which makes fixed annuities a good choice for retirement financial planning. Guaranteeing an income during retirement is a common financial planning goal. It is important, however, to note that there will be no adjustments in the annuity income for inflation or rising costs of living. The specified amount continues to be the same regardless of these factors unless steps have been taken to counteract this situation. The investor can elect to pay extra for an annual Cost of Living increase or inflation protection as an option on the annuity contract.

Variable annuities are typically based on mutual funds and pay a stream of income that moves up and down with changes in the value of the underlying funds. A variable annuity is a riskier investment for retirement since there are no guarantees as to monthly income.

Many financial retirement planners recommend fixed annuities since retirement is generally a time in life when risk must be avoided. There are no wages and little time to make up potential losses once the investor enters retirement. Fixed annuities are less risky and provide a more reliable income stream. Some planners might recommend primarily fixed annuities with a smaller amount invested in variable annuities if the specific situation allows this without putting the retiree in a precarious situation.

Choosing Between a Lifetime Annuity and Term Annuity

Lifetime annuities are annuities that pay an income stream when annuitized for the remainder of the investor's life – no matter how long he or she lives. In fact, depending on how long the investor lives, a lifetime annuity could pay a higher sum over the investor's lifetime than originally invested in the annuity. The opposite could also be true – the investor could die before recouping their investment. Because of this, many annuity products offer premium protection – insuring that the investor or their heirs will receive back at least as much as was invested. It all depends upon the payout option chosen. Payout options should never be selected until full understanding exists.

Lifetime annuity payout options are a good choice for those who want to guarantee additional income beyond an existing pension or Social Security payments. The annuity does not need to be annuitized at any particular time so the retiree can hold funds in the contract until additional income is needed or desired. Once annuitized, the income stream will not change so it is important to annuitize only when the income is actually needed.

Term annuities result from selecting payout options that pay the investor an income stream for a specified period of time that he or she selects (versus lifetime income). Term and lifetime annuities are actually the same annuity product – the selected payout option is what results in one or the other annuity product.

Determining Investment Type

There are different types of annuities. Each annuity type brings unique characteristics. The investor and selling agent selects the type of annuity that best suits the investor's needs, or at least that is the goal. There is no specific type of investment that is always right or always wrong. Each investment vehicle has qualities that work well under some conditions and qualities that make it unsuitable in others. The goal is to identify the type of investment vehicle that best suits the investor.

Nearly 80 percent of annuity investors say they chose their product not only for safety but also to earn a good interest return. Compared to other forms of savings, annuities offer guaranteed returns. This is because annuities define an investment in the present giving a return of the same value in the future. Insurance companies sell them with a guaranteed rate of return on the money deposited. This means, even if the investor has not paid the full amount of the annuity, he or she still earns the contracted rate of interest on the money deposited with the insurance provider. Also, if the investor has started withdrawing money from his or her annuity, he or she keeps earning the rate of interest on the money that remains with the insurance company.

To understand annuities some basics are required. An annuity is an investment made through an insurance company, as every agent should know. Even though other types of industries, such as the banking industry, markets annuities they are always underwritten and issued by an insurer.

Annuities have few characteristics of typical insurance coverage. Life insurance, for example, insures the premature death of a stated individual while an annuity is intended to fund the insured's retirement years. Annuities may be purchased for other reasons, but they are intended to fund a long-term event, such as retirement.

Annuities may be categorized in various ways, depending upon the source used and the context intended. However, they can typically be categorized in one of three ways:

- Fixed or Variable;
- Immediate or Deferred; and
- Flexible or Single premium.

The first, fixed or variable, will affect the security of the investment since fixed products are always more secure from a risk standpoint than variable.

The second, immediate or deferred, describes when income is desired. Immediate products immediately produce income while the second choice defers income.

The third, flexible or single premium refers to the ability to deposit additional money later on (after the investment was first purchased).

Annuity Participants

There are traditionally four parties to an annuity: (1) the insurer issuing the contract; (2) the contract owner who owns the policy; (3) the annuitant who is the insured individual; and (4) the beneficiary.

The first is obvious: an insurance company must accept the risk and issue the policy or contract. The second is the individual who owns the policy. He or she may or may not also be the annuitant. The contract's money is controlled by the contract owner and it can typically be assumed that it was his or her money deposited into the policy. Because it is the owner's money, only he or she can terminate the agreement or begin a payout mode. The owner is typically a named individual but it can also be a trust, corporation, or partnership. There can be more than one policy owner; in some cases it is a couple such as a husband and wife.

The annuitant is the **"measuring life"** of the policy, which is similar to the "insured" in a life insurance policy. It is the annuitant who would be considered the insured individual. The annuitant has no voice in the contract unless he or she is also the contract owner, which is often the case. Unless the annuitant is also the policy owner, he or she has no ability to make withdrawals or deposits, change beneficiary designations or make any other policy decisions. Only the contract owner can do such things.

The beneficiary has no effect on the annuity contract unless the annuitant dies. The beneficiary is the person who would profit from the annuitant's death, assuming the contract has not been annuitized with a lifetime payout option selected. If a lifetime payout option has been selected through annuitization the beneficiary is, for all practical purposes, removed from the contract.

One person can serve multiple functions. It is common for the policy owner and annuitant to be the same person, for example. A function can also be served by a non-human except for the annuitant who must be an individual. The annuitant must be a living person because it is he or she that is the "measuring life" of the contract. No insurer would issue a contract without a measuring life because that is how they assess their risk.

Annuity Terminology

All legal contracts use terminology specific to them. Agents must be aware of all terms and conditions in the legal contracts they sell – insurance policies and annuities. Agents must also be able to communicate well enough to explain in lay terms what these terms mean to the policyholders and their beneficiaries.

1035 Exchange

As specified by the tax code, section 1035(a), permits a (usually) tax-free funds transfer from annuity to annuity; the 1035 exchange *excludes* the transfer of funds within an annuity from one subaccount to another.

403 (b)

Similar to a 401(k), the 403(b) is a tax-deferred retirement savings account offered to employees of nonprofit organizations, through which contributors invest in annuities (often referred to as TSAs) or in mutual funds.

10% Penalty Tax

As it applies to annuities, a 10 percent IRS fee charged upon the withdrawal of pretax savings (contributions or earnings) from an annuity before the age of 59 ½.

Asset Allocation

In a variable annuity, asset allocation is the distribution of assets across multiple classes (such as stocks, bonds, and cash) in order to meet an individual's financial goals in terms of risk and length of investment. Asset Allocation can reduce risk and maximize returns on the investment.

Back-End Charge

Fees incurred by an investor for cashing out early on a deferred annuity or variable annuity, usually within the first 7 to 10 years after investing (depositing). This is often called a surrender charge.

Bailout Provision

If a fixed annuity's interest rate falls unpredictably below a rate specified in the annuity contract, the provision assures the surrender-charge-free withdrawal of all funds from the under-performing annuity account.

Balance Inquiry

A balance inquiry is an on-line tool allowing contract holders to check the balance of all accounts held within their annuity.

Benchmark Index

An index that measures the performance of market allocations in a variable annuity. A benchmark index also compares performance between a variable annuity and an investment portfolio. These indices cannot be invested in directly; also, in contrast to an investment portfolio, these indices do not require that transaction fees and other costs be paid by an investor. These may also be called stock or bond indices.

Beneficiary

The individual, organization, or entity that receives money upon the death of an immediate annuity contract holder. It may also include the person, organization or entity that benefits from continuing payments upon the death of an immediate annuity contract holder that has not yet received all of the guaranteed income stream for the contractual time period of the annuity.

Beta (3 year)

A percentage reflecting the relative volatility of the subaccounts in a variable annuity as compared to the market as a whole (often determined using the S&P 500). A value greater than 1 percent is indicative of volatility over the market.

Bonus Rate

The bonus rate is extra interest accumulated in the first year of a deferred annuity that is added to the sum upon which interest is calculated in later years. Also called the first-year bonus rate.

Certificate Owner

The purchaser of an annuity, whether an individual, organization, or entity.

Compound Earnings

In a deferred annuity, the reinvestment of previous interest earnings back into the annuity account.

Contingent Annuitant

In the case of the death of an annuitant prior to the beginning of annuity payments, the person who is designated to receive the payments in the original annuitant's place.

Contingent Deferred Sales Charge (CDSC)

A fee charged to the account of a deferred annuity or variable annuity upon the full surrender of an annuity contract or upon the withdrawal of funds in excess of annuity contract limits.

Contract Owner

The purchaser of an annuity contract and holder of all rights pertaining to it. With a variable deferred annuity, this person or entity may have rights extending to making investment decisions, initiating monetary transfer and redistribution among funding elements, withdrawal rights, and the naming of the annuitant (usually the contract holder) and any beneficiaries.

Death Benefit

The death benefit is a guarantee of payment of the annuity account value or a different, specified amount (such as the value of the original lump sum funding payment minus withdrawals) to designated account beneficiaries upon the early death of an annuitant or annuity contract holder, before the deferred annuity or variable annuity is annuitized (before the annuity is converted into systematic payouts). In many variable annuities the value of the death benefit increases over time, and several kinds of death benefits exist: the greater of the value of the current account or the value of the initial funding payment; rising floor, in which the insurance company provides a guaranteed minimum return, regardless of the performance of any annuity subaccounts, on any deposits; Ratchet, the greater of the values of the contract, any payments minus all withdrawals, or the contract on a given date; and Stepped-up, guaranteeing payment of the value of the annuity account as per set anniversary dates (e.g., on a yearly periodic basis).

Deferred Annuity

Deferred annuities feature a contract with accumulation and can be funded either through a one-time lump sum payment or through multiple payments over time. Any investment accumulates over the years with a tax-deferred status. Deferred annuities can be variable or fixed. When chosen by the policy owner payments from the annuity begin through annuitization options.

Direct Rollover

A monetary transfer classified as a rollover but which occurs from one investment company directly to another, often from one investment plan into another (such as from a 401(k) plan into an IRA account). Direct rollovers must be reported but are not taxed, and therefore annuitants can avoid taxation of distributions by using this method.

Diversification

In a variable annuity, a method that helps an annuitant reduce or avoid risk by distributing funds over multiple asset classes; for example, an annuitant could diversify by investing in stocks within different industries.

Dollar Cost Averaging

In a variable annuity, dollar cost averaging is the investment of a fixed amount of dollars at regular intervals. This is a financial strategy that could eventually ensure that the average cost per unit will fall below the average price or the market high; however, it does not guarantee profit or guarantee the avoidance of a loss. Investors must invest in securities on a continual basis despite any fluctuation in prices and should assure his or her ability to continue purchasing in times of low prices before using this strategy.

Effective Annual Yield

In a deferred annuity, the rate used after the daily compounding and crediting of the annuity's interest. The effective annual yield includes any first-year bonus and can be calculated as follows: using the rate bonus, a bonus paid on the base rate by some annuities (e.g., with a 6 percent base rate and a 1 percent first-year bonus, the effective annual yield will be 7 percent), and using the premium bonus, paid upfront by some annuities (e.g., with a 6 percent base rate and a 1 percent premium bonus, the effective annual yield might be 7.06 percent).

Effective Interest Rate

The interest rate when an annuity is compounded annually. For example, with an initial $10,000 deferred annuity investment, over one year at an effective rate of 10%, $1,000 will be earned in interest. This is also called an annual effective rate or an annual effective yield.

Enhanced Dollar Cost Averaging Program

In a fixed annuity, a dollar cost averaging program providing an often higher interest rate in particular cases, e.g., for new minimum purchase payments within a limited period of time. Specified amounts are usually transferred automatically over a given time period from a fixed to an investment account.

Equity Index

In equity-indexed annuities, equity index is the index used to measure the performance of stocks or bonds selected for indexing the annuity, with an increase in performance resulting in an increase in the value of the equity-indexed annuity.

Equity-Indexed Annuities

A type of annuity offering a guaranteed minimum return rate; may also offer additional interest earnings based on the value of an equity index. The indices used for determining the value of an equity-indexed annuity are commonly well-known stock indices, such as the S&P 500.

Equity Investment Style

Within an annuity, the combination of investment types used.

Exclusion Ratio

The ratio of taxable to nontaxable proceeds in an immediate annuity payment.

Expense Ratio

The percentage of an annuity account that is paid on a yearly basis toward insurance and investment charges.

Immediate Annuity

Immediate annuities guarantee a systematic stream of income. They are funded by a lump sum payment to an insurance company. In a given annuity period, e.g., monthly or yearly, an immediate annuity provides payments composed of both the principal and any interest earnings; payments will, over time, liquidate the principal. Immediate annuities are often purchased for the purpose of providing income during retirement.

Surrender Penalty

Fee charged to a deferred annuity account for excessive or multiple withdrawals that exceed the limits imposed by the annuity contract. Upon the surrender of the entire annuity, the penalty could be assessed according to the total annuity account value.

Surrender Value

Value of an annuity account minus any surrender penalties paid, as specified in the annuity contract.

Yield

Yield is the annuity's rate of return; often a percentage of earnings in relation to the annuity balance.

Annuity Contracts are "Driven"

Although we seldom think of a life product being "driven" annuities react to certain circumstances that "drive" the product, determining how it changes. These circumstances would include death, disability or reaching a specified age.

In the past annuities was typically annuitant-driven meaning that some provisions or sections of the annuity contract came into effect if the annuitant died, became disabled, or reached a contractually specified age. Other elements of the contract might also be affected. Provisions such as waivers of insurer penalties, death benefits, IRS penalties, and required annuitization or distribution of the contract became effective based on what happened to the annuitant (so the contract was "annuitant driven").

Many of today's annuity contracts are now "owner-driven" because the provisions are based on whether something happens to the contract owner rather than the annuitant. Again, the annuitant and contract owner could be the same person, but they are often different people. Many newer contracts also use terminology that state if the owner, co-owner, or annuitant dies, reaches the age of annuitization or becomes disabled certain provisions become effective. In other words, the specified provisions come into play regardless of which person dies, becomes disabled, or reaches a specified age.

Meeting Investment Goals

Before an insurance producer looks at the options among annuity products he or she must know the direction the client wants to go. It is very much like planning a road trip. Few people simply climb into their car and start driving without any direction (although that sounds amazingly similar to how people plan their financial futures). Most people have a destination they wish to arrive at; even the time of arrival is usually planned since most of us have a set amount of time we can vacation before it is time to come back to our jobs.

Financial planning is incredibly similar to this scenario. Each person has a financial starting point, a destination and a time horizon to reach that destination. Even the time horizon has to do with the individual's working years. Individuals must set aside funds from earned income to support him or her in retirement when the earned income has ended.

Those who plan their financial road trip with time on their side will do far better than those who throw a few dollars in their financial car and race off, simply hoping luck will be on their side. They are unlikely to reach their destination and time horizons. Such individuals are more likely to become stuck along the freeway with a flat tire, no spare, no tire jack, and no hope of making it back home on time.

The road trip is a good analogy since most people spend more time planning their vacation than they do their retirement. A vacation gives individuals immediate pleasure whereas retirements often seem far away. Since Americans are spenders by nature it is also difficult for many people to separate out a portion of their income for use many years down the road. The earlier one begins planning the less money will be required, but most people do not begin putting aside funds for retirement until they reach their forties.

Since retirement has become something we feel entitled to it is surprising that so few people adequately plan for it. Citizens are more likely to simply state the goal in an abstract way *"I want to be comfortable when I retire."* What is "comfortable" - a monthly income of $1,000, $2,000, or $5,000?

Any type of investment objective must be turned into a dollar amount. Without having an actual dollar goal, it is not possible to adequately plan from a financial standpoint. Higher goals require higher savings.

Any goal must be realistic of course. Once existing retirement savings is listed, future financial requirements assessed, and other factors considered (such as inflation that will require inflated savings to match) it is relatively easy to determine what must be done. Typically it will mean saving more than is currently being done and perhaps even looking at more aggressive funds, such as those found in variable annuities. It must be pointed out that variable annuities definitely contain investment risk so if aggressive goals require aggressive investments be sure the clients totally and completely understand the risks involved. Many professionals hesitate to recommend aggressive funds to older clients since they are not in a position to take losses. Even when a client is far behind in sufficient savings this may be true since suffering additional losses will not help the situation and has the potential for making it worse.

An investor with time on his or her side may be able to start with a modest amount but over forty years still achieve the final investment goal: a financially comfortable retirement. Investors who wait until their forties, as the average person does, will need to save twice as much to reach the same end result.

Those who begin saving later in life may feel they need to invest more aggressively to make up for lost time. When a smaller amount must grow in a hurry, typically the annuity type recommended is variable annuities. Variable annuities definitely have investment risk, although the sub-accounts can vary from very aggressive to moderate risk or even conservative. If time is on the investor's side, fixed rate annuities make more sense than variable annuities since there is no point incurring unnecessary risk.

It is important to gage the client's risk tolerance. Simply asking the investor "are you willing to accept investment risk?" is not adequate. The selling agent must assess whether high or even moderate risk will cause the investor stress as the market goes up and down.

State the following and request your client respond with one of the available answers:

"Assuming at least a five-year investment period, the final result is more important than daily, monthly, or annual fluctuations in value."

- I totally disagree with that statement.
- I am willing to accept some volatility but not loss of principal.
- I could accept a moderate amount of yearly fluctuation in returns for a good total return.
- I would accept an occasional negative year if the final results are good.

Assessing the client's reply is not the only risk assessment but it will provide a starting point for assessing their risk tolerance. Any investment risk must be completely and totally communicated of course. Agents should consider having a risk disclaimer signed by their clients as well. If principal loss occurs having proof that all risks were discussed may save the agent from a lawsuit. The signed form should be kept indefinitely in the client's file.

In recent years many investors have been encouraged to sue over investment losses, even when the losses were clearly discussed prior to the investment.

The following is an article posted on the internet. There are also advertisements by attorneys offering their services, especially for variable annuity investments that lost money.

How to Sue an Annuity for Losses

By Kay Miranda, Updated: May 5, 2010

Annuities are investment products sold by insurance companies to help investors save toward retirement in a tax-deferred account. Annuities offer fixed rates or variable mutual fund returns depending on the type of annuity. Annuities funded with qualified retirement funds do not get any additional tax benefits and may have higher fees and penalties for withdrawals. Some investors sue the annuity for losses incurred when fraudulent sales practices and lack of adequate disclosures are evident.

Instructions and things the client will need:

- *The annuity policy*
- *Sales literature*

1. *Hire an attorney to review the terms of the annuity contract and discuss the circumstances that led to your purchase. Financial advisers are required to disclose in the sales process all fees, risks and penalties on annuity contracts. Additionally, a financial adviser must also explore other investment options such as IRAs with mutual funds that have lower fees for the same types of funds. Give your attorney all the sales literature you were given as well as the annuity policy.*
2. *Determine the types of losses incurred in the annuity. Variable annuities fluctuate based on the underlying mutual fund investments. If you moved your assets from one type of plan with similar investments, you may not be able to reclaim mutual fund losses since you were already familiar with investment fluctuations. If you were told you were investing in a fixed annuity or not properly advised about penalties and fees, you might be able to reclaim losses on these aspects of the annuity.*
3. *Attempt to settle with the annuity company. In some cases, the company, eager to maintain a positive public image, will work with its clients. Determine where responsibility lies: the financial adviser who sold you the annuity or the annuity company itself. Enlist the help of your attorney to determine who to include in settlements and lawsuits.*

4. *File a lawsuit based on the omissions of information and lack of disclosure. If you are part of a union or larger group that purchased the annuity as part of an employer-sponsored plan, you may want to talk to others who want retribution. Consider having your attorney file a class-action lawsuit to create a bigger, more powerful legal proceeding."*

Of course, every insurance producer should keep an active errors and omissions policy to protect themselves from lawsuits. Even a good agent can be sued, often by the insured's family members. Why would family members sue the agent or insurer? Heirs might sue because they expected an inheritance that did not materialize. Why would there not be an inheritance? If the annuitant selected a lifetime annuitization option without any period certain leftover funds would not go to heirs; the insurer would keep any undistributed funds, even if the annuitant died soon after annuitization. Lifetime distributions effectively erase beneficiary designations. A signed disclaimer stating that all aspects were discussed, including annuitization options, is an effective means of self-protection for the agent.

Of course, diversification is important in any investment plan and agents should be asking enough questions to know the types and quantities of all investments the annuity buyer has. That is part of the annuity suitability assessment that is discussed later in this course.

Annuity Investment Advantages

There are many reasons consumers purchase annuities, but the safety they offer may be the primary reason. Annuities guarantee that the premiums paid, which constitute the principal, are fully guaranteed. Depending upon the type of annuity purchased, some amount of guaranteed growth may also be included in the policy guarantees. As other types of investments experience losses the safety of principal looks very good.

Other advantages, besides safety of principal, include the tax deferral status of annuities. Although taxes will eventually be paid on growth, the interest earnings are not taxed until the funds are withdrawn. They will be taxable in the year withdrawn.

Annuities may be used for other types of plans, such as Roth Individual Retirement Accounts. Since the Roth IRA has tax free withdrawals, when an annuity is used as the Roth vehicle, those withdrawals will be tax free. This is not a feature of the annuity, but rather a feature of the Roth IRA.

An annuity is tax deferred during its accumulation phase, taxable during its payout phase, or tax free if it is used in connection with a tax free investment (like a Roth IRA).

During the accumulation phase, when earnings are tax deferred, the annuity will gain greater growth than a taxable product, even if the same interest rate is applied. That is because compound interest allows previous earnings to earn additional earnings. When taxation is not removing gains, growth is greater because there are greater sums earning that growth.

Safety of Principal

Generally speaking, annuities are safe investments. We say "generally speaking" because not all annuity products carry low risk. Some variable annuities have quite high risk factors. Some equity indexed annuities also have a chance of principal loss under specific conditions. Equity indexed annuities, despite what some consumers believe, are NOT variable annuities; they are fixed rate annuities but with complicating factors.

Even fixed rate annuities that are conservative and safe are not necessarily suitable for all investors or for all investment situations and goals. However, in many cases fixed rate annuities work very well for retirement goals. Annuities are long-term investments. Even the IRS considers them retirement vehicles, as evidenced by the IRS penalties for withdrawals prior to age 59½.

Fixed rate annuities guarantee all the investment capital. There are few investments that guarantee 100 percent of the principal and use the phrase *"principal guaranteed at all times."* From a safety aspect, it is hard to find anything better than a fixed rate traditional annuity. When the market is doing well investment advisors often discourage annuity use because they feel the growth potential is too limited but as soon as the market dives those same advisors turn to fixed rate annuity products. That is perhaps the best example of why diversification works so well. Even in high performance markets having some of the investment pie in fixed rate annuities provides a protection from market downturns.

When money is placed in a variable annuity, returns are "variable." Many variable annuities have a fixed-rate investment option that would provide the same guaranteed rate of return but typically those who use variable annuities are looking for greater returns so they would be more likely to use aggressive or moderately aggressive sub-accounts.

Variable annuities do not have the same types of safety features that fixed rate annuities have but they do still have some safety features backed by the issuing insurer. There is certainly more individual control over funds invested in a variable annuity and for this reason investors should expect to be more involved in this type of annuity product. Variable annuities have a great deal of flexibility so they are often recommended by investment professionals, especially when there is not enough investment time to reach a specific retirement goal. If an investor knows nothing else about a variable product, he or she must know one thing: *variable annuities have investment risk.* Any investment that has the potential for greater growth also has the potential for greater loss. This is true of nearly all investments: greater potential growth means greater financial risk.

Because there are more investor choices there are also more investor decisions to be made. Equity investments mean it is necessary to manage risk and return. The risk of principal loss exists as they do with any investment involving equities such as stocks and mutual funds and exchange traded funds (often stated as ETFs) that invest in stocks. Over a long period of time (no less than five years with longer terms being better) the risks involved may be outweighed by greater potential for return, but that is never guaranteed. Even though greater returns are not guaranteed, historically returns are better if looked at over a long period of time. Greater returns protect investors from inflation.

The key to dealing with greater risk is always a long-term commitment. High risk for short periods of time is excessively risky but given enough time, higher risk often pays higher returns. In many cases, however, there are no guarantees of growth.

We are seeing larger numbers of investors diversifying within an array of annuities. That is, they are buying fixed rate annuities, variable annuities and equity indexed annuities with the goal being diversification of risk. Although it is possible to diversity among annuity types, most professionals strongly advise diversifying among several types of products, not just various annuities. Certainly 401(k) plans and Roth IRAs should be part of the investment package. Any investment that provides matching employer contributions should first be utilized to their full availability.

There is one other point that needs to be made. When an investor buys stocks, bonds and money market accounts through a financial firm they have no liability of loss if the financial firm goes bankrupt because they did not invest in the firm; merely *through* the firm. The investor still owns whatever products they purchased. When investors have lost money in fixed rate annuities it has been because the issuing *insurer* went down but when money is lost in a variable product it is because the *portfolio* lost money. With most fixed-rate annuities the investment funds are commingled with the insurer's general account funds. Luckily most insurers are set up, for various reasons, with investor safety in mind. As a result very little has ever been lost from annuities because the insurer failed financially. Still this distinction must be made.

Investors sometimes question why fixed rate annuities have such strong safety of principal guarantees while variable sub-accounts do not. In a variable annuity it is the investor that makes investment choices, not the insurer. In a fixed rate annuity the opposite is true. The insurer makes investment choices, the annuitant or account holder does not. Since the insurer is assuming the risk in fixed rate annuities (the investors assume the risk in variable products) they invest in very safe government securities, corporate bonds, money market instruments and high-quality mortgages. Since the insurer is assuming the risk they have no desire to lose so they avoid anything high risk. That is also why the guaranteed growth rates are lower in fixed rate annuities. Companies cannot offer high guaranteed rates when they are investing in low earning, but very safe investments.

Insurance companies have more power than most of us realize. *Collectively* insurance companies own, control, or manage more assets than all the banks in the world. They also control, own, or manage more assets than all the oil companies combined. Of course some of these insurers are very small while others are very large, so the control they have is not equal from company to company. Many people do not realize that during the Great Depression it was not the government that bailed out the banking industry but rather the U.S. insurance companies. If everything financial failed in the United States, the insurers would be the next to last to fail, second only to the federal government. If that happens, all is lost in the U.S. because it would take a huge calamity to cause all the insurance companies to collectively fail.

Insurance companies take a lot of heat for everything from high premiums to unfair benefit payments but frankly Americans need them. They allow everything from mortgages to businesses to operate. Without insurance companies our financial opportunities would be severely limited. Banks would not loan money if the loan or collateral could not be insured. New businesses can often start up only because an insurer is willing to insure their operation against natural elements, such as flood, and against liability, such as lawsuits from customers who are injured on their property. It is our right to complain about unfair practices and we need to but we must also stay aware of the role insurance companies play in our lives, making our lives comfortable in ways we cannot even imagine in many cases.

Annuity products have a near perfect financial record, but some companies are safer than others. It is always wise to look for top rated insurance companies when placing a product. It is better to use a product rated A+ by A.M. Best company, for example, than one rated C. Investors do not give up anything by using top rated companies. When an agent chooses a less than top rated insurer it is likely that he or she either does not understand the reason for choosing top rated companies or there is some incentive to use a lesser company, such as a product with high commissions.

Professional insurance advisors usually consult more than one rating company. Having a solid financial rating from two or more companies is best since one rating company may miss early warning signs of an insurer coming into financial trouble.

Variable annuities do not invest in the assets of the insurer the way fixed rate products do, so it doesn't really matter if the insurer develops financial problems. Investors in variable annuities have less to worry about in this respect than those investing in fixed rate annuities. The variable annuity investor is not tied to the solvency of the insurer. Money in a variable annuity would automatically be turned over to the different portfolio managers of the sub-accounts. As we said, the assets of the issuing insurer do not affect the performance of the variable annuity because it is the performance of the annuity's sub-accounts that determines the product's safety and return. The insurer's assets *do affect* a fixed rate annuity because the investment is nearly always commingled with the insurer's general account.

A few insurers do separate fixed rate annuity deposits. In these limited cases, the general account of the insurer would not impact the fixed rate annuity's values, rates of return, or liquidity.

Reserve Pools

The states generally require all insurers doing business in the state to become part of the state's legal reserve pool. This provides financial protection for annuity investors and life insurance buyers. The reserve pool is a system of insurance companies that assumes the liabilities of a company that goes bankrupt or becomes defunct. If one insurer goes out of business the remaining insurers assume their liabilities and obligations. Each remaining insurer assumes a portion of the defunct company with their portion based on the amount of business it does in the state.

Insurance pools are intended to cover fixed rate annuities or products with fixed rate guarantees (as some variable annuities have). In many variable annuities, the insurer's situation does not affect the variable annuity; they are affected by how well the underlying portfolio performs (stocks, bonds, and so forth).

Tax-Deferred Growth

When investment accounts are allowed to delay taxation this is generally advantageous. When earnings are not lost to taxation, the account is allowed to grow faster than one that must take part of the earnings to pay taxes on that growth.

Annuities enjoy a tax-deferred status; taxes must eventually be paid when earnings are withdrawn but as the product grows taxation is not an issue. It is this tax deferral status that attracts many investors. Tax returns do not request any information on money sitting in an annuity because there are no tax consequences until funds are withdrawn.

When money is withdrawn from an annuity, it is the growth that is withdrawn first. The principal has already been taxed, unless it is a tax-qualified account where the capital was not taxed prior to deposit. Even when the investor would like to consider withdrawals first principal and second growth, the IRS always considers withdrawals to first be earnings and, therefore, taxable. As of 1981, money withdrawn from an annuity has been considered interest first, principal last by the Internal Revenue Service. However, those with annuities issued prior to 1981 may still be able to stipulate that principal is taken first and growth second. These investors should seek advice from their accountant.

Tax-Deferred Defined

"Tax-deferred" refers to an investment in which some or all taxes are paid at a future date, rather than in the year the investment produces income. Tax-deferred *investments* in particular refer to retirement accounts which allow deferral of taxes on contributions, growth, or both; taxes are not paid until withdrawal of funds during retirement.

When comparing tax deferred accounts with annual taxable accounts several factors must be considered:

- How soon will the funds be needed?
- Are these funds to be used for retirement?
- What is the investor's current tax rate and will it increase or decrease in the future?
- What is the ultimate goal or use of the funds?

The time horizon for deferred account funds is an integral part of the decision process. If the funds are to be used in short term time frames, tax deferral probably doesn't give much advantage. Since annuities are long-term vehicles, they are more likely to benefit from tax deferral than many other types. If the investor takes into account his or her current tax liability then the actual net gain can be established. Also tax deferral allows for the growth of funds that would normally need to be set aside for taxes.

The original deposit earns interest and since the tax that would normally be paid on the gain is also deferred it gives the added advantage of using funds that would otherwise go to the government. When the additional earned interest is added in, the combination of growth from these three areas will provide even greater funds in the future.

Tax deferral allows the following:

1. Interest on the original deposit;
2. Interest earned on the interest from the original deposit; and
3. Interest earned on the tax liability that would be deferred.

In other words, to best calculate the net annual saving on tax deferral:

$1,000 earning 6% interest

Tax liability of 25%

Net annual yield after taxation would be 4.5%

If the funds could be tax deferred, then the amount of net dollars available would be greater just based on common sense. Every year the funds are tax deferred the interest paid on the future accessed gain would be less because of the power of tax deferral.

Tax Deferred Status

As every agent 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 occurs when gains are: (1) withdrawn, (2) payments begin (annuitization), or (3) the annuitant dies, with the annuity funds distributed to heirs.

When partial withdrawals are taken, interest is considered to be withdrawn first and principal (premiums) withdrawn last. Therefore, taxable gains are the first to be withdrawn and gains would be 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 annuity's 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 out come, 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's why Roth IRAs are so popular – no taxation upon withdrawal). If annuity growth was taxed as capital gains, taxation rates would be much lower. Of course anything taken out prior to age 59½ will also feel the pinch of the IRS 10% 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 is simply a price 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 well during retirement. For tax purposes, equity indexed 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 at ordinary income tax rates – if held to maturity. If not held to maturity they could be devaluated.

There is no point in comparing annuities to 401(k) plans or other vehicles that are designed differently. Once again, it would be comparing apples to oranges: both are fruit, but they are very different types of fruit. Annuities are taxed no worse than other *similar types* of investment vehicles.

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 of 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 own. 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. 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 hire a tax specialist.

Annuity Gifts

Investors must be very careful when a gift is made of an annuity product. Most professionals strongly advise the investor involve 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.

Annuities Are (Sometimes) Protected Assets

Generally speaking, 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 an annuity that might be considered a fraudulent transfer.

However, aside from situations that are used to either obtain funds fraudulently or transfer funds fraudulently, annuities are typically safe from creditors.

Most annuities are not purchased with asset protection in mind; they are purchased as a means of retiring in comfort. However many people are involved in occupations that have a high liability, such as physicians, financial planners, and insurance agents. These occupations are regularly and successfully sued by their clients. For those in such high-risk occupations annuities should have special appeal: safety from creditors. It is not possible to transfer funds into an annuity after the lawsuit has been filed, because that would then become a fraudulent transfer. Annuity investments must be made prior to legal issues.

It is always important to consider the laws of the domicile state, since annuities are not equally protected in all states. Some states completely protect a lawfully purchased annuity from all creditors, even during bankruptcy. The 2005 bankruptcy reform legislation left annuities with that protection, even though many other types of investments suffered changes.

For those who do not live in a state that protects annuities adequately from creditors it is possible to move to a state that does offer protection. However, that would have to be done prior to a filing by the creditor. Once a creditor files on an annuity, moving would not protect the funds within it.

A better option might be use of a trust that lends legal protection to the annuity values and other assets. Such trusts are not simple documents and may be expensive to have prepared. Even so, for the physician that knows even good doctors are sued it is worthwhile to do so. Even good financial planners and insurance agents face lawsuits in this very lawsuit prone society. Agents should be aware of their state laws and if their domicile state does not provide annuity protection from creditors and lawsuits it might be wise to move to a state that does or create a trust that will protect their assets. Although career agents purchase errors and omissions policies to protect them from lawsuits, it is a smart agent or planner that goes a step further.

For investors who do not have large values in their annuities it may not be necessary to take expensive legal steps to protect those values from creditors, including lawsuits. For those who have large values, however, it may simply be prudent to pay the cost of having legal protections in place. It will require a skilled attorney who specializes in such matters; any attorney will write the necessary papers of course, but it pays to hire one who does this on a regular basis. There is something to be said for professionals who are specialists in specific fields of service. The attorney who is a specialist in trusts is more likely to cover all necessary aspects than one who only drafts such trusts occasionally.

We must also realize that state laws change. A state that provides wide protection today for annuity values may not do so next year. Laws change and those with much to protect must be prepared. Even in states that offer annuity value protection an investor may benefit from the extra protection afforded by a well-drafted trust. If the amount owed a creditor is large enough, the creditor may find ways around state laws (such as filing in the state of the insurer's domicile rather than the domicile of the policyholder).

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. There are certain types of trusts that perform very well in specific situations (a spendthrift trust for instance). Trusts can be drafted by anyone and there are companies knocking on consumer's doors offering to provide them. In fact, insurance agents may be in the business of offering revocable living trusts to their clients (attorneys are usually also involved in drafting the documents) but it is seldom wise to accept services of this kind. Expert, specialized attorneys do not send agents and other salesmen out to knock on consumer's doors. Their experience and knowledge brings in sufficient clientele.

Probate

Annuities bypass probate procedures (although annuity values must still be listed during probate). 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 very 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.

Sometimes an Annuity is a Bad Idea

Far too many investments are purchased for the wrong reasons. Maybe Uncle Joe had an annuity that paid well for him so he advocates everyone have them. Maybe the age restrictions for withdrawal are misunderstood by the young couple wanting to save for a house. Maybe the agent knew too little and misunderstood too much about the product he sold. Whatever the reason, annuities are not always the right choice for consumers.

Age

Yes, we have said this multiple times, but it is important: *withdrawals made prior to age 59½ will incur a 10 percent Internal Revenue Service penalty for early withdrawal.* Annuities were created with retirement in mind, so regardless of whether it happens to be an equity indexed annuity or a traditional fixed annuity, early withdrawal penalties apply. Most annuity contracts allow for free withdrawals even during surrender periods, but that does not apply to age and the IRS penalties. Any person who may need any portion of their money prior to age 59½ should not buy annuities.

Surrender Penalties

Surrender periods exist in annuity contracts to discourage contract surrender for the first seven to ten years; the exact length of the surrender periods will vary among contracts. Anyone selling or buying an annuity must be well aware of the length of the surrender penalty period. An investor who anticipates needing the premium paid for the annuity during the surrender period should consider an alternative investment. Even in the last year when the penalty amount may be only one percent caution is still advised. If the amount they anticipate needing is small the contracts that allow for surrender-free withdrawals might still work but even then the agent should be cautious in selling the product. Of course agents must always disclose all possible penalties; agents must ask the investor if he or she anticipates needing any substantial amount during the early withdrawal surrender penalty period. This comes down to suitability. Investors who think they might need the money during the surrender years are not suitable for an annuity product in most cases.

Some annuities may waive early surrender charges under specified conditions. This should never be assumed however. Consult the policy to see if the contract has this feature. If it does, there will be specific conditions that must first be met. Look for a heading similar to "Extended Care Waiver" or wording that is substantially the same. While there may be variations it is likely to say something similar to 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 all of 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."*

Proof will be required of the confinement and of course that proof must substantiate what the insured has stated. Proof must be provided *prior to withdrawal of funds*, never after the fact.

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. However, a wise investor will certainly consider all aspects of their investment portfolio. This applies not only to annuities but to all investment vehicles.

The purpose of most annuities is to fund the investor's retirement. While taxation and estate issues are certainly important they should not cloud the real purpose of saving for retirement. Annuities should be considered primarily for that purpose. When investors get so side-tracked by other issues that they lose sight of their primary purpose it is difficult to stay focused on saving adequately. While annuities may end up growing an estate that is not their designated purpose; their designated purpose is to provide income during life.

Death of the Annuitant

Annuities were designed to pay income to the annuitant or contract owner during their life, but that does not mean that all annuities are used for income purposes. Many annuities are never annuitized. If withdrawals are never made, growth is never taxed.

The death of the annuitant would generally mean the contract is terminated, but if one spouse is named as the annuitant and the other as the beneficiary the contract can continue. The surviving spouse has the option of liquidating part or all of the investment without cost, fee, or penalty by either the IRS or the insurance company. However, withdrawals or surrender of the policy could trigger an *income tax event*. Annuities are tax deferred; not tax free.

Eventually both spouses in our example would die. Upon the death of the second spouse the heirs or beneficiaries would receive the annuity proceeds if the annuity was never annuitized with a lifetime payout option. At this point the beneficiaries would have several choices, including:

- Pay all taxes immediately;
- Make withdrawals during the next five years, paying taxes as withdrawals were made;
- Wait for five years, then liquidate the annuity and pay all taxes due; or
- Annuitize the contract and pay some taxes on each withdrawal.

Since laws and taxes can change it is always best to consult a tax advisor. We are not attempting to give or provide any type of tax information and we do not consider ourselves tax experts.

1035 Exchanges

Also known as tax-free exchanges, 1035 exchanges are named after the Internal Revenue Code (IRC) section that allows such exchanges. 1035 exchanges allow the investor to move funds from one annuity to another without taxation. In other words, the move is not considered a withdrawal of funds.

To be considered a 1035 exchange, the money must be moved from one company directly to the other; at no time should the money be given in any form to the investor or contract owner. Even though there will be no taxation, there could be insurer penalty fees if the money is moved during the surrender penalty phase of the annuity contract.

Making the Right Annuity Choices

Often it is not whether an annuity is the right vehicle, but rather if the annuity product chosen meets the investor's needs. Choosing the right type of annuity can be critical to meeting investment goals. Consumers seldom know which annuity type best suits their needs, so it is typically the agent that must provide enough information for the correct choice to be made. It is important that agents not pre-judge the client's goals, thus failing to provide full information.

The first step is determining the client's goals in order to fully understand which annuity is likely to be appropriate. Often the goal is retirement income. Determine exactly when the client expects to begin receiving annuity income. Is he or she near retirement or years away from that date?

If the client is nearing retirement age, it is possible that he or she has a lump sum to deposit but if the client is much younger, it is likely that periodic payments will be made into the annuity vehicle, called a **deferred annuity**. A deferred annuity takes many years to accumulate cash build-ups and does not typically begin paying an income stream for many years.

For those either coming to or already in retirement an **immediate annuity** may be their goal, but not everyone annuitizes their annuity so even this should not be automatically assumed. As we know, an immediate annuity immediately begins paying an income stream to the annuitant. How long that income stream lasts will depend upon the payout option chosen at the time of annuitization. Payout options include a life time income stream but it is important to realize that the amount received each month is directly related to the amount of cash in the annuity. Obviously if the client has only accumulated a few thousand dollars, the monthly income will be very little – certainly inadequate to support the individual in retirement.

That brings us to the second step: how the annuity funds should be invested. With a fixed annuity, the annuity issuer determines an interest rate to credit to the investment account. An immediate fixed annuity guarantees a particular rate, and the payment amount never varies. A deferred fixed annuity guarantees the rate for a certain number of years; the rate then fluctuates from year to year as market interest rates change. A variable annuity, whether immediate or deferred, gives the investor more control and the chance to earn a better rate of return (although with a greater potential for gain comes a greater potential for loss). The annuity investor selects their investments from the separate accounts (similar to mutual funds) that the annuity issuer offers. The payment amount will vary based on how the investments perform.

So Many Choices

Unfortunately agents do not always have the freedom needed to shop around for the right annuity. In some companies, the products are chosen by the brokerage and the agents have only those products to represent. However, agents do have the freedom to work elsewhere if the products represent more advantages to the company than to the agent's clients. Some annuity products provide hundreds of dollars more each year than others. Why? Rates of return and out-of-pocket costs for clients can vary widely between different annuities. Of course, the insurer chosen should be reputable and financially sound as well. Refer to one or more rating agencies to determine an insurance company's financial strength, investment performance, and other factors. Most professionals recommend checking more than one rating agency since their reports are a mixture of information. Check to see how the rating agency makes their determination as well; do they do their own research or do they rely solely on the information volunteered by the insurer?

Not all annuities are the same, although the differences are sometimes vague. The financial planning community views some annuities (particularly fixed annuities) as being the ideal solution to a retiree's need for guaranteed income because they have a very good reputation. However, some annuity products are viewed as unnecessary and very expensive. Whether or not this is true is partially opinion and partially fact in many cases, but it is important to know all the annuity features – both good and bad - prior to selling them. At no time should an agent ever omit facts when presenting annuities or any other insurance product to the client.

When stocks are performing well, fixed annuities are accused of giving lower returns than available elsewhere and this is often true. What investors and even financial planners may fail to take into consideration is the safety annuities offer. Safe investments always pay lower returns than riskier investments. Recent lows in the stock market have emphasized this very well. In return for the retirement income certainty provided by fixed annuities or equity indexed annuities the investor gives up the opportunity to make bigger returns by investing their money in assets that fluctuate in value, as stocks do. Even the safer mutual funds have seen downturns recently, again emphasizing the safety of fixed rate annuities. A fixed annuity is considered to be a safe and conservative investment but this means the investor will not see the possible gains (and losses) of a riskier investment – like the stock market.

Although it is not necessary to annuitize, annuities are designed to do just that in order to provide monthly income. A problem with annuitizing, however, is the inflexibility that results from annuitization. Annuities are typically less flexible than some other retirement options; once the annuity contract is annuitized the capital is tied up in the annuity, meaning the annuitant no longer has access to that lump of money. Perhaps that is why so many annuities are never annuitized. Perhaps the investor prefers taking out sums of money periodically rather than receiving a guaranteed income stream. Some retirement planners recommend their clients reserve at least 40 percent of their retirement assets for unforeseen circumstances. *Annuitized* annuities are not ideally suited to cover large unplanned expenses but if the contract is never annuitized it may be possible to use them for such things (depending on whether or not the annuity is still in the early years when there could be surrender fees involved).

Annuity products can be structured to strengthen an individual's retirement financial plan. As we seem to be repeating in this course, the best type of annuity for retirement is a fixed lifetime annuity. Many planners would recommend an annual Cost of Living Adjustment that protects the income from the affects of inflation be included. A fixed lifetime annuity gives the investor an income stream for the rest of his or her life – no matter how long he or she lives and it offers a guaranteed payment regardless of stock market performance.

Annuity products are not perfect. Although they provide exactly what most retirees need - guaranteed income – annuities also tie up the capital, so the investor loses flexibility. However, trading flexibility for guaranteed income is not necessarily bad. One of the major retirement mistakes is over-spending in the early years of retirement, so the inflexibility may actually be an advantage, although some planners consider it a downside to using annuities. Since so many people do over-spend in the first twenty years of retirement (using up all their savings when they still have another ten years of living) perhaps it is a good thing that annuities do not allow the investor to dip into the lump sum of money held in the annuities; perhaps that is a selling point – not a disadvantage after all.

As every agent should know, not all annuities are created equal; some annuity products or special features may actually be bad for retirees or for a particular situation. In addition to choosing between a fixed (mostly recommended) or variable (riskier) annuity, there is also the matter of deciding where to purchase the annuity. Of course, agents would prefer to be the selling entity but they are available from many sources. Although the underwriting is always done by an insurer, annuity products can be purchased through banks, loan companies, and many other institutions.

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 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 CD and buys an immediate annuity from her local insurance agent. 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 payment 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.

Although deferred annuities may be used by anyone, they are commonly used by individuals who need to accumulate funds for use at a later 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 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 rates rise, but recently that has not been the case.

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 savings is better than none at all.

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, semi annually or annually throughout the life of the policy holder, or for 2 or more people. Contracts can also be for a predetermined time period. In all cases, it is important for the investor to select an annuity contract that suits their needs and saving abilities.

Flexible premium deferred annuities may 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.

Policyowner Risk

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.

All investments also face tax rate risks. Investors often overlook the risk of taxation, but taxation can erase all interest earnings. Tax deferral vehicles, therefore, are often preferred since the time of taxation can be controlled. In tax deferred vehicles, taxes are paid in the year in which earnings are withdrawn.

Tax *rates* are something that cannot be controlled by the investor but the *time* of taxation can be controlled. Future tax rates are an uncertainty and deferring taxation does not always remove the threat, especially since we cannot predict future taxation rates.

Tax rate risk is defined as the danger that an increase in income tax rates during retirement might cost the investor more money than anticipated, hurting the retiree's lifestyle to some degree. Studies show that income tax rates fluctuate over time. Even when the stated rate remains the same, the effective tax rate on personal taxable income may increase when the government increases, restricts, or repeals tax benefits. Changes could occur in the size of the personal exemption, itemized deductions, tax credits, exclusions from income, and other areas.

Each investor has what is commonly referred to as "risk tolerance." This means the ability of the investor 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. A young investor has time on their side; if they lose big, they have time to make up their losses. An older person does not have time on their side. Older investors should always seek safety rather than excessive risk.

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

Variable Annuities

Variable annuities are issued through insurance companies just as other annuities are, but they are not like fixed rate 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, although the rate of risk depends largely on the sub-accounts chosen by the investor. He or she has the ability to increase or decrease their risk, based on the types of sub-accounts they choose for their investment portfolio.

Many professionals feel the greatest risk in a variable annuity is the investor him or herself. Since many decisions must be made by the investor, there is ample opportunity for poor investment choices to be made.

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. Generally speaking, the risk in these annuities is 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.

Since variable annuities offer multiple investment choices, known as sub-accounts, ranging from conservative to aggressive the potential for gain or loss is in the investor's hands. An investor that takes the time to study all options is likely to make better choices than those who jump into it without adequate preparation.

The first step for an investor is deciding what goal is desired. Like our road trip analogy, the investor must know his or her destination in order to make the best investment decisions. If the investor is seeking growth and income he or she will look at investments that meet that need. The amount of risk is still a factor of course and should always be part of the investment consideration.

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 as long as 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 funds investment. These are often indirectly paid by the investors making it difficult to understand their investment impact.

When an investor chooses variable income option upon annuitization, the amount the investor receives each month is based on an assumed interest rate, called an AIR. It might also be called a hurdle rate or a benchmark rate.

Investors may be able to choose one of two interest rates, such as 3 percent or 5 percent. That rate is used to determine the amount of the first income check received and is the standard or "benchmark" that is used to determine whether future checks are more or less than the initial one.

At a lower rate, the initial amount is also lower but there is a greater potential for the amount received to increase and for larger payments over time. At the higher rate, the initial amount is larger and the investor can expect any increases to be more gradual.

If the investor chooses the higher benchmark rate (5 percent in our example, but the amount offered can vary) and the investment continues to produce a straight 5 percent return after the annuity and investment expenses are subtracted – as unlikely as that is – the annuity income would stay the same. Any change, whether up or down, in the performance of the selected investment portfolio means the investor will receive different amounts of monthly income, which is why they are called variable annuities (payments are likely to be variable). Some variable annuity annuitization plans adjust the amount annually and monthly payments throughout the year remain around the same dollar amount. In other plans the amount is adjusted monthly or quarterly. It is always important that the investor understands how his or her annuity will determine payments.

If the investor chooses the lower benchmark, 3 percent in our example, it will produce a smaller initial payment but he or she can anticipate larger increases in the monthly income when performance of the investment portfolio they chose is strong. There is greater protection against a drop in income since the investment return may be less likely to drop below the lowest rate.

While committing oneself to a choice such as this may seem difficult, the agent can track what has happened to variable incomes over the ups and downs of the past ten years and what a sustained drop in the underlying investments would mean to the investor's income.

Variable annuities tend to offer more equity than fixed-income portfolios. Although there are fewer guarantees when compared to fixed rate annuities, the possibility of keeping up with inflation still brings investors to variable annuities. Historically variable products have outpaced inflation by a wider margin than other annuity types over time. Investments that are tax deferred and that automatically reinvest earnings have generally outpaced inflation since the account grows more than the cost of living increases. The larger the investment account the more available to annuitize and fund retirement. Beating inflation must be considered since it is one of the great investment minimizers.

It is inflation that has likely maintained the popularity of variable annuities, despite their market risk. Variable annuities have historically outpaced inflation if the annuities are held for the long-term. Tax deferred status is a major component of their success.

Why not just buy stocks since variable annuities are based on stocks anyway? For some investors, buying stocks outright may better suit their investment needs; for others, variable annuities will still be the right choice. For those who want the insurance protection, variable annuities is a better choice. Although not all agree on the value of the included insurance, variable annuities offer three major elements:

1. The guaranteed death benefit to protect beneficiaries against market turndowns like we have seen in the past few years.

2. The right to choose a payout option that provides income. If a lifetime option is chosen income will continue even if the capital invested and all earnings are exhausted. Income will literally continue for the annuitant's lifetime.
3. The guarantee that the fee that pays for this insurance will not increase.

Variable annuities allow the investor to leave some or all of their retirement savings in equity accounts even after income begins. As a result, the payments received may increase over time, but of course they could also decrease if the market performance is down.

Variable annuities offer tax free transfers among the portfolios offered by the annuity. That allows investors to make choices based on current market conditions. It is also an important reason that investors in variable annuities must pay attention to their portfolios and make decisions that reflect current market conditions. Variable annuities have good flexibility, but that flexibility requires investment attention from time to time.

Most non-professionals do best when working with an investment professional. However, since many advisors are not rated by any professional organization it can be difficult to know who to trust for professional advice. For example, stockbrokers are not ranked on their investment performance so investors do not know if a particular person has had great or poor success. It is unlikely that an investor could ask a stock broker how well he or she has done for his or her clients and get a real answer. If all of them have done "well" for example, why have so many people lost money recently? On the other hand, if a broker tells a potentially new client "I have done poorly this year" will that new client move on to someone less truthful, but with the answer the investor wants to hear (I've done great!)?

Millions of people have lost money with stockbrokers, financial planners, account managers and so forth. To be fair, the last few years have been financially difficult and even very good people have done poorly in many cases. People have also lost money in mutual funds and variable annuities, but having professional management often means doing better than other investors that do not have professional management.

As it relates to annuities, there are several firms that track annuity performance, which may help investors decide on products. Some of the rating firms include Morningstar, Lipper Analytical Services, and VARDS. It is also possible to find articles in such places as the Wall Street Journal and Money magazine.

Although annuities are commissionable products, the investor does not get charged a direct commission as some investments levy. Of course, agent commissions are accounted for in some way in the insurer's overhead but investors do not see a direct withdrawal of commissions in their statements. One hundred percent of principal begins immediately earning interest gains.

Now and then there are articles (typically authored by non-agents) who advise bypassing the insurance agent but that makes no sense. Whether or not an investor uses an agent will not alter the annuity they purchase. The product is the same with or without an agent so why not use an agent and have a direct contact? Despite this fact, it is likely we will continue seeing such advice from those least qualified to give it.

Annuities may be referred to as no-load products. That merely refers to a product that does not charge the investor a commission fee. The insurer can afford to pay agent commissions from their overhead due to the surrender penalties they levy for early surrender or withdrawals above the allowable 10 percent per year (in most products). Surrender penalties are sometimes referred to as **"back-end penalties."**

Fixed Annuities

Both immediate annuities and deferred annuities are fixed products. 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 provider 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 fixed rate annuities 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 are 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.

Declared Rate Fixed annuity contracts 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).

Indexed Fixed Annuities

An equity indexed annuity is first and foremost an annuity product. Unfortunately, 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**. They may be one of the best retirement tools developed in recent years, especially considering how the stock market has recently performed. EIAs typically guarantee at least one year of initial premiums returned if the product is held past the surrender period. Since the indexed annuities are linked 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 very complex. Equity indexed annuities (called EIAs) are *not* regulated as securities even though they are linked to the stock market index. This means they are not regulated. As a result, salespeople are not required to have a securities license as 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.

Tier 1

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.

Tier 2

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 investors, 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.

Clients should make sure that these types of annuities are suitable for their situation. These annuities are not suitable for everyone and agents 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. Investors may believe they are receiving a competitive rate of interest when, in fact, they are not due to charges in the contract.

Investment Risk

Annuities are investments that pay a rate of interest on the principal. An annuity is not a savings account; it is an investment with investment risks. It is not possible to understand how a product will perform, including any risks, without knowing how interest rates will be earned and applied.

Consumers think they understand interest; after all, they deal with interest in one way or another every day. What many do not understand is that investments often do not use interest in the same way their mortgage does or their credit cards do.

There is both simple interest and compound interest. Simple interest credits growth only on the original deposit, called a premium in an insurance contract. Compound interest credits growth to the total account value (meaning both the premium and past earnings that have been credited). In some equity indexed annuities, interest is not credited until the end of the annuity term. In these products, any withdrawals greatly impact the final earnings.

Interest rates in fixed deferred annuities is generally the simplest to understand since they earn a rate of interest that changes from time to time, declared usually at each anniversary date. The declared rate is determined by the insurer but since they must remain competitive, they are usually close from company to company on similar products.

The **current rate** is the interest rate the company decides to credit to the contract at a particular time. The company guarantees it will not change for some specified period of time. In the past, these rates were scoffed at by professional investors as too low. In today's uncertain financial times, what was considered a disadvantage in the past is suddenly a product advantage – guaranteed growth rates.

The **initial rate** is an interest rate the insurer credits for a set period of time after the product is first purchased, thus the name "initial" rate. The initial rate may be higher than the guaranteed rate, depending upon current market conditions. Sometimes this is referred to as a **bonus rate**.

The **renewal rate** is the interest rate credited by the insurer after the end of the initial set period of time (at policy renewal). The contract states how the insurance company will set this renewal rate. It may be tied to some external reference or index, but not always.

The **minimum guaranteed interest rate** is the lowest rate the annuity product will earn. This is the rate stated in the contract, so it is contractual.

Some annuity contracts have multiple interest rates that apply different rates to each premium paid, or premiums paid during the contract term. Some annuity contracts have two or more accumulated values that fund different benefit options. These accumulated values might use different rates of interest. The investor may receive only one of the accumulated values depending on which benefit he or she chooses.

Portfolio based interest rates are connected in some way to a market index. It is doubtful that most investors realize the numerous definitions connected to portfolios. Although there can be variations (investors should always look at contract terms in their policies) generally a *portfolio based rate of interest* is defined as the rate of return computed by first determining the cash flows for all the bonds in the portfolio and then finding the interest rate that will make the present value of the cash flows equal to the market value of the portfolio.

Old Money-New Money

There is often a difference between annuity 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.

Many life insurance companies use a concept called **"old money/new money" interest crediting** in fixed annuities and in certain life insurance policies that pay dividends or earn interest. The insurer has a couple of goals: they want to make the product attractive so there will be buyers and they want to be able to pay agent commissions, overhead expenses, and make a profit (as all businesses hope to do). It can be very difficult to meet both of these goals so in the 1990s some companies began to use an "old money/new money" approach. In other words, original deposits could earn a different rate than current contract deposits. Usually, deposits (premiums) made more than twelve months ago would earn less than current deposits. While contract wording might vary, it could say something similar to:

> The Current Interest Rate on New Money is 4.00%. Current interest rates declared for new premiums include some bonus interest during the first twelve months. A different rate may be credited after the first twelve months.

Although they use the word "may" if this is in the annuity contract it is very likely that different rates *will* apply. Unless states mandate this notification, there is no guarantee that the annuity contract will state this fact regarding old and new money; some do not.

Throughout the 1990s and beyond the gap paid on old and new money was distinct, with old money often earning a third less than new money. Few investors realize the difference even when percentages are stated. It is not easy to calculate the difference and few investors would even know how to do so. Although this method began with annuities, it is also used for some cash value life insurance products.

Some companies, in the absence of state requirements, do a better job than others in declaring the crediting differences. For example, the following is an example of how another insurer stated old money/new money crediting:

> The following interest rate includes a 2.00% bonus which is only payable the first 12 months after receipt. For new premiums received [date inserted] interest will be earned at the rate of [% inserted]. For premiums received prior to [date inserted] interest is being earned at rates between __% and __% depending on when those premiums were received. The company may change the interest rate upon the expiration of the guarantee period. Interest is credited daily and compounded annually.

While this language is certainly more detailed, it is unlikely that investors really understand what it means to the final earnings.

While there are varying opinions on this crediting method, insurer actuaries justify it by arguing that the interest rate paid on an investment should be tied to the investments purchased with the premiums at the time the money comes in. There is some logic to this since the investment an insurer is able to purchase with today's premiums may not be available when tomorrow's premiums are paid. However, this logic may also seem backwards. Ten years ago interest rates were higher than they are today so it would seem that "old money" should be earning higher rates than "new money" – not the other way around. Historically, insurance companies continually credit lower rates to old money, not higher rates, even when investments earned more in the past than they do in the present. This is likely due to the fact that there is more "old money" (money deposited more than twelve months ago) than there is new money (money deposited within the last twelve months) so it is advantageous to companies to credit old money less than for new money. At least that is the position of those who oppose this interest crediting method.

Interest Rates

All of us, not just investors, are affected by current interest rates. Interest rates affect whether we can afford to buy a home or take out a general loan. Investments are certainly affected by interest rates. As we know, investors are unlikely to earn 7 percent on an account if the current interest rate is 3 percent.

While we cannot know where rates will go in the future, it is still better to invest something than nothing. It is still better to get 3 percent on some quantity of money than wait for an offering of 7 percent before setting aside savings.

Interest rates are not an exciting field of study and most people do not take the time to understand interest rates or how they are affected by inflation. It is in the investor's best interest, however, to at least understand the basics of what interest rates are and how they affect investments. The term **"interest rate"** is defined as the rate that is paid on borrowed money. This rate is applied to the principal of a loan and is usually calculated annually. If the interest rate on your $1,000 loan is 10 percent, at the end of the first year the bank will charge the borrower $100. Interest rates fluctuate all the time and constantly affect how companies are growing which influences the price of stocks and other investment vehicles.

Changes in interest rates influence the value of company stocks and shares because the risk of a particular investment increases as interest rates increase. As risk increases the cost of stocks decline and investors lose money. The converse is actually beneficial. If the U.S. Reserve decides that the interest rate will be reduced, then stock prices typically increase, and investors make more money.

An increase in interest rates will increase the cost of capital. A company paying a higher interest rate on their loans will have to work harder to create increased returns. If a company fails to generate sufficient returns the loan's interest rate will take a chunk out of their profits affecting their overall financial situation. As interest rates on loans increase, profits decrease and this causes the stock value to become reduced and the investor loses money. It is important to keep in mind that companies have debts. An increase in an interest rate means their monthly obligations go up in price. If they cannot afford the increases, their viability could be in danger.

An increase in interest rates is usually a good indicator of a slowing economy. A higher interest rate deters people from purchasing things and it stops companies from investing in stock options that will help them grow which causes sales, profits, and stock prices to fall. The role of interest rates in investing is complicated; it would take far more space than given in this text to fully cover, but in general, increasing interest rates are bad for investors because it is bad for the companies they are investing in. It is important to have a basic idea of how interest rates affect investments in order to make educated investing choices. When investors understand how interest rates affect their investments they can anticipate rises in the interest rate market and adjust their financial plan and investment portfolio accordingly.

Most investors will assume they want the prime interest rate higher so their interest bearing investments will earn higher rates as well. It is difficult for many investors to understand that higher loan rates mean losses to the very business stocks their investments rely on. When rising rates are mentioned in the news, inflation is nearly always included in the comments. The two nearly always are connected in some way.

In the United States interest rates are decided by the Federal Reserve. The Federal Reserve meets eight times each year to set short-term interest rate targets. During these meetings the CPI (consumer price index) and PPIs (producer's price index) are significant factors in the Federal Reserve's decision.

Interest rates directly affect the credit market and loans because higher rates make borrowing costlier. By changing interest rates the Fed tries to achieve maximum employment, stable pricing, and good growth levels. As interest rates drop consumer spending increases (they hope for this at least). Increased consumer spending stimulates economic growth. This is why our government initiated a stimulus package and issued checks to many Americans; they hoped to stimulate economic growth.

Contrary to popular belief, excessive economic growth can also be detrimental. At one extreme, an economy that is growing too fast can experience what is called hyper-inflation. At the other extreme, an economy with no inflation has essentially stagnated. The right level of economic growth, with some inflation, is somewhere in the middle. It is the Federal Reserve's job to maintain that balance. A tightening, or rate increase, attempts to head off future inflation while keeping the country prosperous.

Inflation is always an economic issue but it is not the only factor influencing the Federal Reserve's decision making. They might choose to ease interest rates during financial crisis to provide liquidity, meaning they might allow investment flexibility so businesses can pull money out of investments.

Price Inflation

Inflation is a sustained increase in the average price of all goods and services produced in an economy. Money loses purchasing power during inflationary periods since each unit of currency buys progressively fewer goods. Suppose the overall price level increased by 3 percent during the past 12 months. If a typical household spent $3,000 during the first month for all household expenses, then they must budget $3,090.00 during the last month for exactly the same quantity of goods and services. Prices of individual items may have increased at different rates and some prices may have even declined, but overall they must budget about $90 more per month now. If their income after taxes does not increase by that amount, they might save less, substitute less expensive items, forgo some items, or incur debt. Investments may not be possible if other costs and debts steal the money intended for savings for retirement, college educations, and other financial goals.

Inflation is often reported as a percentage change in the overall price level between two periods as measured by a price index. As previously noted, the CPI is a popular measure of inflation in the U.S.

Most statistics deal with changes in the **rate** of inflation, not changes in actual **prices**. A downward-trending line above zero means that prices are still increasing, just at a lower rate. This is sometimes called **disinflation** but it is still inflation. When the rate falls below zero, average prices actually are falling (**deflation**). Most people would consider lower prices to be advantageous from a consumer's point of view, but deflation leads to rising unemployment and falling production; a situation that is extremely difficult to recover from. If a company is selling its goods at a loss, that company must cut costs somewhere and that "somewhere" is likely to be in the form of employees. As people lose their jobs, they cannot spend, so there is even less of a market for the goods they used to make when they were employed. An inflation rate of 1 percent to 2.5 percent seems to be currently acceptable by many economists, although there are varying opinions on this.

Since the inflation rate is a national average of all prices, it may differ considerably from the rate experienced by any one particular household. Each of us has different needs and goals and each of us therefore buys differently. A retired couple is less likely to buy furniture or other household goods than would a young couple just beginning their life together, for example. Each household will have different types and quantities of purchased items and therefore may experience the effects of inflation differently.

Long term inflation occurs when the money supply (currency and check writing deposits) grows at a faster rate than the output of goods and services. When there is more money available than is needed to accommodate normal growth in output, consumers and businesses want to purchase more goods and services than can be produced with current resources (labor, materials, and manufacturing facilities) causing upward pressure on prices. In effect, there is too much money chasing too few goods.

In the short term, inflation can result from various shocks to the economy. Food and energy price shocks are common examples of this in the U.S. The price of a critical commodity (such as fuel) may suddenly rise in sharp contrast to other prices. Since the market does not have time to adjust other prices downward in response, a short-term increase in overall prices occurs. The rate of inflation is sometimes reported with the categories of food and energy omitted since these can alter other areas and cause false results for other categories.

All governments need to control high levels of unpredictable inflation since it can severely disrupt the economy, cause uncertainty in financial decisions, and redistribute wealth unevenly. Governments try to manipulate specific inflation factors, such as monetary policy (increase or decrease the money supply), fiscal policy (change the amount of taxes and governmental spending), and various controls on prices, tariffs, and monopolies. Many nations (including the U.S.) choose monetary policy as their primary tool since it has proven to be very effective, it is less disruptive to market operations, and it is easier and quicker to implement since adjusting the money supply does not require legislative approval as would, for instance, changing the tax structure.

Measures of Inflation

The three most widely used measures of inflation in the U.S. are:

- The **Consumer Price Index** (CPI) which measures inflation at the retail level,
- The **Producers Price Index** (PPI) which measures inflation at the wholesale level and therefore may also predict future retail prices. However, wholesalers may not always pass the full increase along to retailers during a sluggish economy or when they think the increase is temporary, and
- The **Gross Domestic Product Deflator** (GDP), the broadest indicator, which measures prices for all finished goods produced domestically, including those for governmental purchase, capital investments, and net exports.

The CPI and PPI are compiled by the US Bureau of Labor Statistics. The GDP Deflator is produced by the US Department of Commerce.

Time Value of Money (TVM)

Price Inflation greatly effects time-value of money, called TVM. It is a major component of interest rates which are at the heart of all TVM calculations. Actual or anticipated changes in the inflation rate cause corresponding changes in interest rates. Lenders know that inflation will erode the value of their money over the term of the loan so they increase the interest rate to compensate for that loss.

An estimate of the inflation premium contained in interest rates can be seen by comparing two risk-free securities with the same maturity date, one with a fixed rate and the other with a rate indexed for inflation. The Federal Reserve strongly influences short term interest rates with their monetary policy. Longer term rates are set by the market and reflect an inflation rate that is its current best guess.

Although it may not be a perfect indicator, the yield of a 10-year fixed rate U.S. Treasury note when compared with the rate of a Treasury Inflation Protected Security (TIPS) of the same maturity at least shows that some amount of inflation premium exists.

Issue Age Guidelines

There can be both an annuity owner and an annuitant. This is often the same person, but it does not have to be. The **owner** is the individual who owns the "rights" to the annuity income. The **annuitant** is the person whose life is measured by the annuity. In a life insurance policy, he or she would be called the insured but in an annuity product they are known as the annuitant.

Insurance companies typically have age limitations on annuity applicants. This is not surprising since lifetime annuitization options are affected by the anticipated longevity of the annuitant. It has been a common practice for an individual who is beyond the allowed age to name someone else as the insured, or the annuitant. The older-aged person could still be the contract owner, but the measured life would be a younger person who was named as the annuitant.

Actual age limitations will depend upon the product, but it is common for the maximum age allowed to be between 75 and 85 years of age. Most products will not issue a policy to individuals over the age of 80. Minimum ages also vary. Although annuities are routinely used for other purposes, the intent is to provide income at a later date, which is why they are often considered a retirement vehicle. The federal government considers annuities a retirement vehicle and imposes a 10 percent penalty for withdrawing funds prior to age 59½ but of course the funds can be used for any purpose.

Annuity Date

Most annuity contracts are "annuitant-driven" meaning provisions come into being if the annuitant dies, reaches a certain age, or becomes disabled. Some contracts are "owner driven" meaning it is based on the policy owner rather than the insured. Of course, if the insured and the owner are the same person there is no difference. Because an annuity is a contract it must state some date in the future for the owner to elect an annuity settlement option to begin receiving payments by way of annuitizing the contract. The length of time before this must happen will vary, but all annuities have a date listed. The owner will receive a letter from the company advising them of their settlement options when that date arrives.

The annuity date and/or maturity date printed on the Policy Data Page is meaningless for many investors. It does not mean the date at which the investor may access his or her funds. Nor does it mean the date at which the investor may begin annuitization. Most contracts allow the owner to change the annuity date and most companies will allow their policyholders to annuitize the contract at any point after the first contract year.

The actual date will generally appear on the Policy Data Page and may be listed as "Annuity Date" or "Start Date." Agents might be wise to specifically explain this date so clients are not confused or believe they do not have access to their funds until that time.

Withdrawal and Surrender Charges and Waivers

A contract owner may take part or all of their annuity value at any time, but penalties may apply if they do so in the earlier years of the contract. Usually penalties are figured as a percentage of the contract's current value. Typically withdrawal or surrender fees do not apply if the insured dies or annuitizes their contract for systematic income. In some policies, if the interest rate paid by the insurer falls below a specified rate, the insured may withdraw all funds without any penalty; this is called a **bailout option**. In multiple premium annuities, the surrender charge could apply to each premium paid for a certain time period; this is called a **rolling surrender or withdrawal charge**.

Some annuity contracts have a **market value adjustment** (MVA) feature. If interest rates are different at surrender of the annuity than they were when it was purchased, a market value adjustment is made that might make the surrender value either higher or lower. An annuity with a MVA feature might credit a higher rate than an annuity without this feature.

Most annuities have features that allow up to 10 percent of cash values to be withdrawn without insurer penalty. The Internal Revenue Service may impose a penalty however, if the withdrawal is made prior to age 59½. Insurers have no ability to waive the IRS penalty no matter what the withdrawal circumstances. Indexed annuities that credit interest earnings at the end of the term will not pay earnings on any amounts prematurely withdrawn.

It would be unusual to see an annuity contract that did not have surrender fees imposed on early withdrawals and contract termination. The length of the fees will vary, with seven to nine years being common. Insurers can guarantee interest rates 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.

In most cases, 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. Surrender penalties 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. The term is sometimes mistakenly referred to as policy maturity, although *actual maturity* is not the end of the surrender period. Most contracts state a specific age for maturity, such as age 100. Since "maturity" is so often used for "term" many professionals use the two terms interchangeably, even though "maturity" actually means something else.

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 on. Whatever payout option was chosen determined length and amounts of systematic income.

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 every agent knows, insurers measure risk. For example, under a life insurance policy, the insurer "loses" if the insured dies prematurely (meaning they pay out funds prior to receiving the time they need to earn a profit) but "wins" if the insured lives longer than expected. In an annuity where a lifetime income is selected, the insurance company retains any undistributed funds. Therefore, under the *lifetime annuitization* option, the issuing insurance company "loses" if the measured life lives beyond his or her lifetime expectation (collecting funds beyond what was deposited into the account) and "wins" if the insured dies prior to collecting all the funds he or she deposited. Unfortunately, many annuitants do not realize (so therefore fail to notify their beneficiaries) that lifetime annuitization selections eliminate beneficiary rights to unused annuity funds. Since annuity products are intended for insureds – not their heirs – this should not be surprising but it continues to be overlooked and unexplained by agents. There are annuitization options that send undistributed deposits to beneficiaries, but not under lifetime selections.

Some annuity contracts have provisions for early payout under specified conditions. Typically these include such things as institutionalization in a nursing home, terminal illness, disability, or unemployment. It is always necessary to look at the actual contract to determine if these waivers exist in the policy. It would be unwise to simply take the word of an individual in place of reading the actual policy.

Withdrawal penalty waivers may come under a variety of headings, but typically they will say something similar to "Early Withdrawal Charges," "Disability Waivers," "Long-Term Care Waiver" or other similar wording. It is always important to read the requirements since there may be limiting conditions applied. In all cases, proof of the circumstance must be presented to the issuing insurer.

Premium Payments

There are various ways of paying annuity premiums. Some of these have been discussed previously. For example, in an immediate annuity, one payment is typically made so that the payout phase can immediately begin (thus the name). In this case a single premium is paid and it is called a **single premium annuity**.

Many annuity contracts allow for multiple payments made at various times, often systematically but not necessarily so. Most financial planners would recommend systematic payments into the annuity so that accumulation can occur. Obviously, if too little is saved the end goal is unlikely to be reached so systematic payments (such as payroll deductions) are more likely to be successful over the years. Annuities that allow flexibility in how premiums are paid have what is called **flexible premium options**. Even when these annuities are labeled flexible premium annuities that really only describes an option that is allowed in the contractual terms. The actual annuity is still a fixed, variable or equity indexed annuity. It has simply taken on the name of how payments may be made so "flexible premium annuity" is not really an accurate name.

It is always better to save something, even if inadequate, versus saving nothing at all. In many ways, it is better to have a contract that requires specific payments (premiums) be made at specific intervals because it increases the likelihood that money will be saved. When the contract allows premiums to be paid on whatever basis the contract owner wishes, it is much more likely that adequate funds will not be saved. Those elusive "extra dollars" just never seem to materialize.

Contract Administration Charges and Fees

It is not unusual for annuity contracts to have various fees, such as administration fees. Names may vary in the contracts for these fees but typically they are listed somewhere.

Administrative fees are charges that cover record-keeping and other administrative expenses of the insurer and may be charged as a flat account maintenance fee. Usually this amount is $25 or $30. It may also be a percentage of the account value.

A **contract fee** is a flat dollar amount charged either once, usually upon issuance of the contract, or annually upon contract anniversary dates.

A **transaction fee** is a charge per premium payment of additional transactions beyond the first premium payment.

A **percentage of premium charge** is a charge deducted from each premium paid. The percentage may be lower after the contract has been in force for a specified number of years or after total premiums paid have reached a certain amount.

Some states impose a tax on annuity contracts, usually called a **premium tax**. The insurer pays this tax to the state. The company may subtract the amount of the tax when the investor pays his or her premiums, when contract values are withdrawn, when the investor begins receiving income payments, or when the company pays a death benefit to beneficiaries. Generally the exact time of the fee will depend upon the requirements of the state.

A **mortality and expense risk charge** is equal to a percentage of the account value and compensates the insurance company for risks it assumes under the annuity contract.

Underlying Fund Expenses are fees and expenses that are imposed by the underlying mutual fund investments in variable annuities. These fees typically are paid indirectly by the investor, so he or she may not be aware of them. These fees are taken annually as a percentage of the investor's assets invested in the fund.

There may be additional fees besides those listed here. Special features offered by some annuities, such as stepped-up death benefits, a guaranteed minimum income benefit, or a long-term care insurance benefit may cause additional fees or charges to be levied in the contract by its issuing insurer. In the case of the **guaranteed minimum income benefit**, it guarantees a particular minimum level of annuity payments, even if the investor does not actually have enough funds in the account to support the level of payments. This is most likely in a variable annuity that has suffered an investment loss.

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 usually preempts all state laws that relate to ERISA plans. However, ERISA does not preempt state insurance, banking or securities laws, even if they do relate to an ERISA plan. As a result, state laws will 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:

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 owner. The insurer would then assume the obligations of the plan.

The tax code does not specifically define "annuity" although it does require 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 agent 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.

Group and Individual Annuity Contracts

Tax-favored retirement plans may use individual annuity contracts and group contracts. As a practical matter, however, group annuity contracts are most often used to fund tax-qualified plans and governmental 457(b) plans. This is primarily because group annuity contracts are less costly than individual contracts, and when applicable, more likely to meet ERISA requirements. Section 403(b) is different as it can be funded exclusively by individual annuity contracts, but group annuity contracts can be used, mainly for ERISA arrangements.

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 the plan was transferable, then the fair market value of the contract is taxable to the person receiving the distribution.

If an 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 have 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).

Annuitization works the same whether the annuitant or contract owner will owe taxes on the earnings or not. 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 considered to be growth, with the last money withdrawn being principal. In a non-qualified annuity the principal was taxed prior to deposit.

Fixed Rate Annuities

As we know, an annuity is a contract between an insurer and the annuity policyowner. It is not a life insurance or health insurance policy. It is not a savings account like an individual might open at their local bank. Additionally, annuities are not suitable for short-term financial goals.

The **"value"** in an annuity is the premiums the individual has paid in, less any applicable charges or policy loans, plus any interest that has been credited.

During the annuity accumulation period, the money in fixed rate products earns interest at whatever rate has been set by the issuing insurance company. The insurance company guarantees that it will pay *no less than* a minimum rate of interest, which will be stated in either the contract or in an amendment to the contract. The issuing insurer might pay more than the minimum rate stated but it can never pay less.

All fixed rate annuities typically have the following features:

- A guaranteed amount at the end of a specific time period;
- A free bailout option;
- The ability to add new contracts;
- A secured future program, and
- Tax benefited annuitization.

The *guarantees* of a fixed rate 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 his or her 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 chooses a nine-year option at 3.33 percent, he or she would be guaranteed 3.33 percent for the length of the contract, whether or not other aspects of the economy go up or down. Actual rates will vary from company to company and even among annuity products with 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 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, he or she may choose an annuity that offers the longest possible term (perhaps ten years). If the investor is uncertain about the direction interest rates may take, he or she can opt for a mid-term annuity, perhaps a five to seven-year term. 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 our economy this non-annuitization trend may reverse since retirees are more likely to need all their funds to make it through retirement. 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 expensive retirement communities or as their health declines, into assisted living facilities. Our mothers and grandmothers were more likely to care for their parents with help from other family members. Families have shrunk and they often do not live nearby so caring for parents is now much more difficult. With today's retirees spending much more freely than our parents or grandparents did many analysts believe annuity products will be accessed by today's retirees, even though this was not true in the past.

Annuity Bailout Options

The *free annuity bailout option* is closely tied to the guaranteed interest rate provision of a fixed rate annuity. This can be very advantageous to the investor, which is typically the contract owner.

Once the guaranteed interest rate period is over, if the renewal rate is less than a specified percentage 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 of earnings. If the investor wants to change, and the renewal interest rate is not less than the specified percentage of the previously offered rate, the insurance company may charge a back-end penalty (surrender fee).

Most single premium fixed rate annuities do not allow additional deposits to an existing annuity contract; the individual must purchase another annuity. The fixed rate single premium annuity is a contractual relationship. The insurance company is guaranteeing a rate of return on the amount originally deposited - no more, no less. Although some insurance companies allow a person to add to an existing single premium annuity contract, not all do.

If it is an accumulation fixed rate product it will be possible to continue adding to the existing product. Accumulation annuities are designed for continual deposits over a long period of time.

Fixed rate annuities are conservative products but they offer safety that most investments are unable to promise. Fixed rate annuities provide security in that the investor always knows where he or she stands financially. Investors know there will be an exact amount of money at the end of the specified period. The annuity contract will spell out what the investor may expect in the way of growth of principal, and it will detail the exact amount of any penalties or fees that may exist and when and if such costs disappear.

Annuities were, as we know, designed with annuitization in mind. *Annuitization* provides an even distribution of both principal and interest over a period of time. The amount of each check depends on:

- The competitiveness of the insurance company,
- The level of current interest rates,
- The amount of principal that is to be annuitized, and
- The duration of the withdrawals (payout option selected at annuitization).

Competitiveness varies among companies. Agents commonly rely on their insurers to guide them, but it makes sense to look at rates and compare companies. Shopping around for the insurance company that offers the best interest rates is not always easy but it often pays off in the long run. Investors and producers alike may not realize that insurance companies also vary in the returns provided upon annuitization. This variance has to do with the method used to determine longevity and payout streams, along with other factors. It would be unusual to have a client who understands this and even more unusual to find an individual who had shopped around on the basis of annuitization payments. An individual could decide to change insurance companies at the time of annuitization, based on the payout they would receive. However, it is unlikely that many people shop around even at the time of annuitization. Investors generally spend more time planning their vacations than they do their retirements. Even so, knowing there are options available can be very advantageous to the agent who has done his or her homework, including how distributions are determined by the various insurers.

When an investor decides to annuitize, the amount of each check on a fixed rate annuity will depend on the current interest rates. Of course, interest rates are not the only factor, but it is a major one. A person can decide to only annuitize a portion of the contract so that some of the investment left invested is still earning interest. Why would a contract owner choose to annuitize only a portion of their annuity? Consider the following example:

> Myrtle has $50,000 in her annuity when she reaches her retirement age of 62. At the time Myrtle wants to begin distributions the current interest rates are very low. It is likely that she would receive only 3% interest due to the currently low rates. Myrtle believes interest rates will rise over the next five years but she needs some income now. She annuitizes half of her $50,000 annuity leaving the other half as it currently is. In five years, she will annuitize the other half, assuming interest rates are where she wants them to be.

The amount of the annuitization check received each month depends on the amount of the investment annuitized. The larger the investment is, the larger the check received will be. This is not surprising; it is something that most people understand without much explanation. What will surprise many of your clients is how little they receive from a $50,000 or even $100,000 annuity when a lifetime annuitization option is selected. Many people assume they will receive more each month because they do not take into consideration the longevity of the payments. On a lifetime annuitization option, insurers must make the money last until the time they estimate the annuitant will die. That is typically between twenty and thirty years of life, depending upon various factors. The insurer will look at the current age of the annuitant, the annuitant's health history, lifestyle history (such as tobacco use), and other factors that impact longevity.

The time allotted to the annuitization will certainly affect the size of the check received. Obviously the check will be larger if a shorter annuitization period is selected (such as ten years versus 20 years or lifetime income).

There are tax advantages in annuitization since disbursements are tax favored. Systematic and/or sporadic withdrawals are not. The disadvantage is that once the process is started, it cannot be altered and the rate of return during annuitization may be artificially low.

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 fixed rate annuities.

Annuities in general have several advantages that those in or near retirement often seek. Annuities seem to work best for long-term goals, such as retirement, although they are not limited to use in retirement.

Some financial planners consider fixed rate annuities to be the quiet cousin of the annuity family. A fixed rate product (even a fixed-rate subaccount in a variable annuity) provides the owner with a guaranteed rate of return. In many ways, it is similar to the Certificates of Deposit that so many people utilize, but with tax deferral. Certainly fixed rate annuities are the easiest member of the annuity family to understand. Both variable annuities and fixed rate equity indexed annuities are much more complicated.

When a fixed rate annuity is purchased the buyer receives guarantees that few investment vehicles offer, such as guaranteed rates of return. All annuities are long term investments and fixed rate annuities are no exception. While the lengths of annuity maturity vary, they often have surrender penalties for up to ten years. Generally speaking the longer the surrender period, the higher the guaranteed earning rate will be. For example, a five year surrender penalty may provide lower guaranteed interest rates than does a ten year surrender penalty product.

The lowest guaranteed rate of return is contractually stated. In other words, the very lowest rate that is guaranteed in the annuity is part of the contract. Most fixed rate annuities offer a higher rate that is re-stated each contract anniversary. In the first year, for example, the contract might guarantee a two percent return, but the current rate paid may be three percent - one percent higher than the lowest guaranteed rate. Each anniversary of the annuity the currently paid rate will be announced to the policy owners. Each policy owner knows their product will never pay less than the contractually guaranteed rate, but it could pay higher in some years. The announced rate for each year will depend upon many factors, especially current market rates.

Fixed rate annuities are often the choice of people near or entering retirement because they want the guarantees they offer. Fixed rate annuities are the safest among the various annuity types. They are also the easiest for the consumer to understand.

Several years ago the fixed rate annuity was the type most often recommended by agents but other types have gained investor and agent interest. We are seeing an expanding interest in equity indexed fixed rate annuities because many consider them more likely to return a greater growth than the traditional fixed rate annuities. However, even though they are fixed rate products, equity indexed annuities are much more complicated so consumers must understand them prior to purchase. Certainly agents must understand them prior to presenting the equity indexed products.

Every retirement portfolio needs variety. It does not make sense to purchase only one type of product since each type performs differently in different economic climates. The mixed portfolio will do best since there are multiple types of investments; when some investments are down, others are likely to be up. The highs and lows eventually even out, hopefully providing an overall profit for the investor.

Investment diversification does not simply mean having one fixed rate product, one equity indexed annuity, and one variable annuity. While that is diversification among annuities it does not fulfill the true meaning of a portfolio diversification, which should contain not only annuities but also stocks and mutual fund accounts. Even the low yielding certificate of deposit has its place in a diversified portfolio.

Guaranteed Rates of Return

Fixed rate annuities generally provide greater return on investments than Certificates of Deposit. Additionally annuities add the advantage of tax deferral. Insurance companies are able to offer better rates because they know from years of experience that very few people surrender their annuity contracts. Few investors even worry about the surrender penalties that often exist for ten years for early contract liquidation. Statistically investors who favor fixed rate annuities do not plan to withdraw funds early.

An annuity is a contract between the insured and an insurance company. A lump-sum payment or series of payments is made to the annuity. In return, the insurer agrees to make periodic payments to the insured beginning immediately or at some future date. Annuities offer tax-deferred growth of earnings and do not affect current taxation status unless funds are withdrawn. If a beneficiary is listed, upon the annuitant's death proceeds go directly to the individuals or entities listed, bypassing probate procedures. Payout options vary so it is very important to understand which payout option has been selected since some payout options eliminate beneficiary designations.

There are generally two types of annuities: fixed and variable. In a fixed annuity, the insurance company guarantees the annuitant a minimum rate of interest during the time the account is growing; periodic payments will be a guaranteed amount per dollar resting in the account. These periodic payments may last for a definite period, such as 20 years, or an indefinite period, such as the annuitant's lifetime or the lifetime of two or more named people. The contract owner will decide how payments are made.

Financial Strength of the Insurer

Annuities are usually long-term investments so it is very important that the company selected be financially strong. Of course, agents should always use only top rated companies, but this becomes especially important for long-term vehicles. Unlike bank accounts, the federal government does not guarantee annuities. Since the company is promising lifetime income, the consumer wants to be sure the insurance company is operating throughout their lifetime.

An annuity is a contract purchased with a sum of money to provide the buyer or annuitant with regular payments in return. Annuities work like loans in that an individual purchases an annuity from a company and gives the company a large sum of money. In return, the company pays back the sum of money over a period of time plus interest. Typically taxes are deferred on annuities until the payments are made to the annuitant.

How Fixed Period Annuities Work

Annuities can vary in amounts paid, frequency of payments, and time periods over which the payments are made. Under some circumstances an individual annuitant can decide either how much is paid in each payment or the period of time over which payments are made. Since the total sum of money received each month is decided upon by the amount held in the annuity at the time of annuitization, a shorter fixed period annuity would typically have larger payments to the annuitant than a longer fixed period annuity. In some cases, a life time annuity payout would be very little each month if the amount saved in the annuity was inadequate.

If the annuitant wants a specific amount of income each month that amount would determine how long monthly payments could be made. Obviously, it requires sufficient funding to provide specific amounts of income each month for a long time period. There are typically multiple payout options available for each annuity. That would not necessarily mean all payout options would produce the results desired by the annuitant since it all comes down to *how much* he or she saved.

Fixed period annuities are annuities where the individual annuitant or owner/purchaser of the annuity chooses the amount of time over which the annuity is paid back. Fixed annuities pay a fixed amount over a fixed period of time chosen by the annuitant. The amount of time is usually a function of many years (such as ten or fifteen years) during which annual, bi-annual, or monthly payments are made to the annuitant. Fixed period annuities usually offer the following payout categories:

- **5-year fixed period annuity**, level payments are made over a period of five years;
- **10-year fixed period annuity**, level payments are made over a period of ten years;
- **15-year fixed period annuity**, level payments are made over a period of fifteen years;
- **20-year fixed period annuity**, level payments are made over a period of twenty years;
- **Lifetime fixed annuity**, paying the annuitant for his lifetime regardless of how long he or she lives. Beneficiaries would not receive any remaining funds even if

the annuitant died before all invested funds had been returned by the insurer. Therefore, this payout option gives the maximum monthly income available.

- **Joint-and-Survivorship Lifetime fixed annuity,** guaranteeing income for the lives of two or more individuals. This payout option is often used by spouses, but any two or more people can utilize them.
- **Period Certain, plus Lifetime fixed annuity**, guaranteeing a specific length of time over which payments will be made, either to the annuitant or their beneficiary, with lifetime income guaranteed to the annuitant. The beneficiary would only receive the remainder of the guaranteed period of time if the annuitant died prior to receiving income during the "period certain."

Many industry experts feel too little time and thought is given when selecting payout options. Annuitants often assume that beneficiaries will always receive remaining investment funds, even when that is not the case. It is a foolish agent that does not fully communicate the situations under which beneficiaries receive nothing. Many industry experts recommend using a disclaimer when the annuitant chooses to take the maximum payment, leaving nothing to their heirs. Having the annuitant sign such a disclaimer stating that he or she fully realized their beneficiaries would receive nothing prevents discontent or even legal action following the annuitant's death.

Equity Indexed Annuities

While there is no ideal investment, there is also no specific type of investment that is always right or 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.

This chapter addresses equity indexed annuities. Like traditional fixed rate annuities, equity indexed contracts are a type of fixed rate contract between the investor and the issuing insurance company. This is a fixed rate product, but it has aspects that are not like the traditional fixed rate annuities. Equity indexed annuities are *not* variable annuities, but they are more complicated than traditional fixed rate products.

The first equity indexed annuity was offered by Keyport Life in 1995. At the time it did not receive much attention and relatively few investors utilized it. There were so many other ways of investing that seemed to produce higher returns, which was partially responsible for the disinterest. The complicated nature of equity indexed annuities probably also played a role in the slight attention they received. Following the 9/11 terrorist attack and the collapse of a few major corporations many people realized that their current financial investment vehicles were less than perfect. Mutual funds were plunging down as well as stocks, so even they were no longer perceived as a "safer" form of the stock market.

In 2001 and 2002 equity-indexed annuities began to receive rising investor attention. It did not take long for sales to move into the billions of dollars. As a result, many states began to require agents selling annuities to receive training in the mechanics of indexed products. Few consumers understood how equity-indexed annuities operated so they did not comprehend the risks that were involved. Unfortunately, even many agents lacked sufficient training in the products. Like all financial vehicles, equity-indexed annuities can adequately meet a client's needs or they can be completely wrong for the particular circumstances. There is no perfect financial vehicle that is right for every person. Each situation is unique in some way because each investor is unique in some way.

This course cannot and does not completely address all tax issues or all regulatory laws involving equity-indexed annuities. Our hope is to address EIA suitability questions and offer training for agents who have little past experience with equity indexed products. At all times tax consultants should be involved to analyze each investor's personal situation.

It is a foolish agent who attempts to act as both insurance agent and tax advisor to his or her clients.

Researching the 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. Yes, there is some information provided (some very good information) but it is seldom complete. There is a logical explanation for this incomplete financial picture: it would take a book to completely explain any financial investment vehicle. It simply is not possible to give a total look at a complicated financial vehicle in a few paragraphs or even a few pages of text. Make no mistake about it: equity indexed annuities are complicated and the choices required of the investor are not always simple.

To make matters even more confusing for the consumer, every author, every agent, and every well-meaning next-door-neighbor claim to be an expert. Who should the average person believe? If you are the selling agent, you hope your clients believe you, but it will only take one mistake to convince your clients otherwise.

The wise agent will 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 client may claim otherwise. When it is the agent's word against his or her client's the outcome is uncertain. This is also a strong argument for agent documentation. Equity indexed annuities can be confusing and choices can have adverse consequences. Even when principal is preserved a client who receives zero growth may become unhappy.

The first step is always to realize that although annuities are an excellent financial and safe investment that still does not make them right for every person and every situation. The length of annuities and the age of the investor are of great importance. Annuities are designed to be long-term investments so they are seldom a wise choice for short-term goals. The Internal Revenue Service considers annuities a retirement vehicle so they will impose a 10 percent penalty on withdrawals made prior to age 59½ (it is an early withdrawal penalty).

If the length of the investment (often up to ten years) and the age of the investor seem to favor annuities, the next step is always to find the annuity product that best fits the investor's needs and goals. Your clients may attempt to find the so-called "right" product themselves by going to their computer. Ninety percent of what they find will be insurers and insurance brokers advertising the products they sell. There is nothing wrong with that; this is the age of advertising. Even attorneys advertise now. Unfortunately, it also means that most of what your clients see will be promoting sales with a company other than yours. Therefore, only those insurance producers who understand the products and can relay that understanding clearly and precisely are likely to maintain their clients. The states have various continuing education and/or training requirements, with some states requiring education in equity indexed annuities. While this may sometimes feel like punishment it is actually intended to help all parties involved. The agent who seeks out education that furthers his or her abilities will benefit and the consumers he or she meets will benefit from the agent's product understanding.

One important annuity distinction is between fixed annuities and variable annuities. Fixed rate annuities are underwritten only through insurance companies although banks and other entities may sell them. In all cases, however, it is an insurer who underwrites and issues the final product.

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 agent to market variable annuities. They do not give the same guarantees of safety as fixed rate annuities offer. Again, equity indexed annuities are not variable annuities; they are fixed annuities.

Defining the Equity Indexed Annuity (EIA)

Unfortunately, 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**. They may be one of the best retirement tools developed in recent years, especially considering how the stock market has. EIAs 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.

Many agents market the unique safety features of EIAs. No, they are not perfect (as no investment product is), but they can protect the investor from premium loss if the markets crash, while allowing gains if the stock markets perform well. Like most annuities, these should be considered long-term investments; they often work well for retirement funding.

An equity indexed contract is first and foremost an *annuity* product. When annuitized, an annuity can produce an income stream for life or, depending upon the payout option chosen, for a fixed period of time. How funds are received will depend upon the annuitization option selected. The amount of money received will also depend upon the amount of funds invested in the annuity. It should be no surprise that inadequate investing will mean inadequate income.

Like other annuity products, equity indexed annuities have the same participants. This includes the annuitant, who may also be the contract owner and the insurance company that issues the contract. Although beneficiaries will likely be listed on the application, and may be changed as the owner wishes, the intent is always to provide the owner with income.

Although annuities are routinely used for other purposes, the intent is to provide income at a later date, which is why they are often considered a retirement vehicle. The federal government considers annuities a retirement vehicle and imposes a 10 percent penalty for withdrawing funds prior to age 59½ but of course the funds can be used for any purpose.

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 every agent knows, insurers measure risk. For example, under a life insurance policy, the insurer "loses" if the insured dies prematurely (meaning they pay out funds prior to receiving the time they need to earn a profit) but "wins" if the insured lives longer than expected. In an annuity where a lifetime income is selected, the insurance company retains any undistributed funds at the time of the annuitant's death. Therefore, under the lifetime annuitization option, the issuing insurance company "loses" if the annuity owner lives beyond his or her lifetime expectation (collecting funds beyond what was deposited into the account) and "wins" if the contract owner dies prior to collecting all the funds he or she deposited. Unfortunately, many annuitants do not realize (so therefore fail to notify their beneficiaries) that lifetime annuitization selections eliminate beneficiary rights to unused annuity funds. Since annuity products are intended for contract owners – not their heirs – this should not be surprising, but it continues to be overlooked and unexplained by agents.

As we continue to live longer, we are justified in fearing we might run out of money before we run out of life. In other words, Americans are at risk for having too little money set aside for the last years of their life. As we continue to have smaller families we may not be able to count on our children to care for us both physically and financially in our last years. A major cost to our Medicaid system is nursing home care for our nation's elderly. As our senior Americans spend all they have, they must turn to Medicaid (which is basically medical welfare) for their health care needs. Few people are saving adequately for their retirement years so annuities, with lifetime annuitization options, make good sense.

As we previously stated, an equity-indexed annuity is a fixed annuity, not a variable annuity. The investor deposits an amount of money, which the insurer will pay back to the investor at some future date, often through installment payments. It is possible to take a lump sum at contract maturity but that would make little sense. The point of an annuity is to provide income over a long period of time. Taking a lump sum would defeat that goal. Many annuities are never annuitized but they were designed with annuitization as the product's final phase.

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

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 with past experience in the stock market.

While annuity contracts are not all the same, generally EIAs do not have internal expenses, meaning there are no fees, or front-end or back-end loads that could retard 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 from 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 or 15 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.

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.

All EIAs track some specified stock market index, such as the 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 was based upon. 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. *EIAs 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, 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 investors.

Variable annuities track the stock market directly, so their values go up and down with the stock market. That is not the case with equity-indexed annuities. 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 well 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 principle 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 took a dive and remained 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 held 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.

Of course, the wise investor always shops around for the best product. That is the only way he or she will know if the best annuity has been purchased. All operating costs (overhead) paid by the insurance company, including commissions, affect the bottom line of their products. Any type of business, in fact, will be affected by their overhead. To this extent, commissions may minutely 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 investor will not get a better contract by bargaining for lower commission rates. The investor would be wise to shop the marketplace for the best product but that is wise regardless of commissions paid. Many critics feel agents only present products that pay higher commissions and there may be some truth to this. That does not prevent consumers from shopping around since many available products are offered through varieties of online websites and through local agents. 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 agents earn that the important issues of investing are overshadowed: safety of principal, insurer financial stability and satisfaction of investment goals.

Many professionals advise consumers to simply find products that fit their needs and leave commissions between the insurers and their agents. Many elements of how insurance companies determine commissions have nothing to do with the actual product so price shopping, while always advisable, may have no bearing on what the agent receives in compensation. Some insurers pay a higher commission for the same reason department stores pay higher salaries: they want the best people representing them. As it applies to equity-indexed annuities, higher commissions may be paid to compete with management fees financial planners would lose if they recommended EIA products. Financial planners stand to lose a substantial sum over the life of the EIA since they would have made multiple fees if they were managing a mutual fund, for example.

Agents do have an ethical responsibility to represent and recommend suitable annuity products. It would certainly be unethical to recommend a poor product simply because it paid a higher commission. Many states already have or are in the process of implementing suitability requirements for annuities because there has been fear that agents might place unsuitable products, especially with older investors who do not have time on their side if a mistake is made. Investors are always best protected by finding a career agent with product knowledge and a desire to be in business long-term. People who plan to be career agents are probably more likely to select product quality over commissions paid. They must if they want to remain in business.

Annuity suitability must always be considered. Since they are long-term investments any type of annuity product must suit the needs and circumstances 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 is). If he or she had an emergency need for cash, there would be none available unless the investor paid an early surrender penalty on the withdrawn funds. Therefore, agents must understand the circumstances of each investor prior to making recommendations. Only if the investor refuses to provide full information is the agent released from his or her ethical obligation to determine product suitability.

EIA Guaranteed Rates of Return

Fixed rate annuities, such as 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 if market conditions were good. At each anniversary the minimum rate is re-set, but that would 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.

Investors must always pay attention to the guaranteed or floor rate since it is the only 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 rate, but the principal is still guaranteed. In other words, in the worst index situation the investor would not lose their principal but he or she might not gain any interest earnings. Generally fixed rate annuities (that are not equity-indexed vehicles) would guarantee at least a couple percentage points in interest 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. In some equity indexed products, 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.

How indexed product 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. Agents should never deposit money the investor may need prior to the term of the annuity contract. Annuities, including fixed equity-indexed annuities, are not suitable for anyone who may need to make large withdrawals prior to the end of the policy surrender periods.

Most annuity owners and annuitants do not consider how rates are determined or credited; they largely prefer to have their agents select and present an appropriate and advantageous product for them. Crediting of participation rates can be complicated even for agents who work daily with the products. It might prove very difficult to fully explain the process to consumers. Despite the fact that 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 company will credit all their fixed annuity products the same but that is not always true. Even within each company, different products might credit earnings differently.

Some 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 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 agent be fully and completely aware of the products he or she is marketing. It doesn't matter how sincere the selling agent was; if a major error is made it is the agent's fault since he or she had an ethical duty to know the products he or she represented.

If the reader learns nothing else, they must learn this: while most fixed annuity products guarantee against loss of premiums paid in, that is not always the case. Some 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 EIA was surrendered during the penalty period, that could also result in a loss. Generally, a loss would mean the investor withdrew funds prior to the end of the surrender term. In these EIA products, withdrawals are not prudent.

Know the Facts Prior to Buying

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

Every agent 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. Investors should 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.

The way an annuity company calculates interest during the policy term will certainly make a difference in the equity-indexed product. Some EIAs 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 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, such as a higher index participation rate.

Some annuities that are not equity-indexed products will offer bonus rates for one year, maybe even several years. Of course, if the investor surrenders his policy during the surrender period bonus rates will not apply. Alternately, some EIA products will offer a bonus to an older non-EIA annuity in order to draw in the business to an equity-indexed annuity product. 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. It suggests, they say, 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 this statement, 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 customers. The cost of offering such bonus points is figured in to overhead; insurers are typically very good at analyzing profit and loss. After all, their business is based on risk factors. Although bonuses can give an EIA product a strong performance start, it is important to also look at any limitations on performance that might affect the final returns.

There can always be variations, although all products offered must comply with state and federal requirements. State requirements can vary so what works in Oregon may not work in Iowa or Minnesota for example.

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 equity-indexed annuity. Of course, withdrawals made prior to age 59½ will incur an early distribution charge from the IRS as well.

Index 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 was 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.

The National Association of Insurance Commissioners (NAIC) has published a buyer's guide for equity-indexed annuities. Although there are more elements to these products than just the potential maximum return, since consumers will be looking for products that produce greater returns, it is likely that this element is often the characteristic focused on.

The NAIC does not endorse any company or contract; their publication is intended to help the general consumer understand equity indexed annuities so that they may make the most prudent choice for their particular circumstances. Their publication states:

> "What are equity-indexed annuities? An equity-indexed annuity is a fixed annuity, either immediate or deferred, that earns interest or provides benefits that are linked to an external equity reference or an equity index. The value of the index might be tied to a stock or other equity index. One of the most commonly used indexes is Standard & Poor's 500 Composite Stock Price Index, which is an equity index. The value of any index varies from day to day and is not predictable."

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 very important aspects to equity indexed annuities: the indexing method and the participation rate.

Equity indexed annuities are fixed 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 principle 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.

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 company 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.

The NAIC states participation rates vary greatly from product to product and even from time to time within the same product. It is certainly important for agents to fully understand how they work but consumers also need a basic understanding of them. A high participation rate may be offset by other features, including simple interest, averaging, or point-to-point indexing methods. Conversely, an annuity company may offset a lower participation rate while offering a valued feature such as an annual reset indexing method.

An important note: some EIA contracts allow the insurer to change participation rates, cap rates, or spread/asset/margin fees either annually or at the start of the next contract term. If an insurer subsequently lowers the participation rate or cap rate or increases the spread/asset/margin fees, returns could be adversely affected.

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 companies average daily, while others average monthly. Many professionals in the industry believe that averaging could reduce earnings. Additionally, they state understanding the complicated methods used to calculate gains in the index the annuity links to can be very difficult. Returns vary more than a traditional fixed rate annuity but not as much as a variable annuity (equity indexed annuities are not variable annuities; they are fixed annuities). Because of the minimum guaranteed interest rates EIAs have less market risk than variable annuities.

Caps

Some equity indexed annuities 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 9 percent but the cap was set at 6 percent, then 6 percent would be the most the investor could earn. Not all equity indexed annuities will have a cap, but it is something that agents and investors must be aware of.

Caps absolutely do affect how these products perform but that doe 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 agent 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 caps and monthly caps but products vary so agents 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 this ability.

Spreads, Margins and Administrative Fees

Some 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. For example, an EIA might charge a 2 percent per year spread from the index-linked return. Figuring the cost over time can be difficult or at least complicated, but over ten years, with the index performing at an average of 12 percent per year, there would be a 2 percent loss, so earnings would be 10 percent rather than 12 percent. This is a simplification, but it does give the reader an idea of how it works.

Returns

Equity Indexed annuities will be linked to such things as the stock market, but that does not mean returns will directly reflect a stock market purchase. EIAs are linked to the performance of the index – not to the actual stocks that the index is based upon. As a result, the annuity does not give credit for dividends that could have been reinvested if the actual stocks had been purchased. Most equity indexed annuities only count equity index gains from market price changes, excluding gains from dividends. An investor who is not earning dividends will not, therefore, have the same gains he or she would have if he or she had directly invested in the stock market. On the other hand, the investor also will not experience some of the losses that would have occurred with directly investing in the stock market. Those who oppose investing in EIAs will point to this potential loss of growth, while those who support EIAs will point to the protection from principal risk. The investor is trading the dividends that might have occurred for their safety of principal. There is no investment that will be ideal. High risk means potential high loss; low risk means less earnings.

Most equity indexed annuities use something simple, such as the S&P 500 and do not take into account reinvested dividends. While the loss in value of reinvestment of dividends can be significant, especially over a number of years, those who invest in these types of annuities are typically more concerned with the safety of their principal and are, therefore, willing to earn less. Even without reinvested dividends, indexes still perform pretty well. EIAs usually they do better than certificates of deposit or bond rates, although that is certainly not guaranteed.

It should never be assumed that every client will appreciate the benefits of equity indexed annuities, especially if higher earnings are important to them. It is always a question of suitability and risk. Those who want higher earnings will probably not be happy with EIAs; such investors will probably want to benefit from dividends for example. Some advocates argue that the loss of reinvested dividends is offset by the annual reset (ratchet) annuities that credit the index return with only a zero in negative years. However, many feel it is unwise to push any investor into any vehicle that they seem unsure of.

There are variables in equity indexed annuities; all products are not identical. For example, an EIA that is back-tested does not ensure financial performance. **Back-testing** means that the annuity was tested against historical returns, perhaps as far back as twenty years. Future performance will not always mimic past performance. We have seen our markets change dramatically and they are likely to remain unpredictable. Additionally, there is no guarantee that the back-testing is reliable since reliability is often determined by those doing the testing.

Back-testing can help to illustrate the annuity, so it is not without merit. However, agents and investors must remain aware that past performance does not guarantee future performance. Professionals generally prefer the use of *Monte Carlo analysis*, which uses multiple samplings of random hypothetical market returns. This may present a more accurate visualization of the product and will not leave a false impression of how the annuity is likely to perform.

Indexing Formulas

Equity-indexed annuities credit earnings differently than other fixed rate annuities. Where traditional annuities state a rate of interest and then apply those interest earnings at specified intervals, an EIA calculates its return against the index to which it is linked. This is called the **indexing method**. Equity-indexed annuities credit interest using a formula based on changes in the index to which the annuity is linked. The formula decides how the additional interest, if any is earned, is calculated and credited. With traditional fixed annuities, interest gains are always earned, although how they are credited may vary. EIAs do not necessarily have interest gains, since they are based on the indexing method. The indexing method, or formula, decides how the additional interest, if any, is calculated and credited. The amounts earned, and when they are paid, depend on the contract features.

There are multiple formulas for indexing, with new methods appearing regularly. As a result we will not attempt to describe indexing formulas. New methods often are developed with the hope of attracting consumers, but in the end the amount earned is going to depend upon the performance of the index that is used. Even professional analysts cannot accurately speculate on market performance over several years and annuities are long-term investments.

Many investors find having multiple equity-indexed annuities, with each using a different indexing method, advantageous. By purchasing EIAs that use different indexing methods, the investor is likely to end up with good average performance between the various annuities. Additionally, many investors consider having multiple EIAs as a means of diversifying their annuity portfolio. Some indexing methods work better under some conditions, and worse under others. Diversification prevents being affected adversely with no other annuity investment to offset the adverse conditions.

Some of the new equity-indexed annuities allow several indexing methods. The designated indexing method on these annuities can be changed at certain times, usually on anniversary dates. These allow consumers to select their indexing method at the time of purchase. Some of the newer EIAs allow consumers to use several indexing methods simultaneously, allowing investors to do with one contract what usually requires several to achieve.

Some equity-indexed annuities will allow the investor to see their progress (or lack of it) at specific times, usually annually. These annuities have “reset” features that lock in gains on some specific basis, such as once per year so that the investor knows whether he or she gained during the year. Generally, EIAs held to maturity do not lose principal, but that does not mean it is guaranteed to have gains. Other equity-indexed annuities do not have the ability to see what returns are until the EIA has run its entire term, which may be many years after purchase. Investors who want to be able to view their returns should choose a reset product.

Annual Reset Indexing Method

For investors wishing to see their returns annually the annual reset indexing method is typically the best choice. Annual reset EIAs usually look at the index at the end of each contract anniversary date and locks in gains made as of that date. This is called the **annual reset method** or may be referred to as the **ratchet method**. Under this method the gains posted at the end of the year (or at whatever point is in the contract) will remain even if the index goes down later. The ratchet method compares the changes in the index from the beginning to the end of the year, with declines being ignored. The advantage is a gain that is locked in each year. The disadvantage is the possibility of lower cap rates and participation rates that might limit the amount of available gains.

Under annual reset methods it is possible that there will be no gains. If the index declined from the previous year, the contract simply credits zero for that period. In the next contract anniversary year, there is then no place to go except up. The previous period's end value for the index (not the annuity value) is used as the starting point for the new period, meaning that each period is looked at individually. It does not matter whether there were gains in previous contract years and will not matter in coming years what gains, if any, were given in the current year. Although there may be a lower contract cap rates and participation rates, investors choose this method for the locked in gains, meaning current profits will not be lost to bad years that may come in the future. Even if the stock market were to crash, any past gains are retained in the annuity values.

Investors often do not mind the lower cap and participation rates because they feel they will be offset by the fact that negative years result in zeros rather than value losses. While we would all like to see our investments increase in value we also do not want to lose values. A zero gain is better than an investment loss.

High Water Mark Indexing Method

Another indexing method is the high-water mark method. It compares the index at various periods during the contract to the index level at the beginning of the term. Although the time periods can vary, typically the contract's anniversary date is the time measure used. The high-water mark indexing method takes the highest of these values and compares it to the index level at the start of the term. While the investor may be credited with more interest under this method than other indexing methods and receive protection against declines in the index, the disadvantage is that the investor may not receive any index-link gain at all if he or she surrenders their EIA early. That is because interest is not credited until the end of the contract term; if the contract is surrendered early, the contract term was not reached. Some of these contracts will still give the investor interest based on the highest anniversary value to date under a vesting schedule. Some high-water mark indexing contracts might impose lower cap rates and participation rates. As always, it is important for investors to know and understand all policy terms. Certainly agents must know this as well.

If it were not for participation rates and caps, the high-water mark indexing method would give investors the highest risk-adjusted returns of any indexing method, but of course there are caps. It is also important to realize that only the highs reached at the comparison periods count (usually policy anniversary dates). If a high is reached midway they will not apply. For example:

> A contract is issued on June 1, 2016.
> On June 1, 2017, the index had increased by 12 percent.
> On December 15, 2017 the increase rose to 42 percent.
> By June 1, 2018 it was down to 10 percent.

Because only the anniversary dates apply, the 42 percent index rate will not apply. Over the next ten years of the product's term, the percent at the anniversary date will be calculated. At the end of the ten-year term, the investor will receive the highest point recorded on an anniversary date during the term of the contract, up to any applicable participation or rate caps. It is not unusual to have a participation rate that is less than 100 percent.

Point-to-Point Indexing Method

The point-to-point indexing method compares the change in the index at two distinct points in time, such as the beginning of the contract and the end of the term. Although the investor may enjoy a higher cap and participation rate, which credits more interest, the disadvantage is that it relies on a single point in time to calculate interest. As a result, even if the index that the annuity is linked to is going up steadily during the contract's term, if it happens to decline dramatically on the last day of the term, then part or all of the earlier gain can be lost. Since gain is not credited until the end of the term, the investor may not receive any index-link gain if the policy is surrendered prior to the end of its term.

To recap, the point-to-point index-linked interest, if any, is based on the difference between the index value at the end of the term and index value at the start of the term. Interest is added at the end of the annuity's term.

Even though point-to-point contracts offer the potential for the best long-term returns the disadvantage is the inability to gauge the contract's performance until the end of the contract's term, which could be anywhere from five to ten years. Until that time, the growth will appear to be zero even if the market is significantly up. If the annuitant dies during the term, for purposes of measuring contract performance, the date of death will be used as the end of the term.

The point-to-point method may be best for the longest-term EIAs since we can expect the best gains over the longest period of time. However, since the ending value is based upon that specific point in time, a sudden or unexpected downturn could prove detrimental to the contract's final value.

Some point-to-point indexing contracts charge a spread, stated as a percentage, per year. Others may limit participation to less than 100 percent or impose caps. The contract may limit or alter the way the means of crediting based on point-to-point. They may use the end point to average the index over the term of the contract and credit interest on a compounded basis based on the average rate, less some stated percentage defined in the contract. As always, all contracts should be fully understood by the selling agent and the investor.

Multiple EIAs with Diversified Indexing Methods

Diversification is not a new idea; agents and professional planners have been advocating that for years. Annuities may also be subject to diversification, which is something many investors may not have previously considered. Obviously we cannot know in advance which annuity indexing method will perform best over the coming years but investors who purchase several types of annuities are bound to average out their earnings. This is especially true of equity-indexed annuity types. Some indexing methods will do better in volatile markets and others will do best in steady markets.

Many professionals feel the indexing methods of the EIAs are not nearly as important as other issues and features, such as selecting highly rated insurance companies. While this is true, it is still important to understand the indexing feature chosen. Also important is choosing a product with competitive interest rates, participation rates, caps and other features. By purchasing several different EIAs with several different features the investor may minimize lower earnings due to market trends. Even professional investors realize that it is not possible to guess which indexing feature will perform best in the coming years, since it will depend upon how the markets perform. Therefore, buying different annuity products with different indexing methods is a good way to diversity within the annuity market.

Whatever annuity products are selected, they should be purchased from different insurers so that there is diversification of insurance companies. Of course, all companies should carry no less than an A rating from A.M. Best company.

Withdrawing Annuity Funds

Most insurance agents are probably familiar with the "income for life" ability 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 may be very small (too little to actually support their income needs). 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 amount, they are setting aside is inadequate that does not mean he or she should abandon saving altogether.

Ideally each citizen should begin setting aside money from the time they first receive a paycheck, regardless of how young he or she may be. Parents are wise to encourage the act of saving a percentage of income from the very first check a child receives for his or her birthday or other occasions from Grandma and Grandpa. Establishing this financial trait is one of the most important gifts a parent can bestow upon their child since it sets up a habit that will benefit their children for the remainder of the child's life.

Payout Options

Annuities are designed for pay-out after age 59½ since the Internal Revenue Service considers them to be retirement designated vehicles. They may still be used for other goals, but primarily they are considered retirement vehicles. Although annuities were designed for payout, they are overwhelmingly used for accumulation. In other words, the majority of annuities are not annuitized (turned into an income stream). Instead most investors accumulate funds in their annuity, and then simply withdraw the entire value or exchange it tax-free for another annuity, with the accumulation process starting over again. Often annuities are simply left intact year after year, eventually going to heirs.

Even though most annuities are not annuitized for systematic payout, it is always important for agents 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).
>
> 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.
>
> Annie also begins receiving $1,000 per month on January 1 just as Alvin did. However, Annie Annuitant lives to a very 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's 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 very 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 agents must be certain their clients understand the advantages and disadvantages of each payout option.

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.

EIA Safety

One of the first investment considerations must be the entity selected to deposit funds with. Whether the investor 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 agent, or just online annuities are always issued by an insurance company.

For equity indexed annuities, once the product is past the surrender period 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. As a result of the rareness of annuity insolvencies even critics of annuities seldom mention the possibility. Even so, it is important to utilize only financially secure insurers because even a very small chance of failure is important.

There are distinct differences between variable annuities and equity indexed annuities. EIAs are not backed by segregated reserves or specific assets, as variable annuities are. The EIA investor does not own the index, index shares, or stocks comprising the index. Equity indexed annuities are *contracts*. EIA 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 products, they are both contracts promising future payments. EIAs are backed by the assets of the annuity company (not just specific assets or specified pools of assets), which explains why it is very important that only financially secure companies be selected. EIAs are roughly comparable in their safety to money-market funds according to Jay D. Adkisson, author of *Equity-Indexed Annuities: the Smart Consumer's Guide*.

A Comprehensive Financial Plan

It is unlikely that any one type of financial vehicle would be sufficient to comprise a fully adequate financial plan. Equity indexed annuities must be part of a portfolio that considers all types of investment vehicles so that the investor's goals and aspirations are fully satisfied. Assets must be logically divided among several types of financial vehicles so that the investor's full needs are met. An agent or financial planner that merely divides the client's assets among an array of annuities, even if diversified among several indexes and annuity types, is probably not doing an adequate job of protecting his or her clients. Generally, it takes several types of investments to appropriately address possible future returns and investment risks.

Most annuities (with the exception of variable annuities) are considered safe financial investment vehicles. Equity indexed annuities could be classified with cash and equivalents such as Certificates of Deposit and money market accounts because they are made up of fixed annuities, which are traditionally safe. The risk is small that the investor will not receive at least the minimum returns. While we would all like to see huge growth, safety of principal is typically the primary concern. The biggest risk is not loss of premium (principal) but rather that the growth will be too small to match or exceed the rate of inflation. It is possible that loss of buying power could occur with annuities. In other words, while the principal is maintained the interest earned is too small to maintain the same level of buying power ($100 may only buy 80 percent or $80 of what it once could buy). This is the same risk that all conservative financial vehicles face. Lower financial risk also means lower rates of interest earnings, so lower rates of growth.

Fixed annuities promise a guarantee that a certain amount will be available at some point in time (depending on contract terms) but they do not promise that the returns will keep up with rates of inflation. Even though equity indexed annuities are not liquid financial vehicles, they do promise that at least the principal will be available at some specified date.

Many investors like to "ladder" their investments, with some coming to maturity each year during retirement or at least during the early years of retirement. Many investors stagger their investments to reach maturity in five-year increments. The goal is to provide continual income during retirement; as one investment is used to fund retirement costs, the next investment matures and takes up where the last investment ended.

For example:

Rachel Retiree has given lots of attention to her retirement planning. She has Social Security income, which is too small to live on, but no pension from her working years. Knowing that she would not receive a pension she saved regularly throughout her working years. With the help of a financial planner she knows approximately what her living costs will be in retirement. The only unknown factor was the rate of inflation so she tried to have more than she thought would be necessary available from her investments. If inflation is greater than anticipated she hopes the "extra" will cover the rising costs of living. On the other hand, if inflation is not as great as she thought it would be she will have extra funds, which of course is what Rachel is hoping for.

In year one of her retirement a Certificate of Deposit matures and is used to fund the first five years of Rachel's retirement.

In the fifth year of Rachel's retirement, a fixed rate traditional annuity is annuitized to provide monthly income for the next five years. Because it will pay out all funds over just a five-year period Rachel will actually be able to put part of the income into a liquid savings account to cover unforeseen emergencies, such as health care needs or dental costs. This expectation of extra funds may not materialize if inflation soars but if it does not she will be over-funded. Although she could use the extra money for travel or other pursuits Rachel is wise enough to realize the future may cost more than the present.

In the tenth year, when Rachel is 72 years old (she retired at age 62 when she could begin collecting Social Security benefits) an equity indexed annuity matures. This annuity promised better returns than her traditional fixed rate annuity so she chose to have it mature when she was older. She felt it may give her more income at a time when living costs would possibly be higher due to inflation. By this time she also hopes her modest stock investments will have grown sufficiently to produce any additional funds that she might need for such things as higher insurance premiums on her health insurance or medical needs associated with growing older. Rachel knows she took on an extra risk when she chose not to buy long-term

> nursing home insurance. She felt she would not be able to pay the potentially rising premium rates of such insurance. Rachel hopes she will not need nursing home care even though historically she is likely to, if just from the frailty that comes with aging (especially for women who make up the majority of nursing home residents).
>
> In the 15th year of Rachel's retirement, when she is 77 years old, her final investment will be utilized, a bond fund. Obviously, Rachel does not know how long she will live but Americans continue to live longer than those before them. It is certainly possible that Rachel could live to be 100 years old. She can only hope her money will last as long as she does. Rachel could have chosen lifetime income from her annuities to guarantee funds for as long as she lives. She chose to receive income for shorter periods of time because she felt lifetime payments would be too small to cover her expenses. Rachel can only hope she made the best choices for herself.

While equity indexed annuities might be classified with cash and cash-equivalents because of their high level of safety they tend to offer some advantages:

- Some EIAs offer a minimum interest rate that could be compared to that offered by CDs and money market funds.
- The interest earned on equity indexed annuities is tax-deferred. This offers a substantial gain over a period of growth years. If withdrawals are taken when the investor is in a lower tax bracket this could be a substantial advantage over other types of investments.
- EIAs offer the ability for equity-like participation in the stock market according to the index linking feature. Obviously, formoney market accounts and certificates of deposit cannot do this. Most financial advisors feel this could offer a greater chance of beating inflation.

It is easy to see why professionals who are familiar with equity indexed annuities might choose them over CDs and money market funds. Still most people tend to keep more money in certificates and money markets than they do in EIAs, probably because so few people really understand and appreciate the features of equity indexed annuities.

Agents may sometimes see equity indexed annuities compared to some types of bonds. Investment returns may be similar, although most bonds do not enjoy the tax deferral that annuities enjoy. Even so, if withdrawals may be needed before the EIA would mature bonds are a better choice for the investor. However, if liquidity is not a concern, it is typically better to invest in the equity indexed annuity because:

- The annuity will be tax deferred; some types of bonds may also enjoy this feature (municipal bonds for example) but they usually have very low returns.

- Bond values can go down if interest rates go up. This would mean holding the bonds to maturity to get the full values from them.
- Bonds are subject to market risks, such as inflation and speculation.
- Equity indexed annuities may do better than minimum rates if the index they are linked to perform well. That would mean better performance than bonds are capable of.

This does not mean that bonds have no place in the investor's financial portfolio since they do offer liquidity that is not available in annuity products. Bonds are used for liquidity and EIAs are used for long-term performance. Bonds might also be the investment choice if funds will be needed prior to age 59½ since annuities would be subject to IRS early distribution penalties for withdrawal prior to that age. As we previously noted, it is always an issue of product suitability.

There is another difference between bonds and equity indexed annuities: investors cannot wait for EIAs to decline in price and then buy them. Since bonds can go up and down in price, investors might wait for bond prices to go down before they buy them. Equity indexed annuities can only go up in value and have only positive correlations to the asset classes that overlap the index the product is linked to.

Agents and financial planners may sometimes want to compare equity indexed annuities to mutual funds or index shares. Mutual funds are vehicles made up of various stocks. Index shares are stocks that track the index. EIA critics often do not like that the annuities limit participation in returns if the index rises. It is true that the investor would do better with mutual funds and index shares if the index goes up, but what if it goes down? Investors that want to enjoy guarantees typically realize there is give-and-take when it comes to lowered market risk.

EIAs are subject to participation rates, caps and other limitations. Utilizing equity indexed annuities should not mean anticipating higher gains than those stated; instead the investor should only consider the minimum guarantees. Higher gains are merely a plus to the diversified portfolio.

Mutual funds typically have fees and expenses that affect the final performance. That does not mean they should not be part of a diversified portfolio but product costs should be considered. Mutual funds carry risks besides fees; managers are not always the best or a good manager may not remain. Managers may take excessive risks, putting the funds in a position to take a loss. Mutual funds are not necessarily tax efficient. Most equity indexed annuities do not have fees or expenses and do not experience annual taxation.

For some investors who track the index mutual funds may be their investment of choice but generally a well-rounded portfolio is best. That means having some of many different investments, including annuities.

Grasping Fundamental Aspects of the Product

In all cases with all investments the investor (buyer) must understand what he or she is purchasing. If the selling agent 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 agent 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 when he or she can return it for a full refund it is still dangerous for the agent 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 can be touched, felt, and shown off. When a new car is purchased the family members might not agree with the purchase but at least they understand the reason for buying it. An equity indexed annuity is not likely to be shown off as a new car would be. The buyer may have every confidence in his decision but if his children become involved it could change to "*the agent took advantage of my aging father*." We are not suggesting that older investors not be allowed to purchase an equity indexed annuity; all ages have a right to invest in any fashion they wish. We are advocating that agents take extra time going over the aspects (both good and bad) of the annuity if there is any doubt whatsoever that the product may be misunderstood or if there appears to be lingering doubts about how the product functions.

Equity indexed annuities can be complex, especially to an individual without past annuity experience. Even agents can misunderstand some of the EIAs characteristics, so it stands to reason that many investors will be learning about the product for the first time. Clear communication is vital to an investor being happy and confident about the purchase they have made. Obviously, it is necessary to disclose all pertinent information about the product prior to the sale. This is true of all annuities, not just equity indexed annuities.

There always seems to be so-called financial experts that do not agree with the annuity concept. Many of these individuals are more interested in selling their books than actually educating the public, but if it causes your clients to doubt their purchase it won't matter if the author actually knows anything about EIAs. The only way to prevent your clients from doubting their purchase is to explain the product well enough for the buyer to remain satisfied with their decision. He or she must remain satisfied even if his or her children question their buying decision; satisfied enough to ignore the so-called experts hoping to sway the investor to their personal investing views.

There are elements of EIAs that agents must completely communicate prior to placing the product. Some basic information is always important:

1. The name and contact information of the issuing insurance company;
2. The name and contact information of the selling agent;
3. The financial rating of the issuing insurance company;
4. The length and amount of the surrender penalties (policy term);
5. The point at which the insured will reach age 59½ and no longer have to 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. Are there 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 must be known, such as taxation as ordinary income when funds are withdrawn. There may be tax matters that are specific to an individual so agents are wise to suggest buyers consult their personal tax accountant.

There may be additional points the agent feels is important to discuss with their clients, but the list we have supplied is typically always addressed for equity indexed annuities.

Equity indexed 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. Therefore, EIAs are not subject to customer suitability, disclosure and sales practices requirements that registered securities must meet. Several states have, as we said, passed "suitability" requirements for annuities however and EIAs would fall under any such suitability standards the state may have.

Terminology for a Complex Product

Most agents are accustomed to specific product terminology but equity indexed annuities are not like the traditional fixed rate annuities so there may be terms the agent is not already familiar with, but that are very important to know.

Adjusted Change: The change in the Index Value for a segment, with adjustments as described in the indexed interest rate provision.

Annual Reset Indexing Method: Index-linked interest, if any, is determined each year by comparing the index value at the end of the contract year with the index value at the start of the year. Interest is added to the annuity each year during the term.

Annuity Benefit: The payments that may be made under the "benefit on annuity commencement date" of the contract.

Averaging: Some annuities use an average of an index's value rather than the actual value of the index on a specified date. The index averaging may occur at the beginning, the end, or throughout the entire annuity term.

Beneficiary/Beneficiaries: The person or people entitled to receive death benefits if the annuitant should die prior to withdrawing all annuity funds, unless annuitized for a lifetime benefit, in which case beneficiaries receive nothing even if the annuitant did not use all premiums deposited.

Cap or Cap Rate: Some contracts will state an upper limit, called a cap, on the index-linked interest rate. This is the maximum rate of interest the annuity will earn. It is the highest Adjusted Change for each segment of the indexed strategy.

Code: The Internal Revenue Code of 1986, as amended, and the rules and regulations that are issued under it.

Commencement Date: if an annuity benefit is payable; the death benefit commencement date will be shown on the contract specifications page.

Contract Anniversary Date: the date each year that is the annual anniversary of the contract effective date, shown on the contract specifications page.

Contract Year: A contract year is each twelve (12) month period that begins on the contract effective date or on the contract anniversary.

Death Benefit Commencement Date: the first day of the first payment interval for a death benefit that is paid as periodic payments or the date of payment that is paid as a lump sum if periodic payments will not be made.

Death Benefit Valuation Date: Although contracts may vary, typically the Death Benefit Valuation date is the earlier of:

1. The date that the insurer has received both Due Proof of Death and a written request with instructions as to the form of death benefit (lump sum or systematic payment); or
2. One year form the actual date of death.

Due Proof of Death: Due proof of death is typically one of the following:

1. A certified copy of a death certificate, or
2. A certified copy of a decree that is made by a court of competent jurisdiction as to the findings of death (this is generally only used when the person or person's body cannot be located). Companies may accept other types of proof in some circumstances.

Floor: The lowest Adjusted Change for each segment of an index strategy is called the "floor." It is the lowest point on equity index-linked interest. It is the minimum index-linked interest rate the investor will earn. The most common floor is 0 percent (zero). While that looks like a bad thing, it actually assures that even if the index decreases in value, the index-linked interest will not go negative, losing money. Yes, no interest would be earned but neither would any principal be lost. Not all contracts have a stated floor on index-linked interest rates but fixed annuities will have a minimum guaranteed value.

High-Water Mark Indexing Method: The index-linked interest, if any, is decided by looking at the index value at various points during the term, typically the yearly anniversary date of purchase. The interest is based on the differences between the highest index value and the index value at the start of the term. Interest is added to the annuity at the end of the term.

Index: An index is the specified index that will apply to an Indexed Strategy for the term shown in the equity indexed annuity contract, usually on the specifications page. If the index is no longer published or its calculation is changed, the insurer may substitute a suitable index at their discretion. Insurers should notify their policyholders if a substitution is made. Sometimes the insurers are required to first get approval of the substitution from the state insurance department.

Index Value: The index value is the standard industry value of the index. The index value for a particular date is the value of the index as of the close of business on that date. For any date that the New York stock Exchange is not open for business, the index value will be determined by the insurer and stated in the policy, but often it is the index as of the close of business on the most recent day on which the Exchange was open prior to that date.

Indexing Method: The indexing method is the approach used to measure the amount of change, if any, in the index. Some of the most common indexing methods include annual reset, or ratcheting method, high-water mark method and the point-to-point method.

Index Spread: An amount by which the Index Change is reduced when computing the Adjusted Change.

Index Term: The index term is the period over which index-linked interest is calculated. In most product designs, interest is credited to the annuity at the end of the term, which may be ten years although the average term is more likely around seven years. Products may offer a single term or multiple consecutive terms. Those with multiple terms usually have a window at the end of each (generally 30 days) during which the policyowner can withdraw his or her funds without penalty. For installment premium annuities, the payment of each premium may begin a new term for that premium.

Index Value: The standard industry value of the index is the index value. The index value for a particular date is the value of the index as of the close of business on that date or the most recent date the Exchange was open.

Interest Compounding: Some annuities pay simple interest during an index term. That means index-linked interest is added to the original premium amount but it does not compound during the term. Others pay compound interest during a term so that the index-linked interest that has already been credited earns additional interest. In either case the interest earned in one term is usually compounded in the next however.

Participation Rate: The participation rate is the portion of the index change that is used to compute the adjusted change. It decides how much of the increase in the index will be used to calculate index-linked interest. It is the portion of the index change that is used to compute the Adjusted Change. Note the definition of "adjusted change" above. Participation rates are typically guaranteed for stated amount of time, but the company will change the rates after that time.

Point-to-Point Indexing Method: The index-linked interest, if any, is based on the difference between the index value at the end of the term and the index value at the start of the term. Interest is added to the annuity at the end of the term.

Segment: Segment is the period of time over which the change in the index is measured for an indexed strategy. A segment may never be longer than the term of that strategy. The initial segment begins on the first day of the term. Subsequent segments begin upon the expiration of the preceding segment. Daily segments that end on a day that the New York Stock Exchange is closed are often disregarded.

Term: For a declared rate strategy, the period of time during which the interest rate is declared; for an indexed strategy, the period over which an indexed interest rate is calculated. The initial term begins on the first interest strategy application date. Subsequent terms begin upon the expiration of the preceding term.

Valuation Date: A date on which the index value is measured to compute the Index Change. If an indexed strategy uses valuation dates that are daily, then dates on which the New York Stock Exchange is closed are disregarded. If an indexed strategy uses valuations dates that are other than daily, the valuation dates are the dates within a month that correspond with the first day of the term.

Vesting: Some annuities do not credit any of the index-linked interest, or only part of it, if the investor withdraws their money before the end of the term. The percentage that is vested, or credited, generally increases as the term comes closer to its end and is always 100 percent vested by the end of the term.

General Contract Provisions

All contracts have general provisions. In life and annuity insurance policies the general provisions establish what might be called the "ground rules." The following is a sampling of what might be seen in an equity indexed annuity policy.

Entire Contract

The contract must be identified. It might state something similar to: *"This Contract is an individual deferred annuity contract. It provides for both declared and indexed interest rates. It is restricted as required to obtain favorable tax treatment under the Code. This contract, any riders or endorsements to it, and the application for it, if any, form the entire contract between the owner and the issuing insurer."*

Changes and/or Waivers

The contract is always the final word on the terms and conditions of the annuity. Agents do not have any authority to make changes or waive any part of the contract. The policy will state this in wording similar to the following:

"No changes or waivers of the terms of this contract are valid unless made in writing and are signed by the insurer's President, Vice President, or Secretary. No other person or producer, including the writing agent, has any authority to change or waive any provision of this contract. The insurer reserves the right both to administer and to change the terms of this contract to conform to pertinent laws and government regulations and rulings."

Misstatements

We usually think of misstatements in terms of age but it can relate to any misstatement. Some errors affect the performance of the policy while others have little effect. Often misstatements change the premium cost of the policy but annuities typically do not have this concern since they are based on the amount earning interest, usually not the age of the insured. In some cases, age does have a bearing however since many annuities will not issue coverage to anyone above a specified age. Misstated age can also affect the amount of systematic payments upon annuitization since age is a major factor in determining projected length and amount of those payments.

Most policies address the issue of misstatements. In an equity indexed annuity it might read similar to the following:

"If the age of a person is misstated, payments shall be adjusted to the amount that would have been payable based on the correct age. If payments based on the correct age would have been higher, we (the insurer) will immediately pay the underpaid amount in one sum, with interest, at the rate of __% per year. If payments based on the correct age would have been lower, we (the insurer) may deduct the overpaid amount, with interest at a rate of __% per year, from succeeding payments and pursue other remedies at law or in equity."

Of course, the interest rate will be filled in, but for our example we felt it best to leave it blank.

Required Reporting

The state insurance departments probably have some requirement for notifying clients of changes in policy status or earnings. Policies will state how often such reports will be issued to their policyholders. Generally, companies notify at least yearly of changes that will affect their policyowners. The policy will state how reporting may be expected. It might read similar to the following:

"At least once each contract year, we (the insurer) will send you a report of your current values. We (the insurer) will also provide any other information required by law. These reports will stop on the earliest of the following dates:

1. *The date that this contract is fully surrendered;*
2. *The annuity commencement date; or*
3. *The death benefit valuation date.*

The reports will be mailed to the policyowner's last known address. If permitted by law, in lieu of that we may deliver these and other required documents in electronic form. The reported values will be based on the information in our possession at the time that we prepare the report. We may adjust the reported values at a later date if that information proves to be incorrect or has changed."

State Law

Certainly, states may have laws in place that affects how the annuity contract may be written and laws change from time to time. It stands to reason that insurance companies must follow whatever laws are in place and any laws that come after the contract was written, if they affect the contract. There is likely to be some statement in the equity indexed annuity regarding state laws; it may read similar to the following:

"All factors, values, benefits, and reserves under this contract will not be less than those required by the laws of the state in which this contract was delivered."

Claims of Creditors

Some states will better protect against creditors than others. Your annuity will follow whatever the state dictates by law. It may be stated as the following: *"To the extent allowed by law, this contract and all values and benefits under it are not subject to the claims of creditors or to legal process."*

The important part of that statement is "to the extent allowed by law." At any point creditors become an issue the insured should obtain legal advice from a competent attorney that specializes in contracts or consumer law. Since laws do sometimes change the policyowner should not rely on information obtained at an earlier date.

Other Contract Items

There will be other items covered in most contracts, such as Exclusive Benefit (who may benefit from the contract), liability issues, tax issues, incontestability and transfer by the company. In all cases, agents must be fully aware of the products they are representing and selling. Of course, applicants have a responsibility to fully read the contracts but as every agent knows, they seldom do. Instead they rely upon their agent to fully disclose all facts and figures.

Even when an insurance producer believes he or she has fully disclosed all relevant facts and features of the product, there is no way to keep the information fresh in the buyer's mind. Since agents do not want lawsuits simply because the consumer forgot what he or she was told it is the wise agent who delivers the policy personally and goes over the features a second time. It is a very wise agent who obtains the buyer's initials on all key points within the policy. This can be done on a separate paper or form that the agent keeps in the client's file at the producer's office. Having the policy initialed is fine as long as the agent has access to it in case of a lawsuit, but that is unlikely.

Additional Payments

Some equity indexed annuities will allow only one initial payment; others will allow additional payments. Too often insurance producers do not think to inquire whether buyers might wish to make additional payments in the future. It is an important question to ask since the buyer might simply assume he or she can do so.

When a contract allows additional premiums (deposits) it will specifically state so. The heading might vary but should say something similar to "Purchase Payments" or "Additional Premium Payments." If additional premium payments are allowed it will state something similar to the following:

"One or more purchase payments may be paid to us (the insurer) at any time before the annuity commencement date, so long as you (the buyer) are still living and the contract has not been full surrendered or annuitized."

Since annuitization locks in payments it would not be possible to make additional payments once annuitization was initiated.

Most equity indexed annuities have minimum premium deposit requirements. Many have a $10,000 initial deposit requirement, but that can vary even among policies of the same company.

Some contracts may offer a purchase payment bonus. If so, it will be specifically stated in the contract.

Surrender Values and Penalties

Equity indexed annuities have surrender penalties just as traditional fixed annuities do. The policy will state the terms of the surrender periods. This is an important part of the contract and should not be minimized.

New Developments in Indexed Products

Insurance companies are constantly developing new products. Sometimes they may be revisiting past products with new twists; other times the product seems completely unique.

For example, climate has always presented a challenge to farmers, herders, fishermen and others whose livelihoods are closely linked to their environment, particularly those in poor areas of the world. Index insurance now offers significant opportunities as a climate-risk management tool in developing countries, according to a publication issued in Geneva. The report, called *Index Insurance and Climate Risk: Prospects for development and disaster management* is part of the Climate and Society series produced by the International Research Institute for Climate and Society. It was published in partnership with the United Nations Development Program, the International Fund for Agricultural Development, Oxfam America, Swiss Re, the US National Oceanic and Atmospheric Administration and the World Food Program.

For poor people, a variable and unpredictable climate can critically restrict livelihood options and limit development. Banks are unlikely to lend to farmers if they think a drought will cause widespread defaults, even if the farmers could pay back loans in most years. The farmers' lack of access to credit limits their ability to buy improved seeds, fertilizers and other inputs.

Index insurance products represent an attractive alternative for managing weather and climate risk because it uses a weather index, such as rainfall, to determine payouts. This resolves a number of problems that make traditional insurance unworkable in rural parts of developing countries. With index insurance contracts, an insurance company doesn't need to visit the policy holder to determine premiums or assess damages. Instead, if the rainfall recorded by gauges is below an earlier, agreed-upon threshold, the insurance pays out. Such a system significantly lowers transaction costs. Having insurance allows these policy holders to apply for bank loans and other types of credit previously unavailable to them.

However, if index insurance is to contribute to development at meaningful scales, a number of challenges must be overcome. For example, some efforts to implement index insurance failed due to lack of capacity, institutional, legal and/or regulatory issues, lack of data, and other constraints. The new publication looks at the technical and operational challenges that currently limit the growth and spread of index insurance. It highlights a number of case studies of the various applications of index insurance across the world thus far. Among them are:

- A public-private partnership program in Brazil to support farmers
- A multinational plan in the Caribbean for earthquake and hurricane risk
- A national program in Ethiopia to complement a drought early warning system
- A program to enable access to credit for smallholder farming communities in Malawi
- Public and private programs in India that offer contracts across many states, for many crops, covering a range of risks, from excessive rainfall to extreme temperatures

There are sure to be other ways indexed products develop and change over time. We often think the insurance field is stationary but that simply is not true. Without insurance development and change many of the businesses that exist today would disappear.

Variable Annuities

Variable annuities are the least conservative of all annuities 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; 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.

Consumers are more likely to be familiar with fixed rate annuities than variable annuities. A fixed rate annuity is the safest of all annuity choices; variable annuities are the highest risk annuity type.

Variable Annuity Death Benefit

A variable annuity is a hybrid vehicle that is almost exclusively an investment, but a small part of it deals with insurance. This insurance feature (often called a "wrapper") is referred to as a **guaranteed death benefit**. All annuities are insurance policies and variable products are no exception. Proceeds are paid to the beneficiaries in the event of the contract owner's death prior to annuitizing the contract; following annuitization beneficiaries may or may not receive proceeds. The guaranteed death benefit is the amount paid to the beneficiary and is always at least 100 percent of the investor's total contributed funds, less prior withdrawals and prior applicable surrender charges. At the death of the contract owner, all future surrender penalties are waived, regardless of the time of ownership.

The variable annuity death benefit basically guarantees the account will hold a certain value should the annuitant die prior to receiving annuity payments. 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.

In simple terms, a variable annuity is a financial vehicle that makes investments on behalf of individuals and institutions sharing common financial goals. The sub-accounts, or portfolios, pool the money of many people, each of whom invests a different amount. The initial investment required varies among companies and sometimes even among products of the same company.

Expert money managers for each sub-account use the pooled money to buy a variety of stocks, bonds, and money market instruments that, in their opinion, will help the sub-account's investors achieve their financial goals and objectives.

Variable annuities were created in 1952 through the work of economist William Greenough, an economist with the Teachers Insurance and Annuity Association. He wanted a retirement vehicle comprised of equities, to counterbalance post-World War II inflation. As income tax rates increased and company retirement benefits decreased, individuals had to take on larger roles in their own retirement planning. Annuities have become one of the primary vehicles for avoiding taxes until distribution and building a larger nest egg faster than other taxable investments.

Each sub-account's investment objective, described in the prospectus, is important to both the portfolio's manager and the investor. The money manager uses it as a guide when choosing investments for the sub-accounts while investors use it to determine the sub-accounts they feel will meet their needs. By law each investor must receive a prospectus prior to or at the time of the investment. The prospectus details investment objectives and restrictions as well as of the costs and expenses associated with the variable annuity. Variable annuity investments include subaccounts that will provide potentially higher returns, although there is also greater risk than with fixed rate annuities. It is possible to invest in more conservative items for lower risk, but often variable annuities attract investors willing to consider higher risk vehicles.

Variable annuities gained popularity because they are convenient and efficient investment vehicles providing all investors access to a wide choice of options. Variable annuities allow an opportunity to participate in foreign stock and bond markets, which for most of us would be inaccessible because of the time, expertise or expense. International sub-accounts make investing across sovereign borders no more difficult than investing across state lines.

Subaccounts

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

Immediate or Deferred

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 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).

Long-Term Investments

Like most annuities, variable annuities are long term investments. The longer the annuitant allows their money to build, the more he or she is likely to gain from the investment. However, unlike a fixed annuity (where the funds sit in an account from which payments provide a fixed income throughout a fixed time period), a variable annuity gives 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 do include 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 investor's to make.

As one nears retirement, it is 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.

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 of the day he or she took out their variable annuity, he or she must pay surrender charges based on a scale. It is necessary to refer to the policy for the actual percentage amount.

Agents should never assume that the percentages or costs we have listed 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

Investors should first maximize their retirement options as far as their individual retirement accounts (IRA) or employer-sponsored programs are concerned. Following maximization of IRAs and employer matching accounts, annuities of various types may be a good investment choice. Variable annuities contain greater risk than fixed vehicles, but may still hold advantages for some investors. Since this is a risk vehicle, few professionals would recommend it as the only retirement investment.

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 Annuity Fees

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

Surrender Fees

Most annuities have surrender fees that are due if the investor does not keep the annuity for several years. The actual length of surrender fees varies, but they are usually between five and ten years. Withdrawing funds during this time will result in fines, although many annuities allow the interest earnings to be withdrawn penalty free. Surrender fees typically decrease as the years go by, often by a percentage point each year. For example, in a five-year surrender period, the first year may impose a 6 percent penalty, 5 percent the second year, 4 percent the third year, 3 the fourth year, and 2 percent in the fifth and final year. Always consult the contract for exact penalties.

Early Withdrawal Tax Penalty

As with most retirement accounts, if the investor withdraws funds prior to age 59½, he or she will be charged a 10 percent early withdrawal tax penalty by the IRS.

Taxation

Gains in variable annuities are taxed as ordinary income tax rates, which can be high. In fact, it can be substantially higher than taxes on long-term mutual fund gains. In some cases, the difference can eat up the advantage of an annuity's tax-free compounding. It may take from 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, since people often keep annuities for 20 years or longer this may not be a deciding factor. 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.

Since variable annuities buy sub-accounts they seldom have a stake in the financial assets and stability of the issuing insurance company, but it is still a good idea to select financially secure insurers. The sub-account, also referred to as a portfolio, pools the deposits (called premiums) of many investors.

Professional money managers have the responsibility of investing the pool of money from many variable annuity investors. He or she will buy a variety of stocks, bonds and money market instruments that they feel will perform well. There are different types of sub-accounts; some are designed for growth; some are designed for yield; and some are designed for safety of principal. A growth portfolio is most likely comprised of various stocks, for example, because stocks are most likely to produce growth.

The Commitment

Investing in a variable annuity should not be a quick decision; it is important to understand the risks involved. Along with understanding the risks involved, the investor should understand their investment objectives, time horizons, risk tolerances, the basics of asset allocation and the investment objectives of the annuity's sub-accounts. The initial investment requires the investor to make two straightforward decisions:

- How much money will be invested?
- How will the purchase be made; as a lump sum or as a series of payments?

Once the investor has made the decision to purchase a variable annuity, he or she must then make a determination on where to invest annuity contributions. On the positive side, there are no absolute rules, although the variables remain the same: investment objective, time horizon and risk tolerance when selecting appropriate sub-accounts.

Luckily the investor can rely on the expert money managers and does not personally have to manage his or her variable product, unless the investor wants to be more involved. Sub-account managers select individual securities for the sub-accounts, with the investor selecting what he or she feels is the most appropriate sub-accounts.

This may sound exactly like a mutual fund investment, and with good reason: it is like a mutual fund investment. When the investor chooses a mutual fund, he or she can rely upon the professional money managers associated with the fund. Variable annuity sub-accounts are mutual funds within an insurance contract and are chosen as investment vehicles for the same reasons mutual funds are chosen. However, an added benefit of all annuities is the tax-deferred status and fund accumulation. Mutual fund features and benefits remain the same, even when they are called sub-accounts.

Another similar feature between variable annuities and mutual funds is that they are usually identified by their investment company and their primary investment objective and/or primary group of securities. An example of this would be Spectacular U.S. Government Bond Fund or Spectacular Aggressive Growth Fund.

Variable annuity sub-accounts include the name of their primary investment objective (Aggressive Growth, Balanced or Specialty Portfolios) and primary group of securities. They can also include the name of the issuing insurer, the mutual fund company or the investment advisor managing the assets and the fund's investment objective. Variable annuity sub-accounts require a more descriptive name to allow an understanding of its structure.

Asset Allocation

There are two main issues to address in asset allocation:

- What are the investor's overall asset allocation guidelines?
- What are the investor's current allocations?

Asset allocation and diversification is not the same thing. ***Asset allocation*** is generally a person's allocation of assets to three primary areas: stocks, bonds, and cash. This would be true, for example, with variable annuities.

Not all investments offer the characteristics many investors need and want for growth, income and liquidity. By distributing assets in these three basic areas it increases the odds that at least a portion of the investor's assets will increase in value. It is likely that a higher, long term, total investment returns will be realized because of the lack of asset concentration in one investment classification. Asset allocation allows a more consistent return. There is also a reduction of risk since asset allocation spreads the risk over all categories. A person who likes real estate could invest in this area, for instance, but it would lack liquidity. Additionally, as we have seen, real estate carries risk just as other investments do.

A person's need for income could utilize bonds and meet the need for growth through common stocks (equities). Cash, which in general has the lowest return, can be used to meet current income needs or because stock and bonds are unattractive. It is easy to see why investors might want to utilize variable annuities to meet these needs. In variable annuities, diversification is choosing the sub-accounts that balance the total portfolio.

For example, an investor could choose the following *asset allocation* example:

- 60 percent allocation of sub-account assets to stocks;
- 30 percent allocation of sub-account assets to bonds; and
- 10 percent allocation of sub-account assets to cash.

Then taking the 60 percent allocated to stocks (equities), the investor can then *diversify* by allocating:

- 30 percent allocation to Aggressive Growth sub-account
- 50 percent allocation to International Stocks sub-account
- 20 percent allocation to Utility Stock sub-account.

The significance of our allocation example is that 100 percent of the stock (equity) investment is 60 percent of the total portfolio. While the investor's selections are limited to sub-accounts, the selection of the individual securities remains with the sub-account managers.

Another approach to deciding on an overall asset allocation strategy, an investor could allot:

- 25 to 50 percent of their portfolio to stocks
- 40 to 70 percent of their portfolio to bonds
- 5 to 35 percent of their portfolio to cash.

It is necessary to explore the expected returns for each asset class over time. A person can determine some likely returns over long periods of time and then apply the appropriate risk profile for each class of asset, helping to determine precisely how much risk is taken for the reward.

Asset Allocation Importance

The proper allocation of assets within the portfolio is considered by most expert money managers to be the principal ingredient for successful investment performance of the assets. The proper allocation of investment assets, combined with specific investment selections, risk management and interpretation of economic and other market influences forms the basis for successful money management and a satisfied investor. Correct asset allocation and diversification will typically reduce (rather than increase) risk. Utility stocks could be used for income, although this might confuse the line between stock and bond allocations. Utility stocks are generally considered as growth vehicles. If an investor begins to confuse growth and income, they will find themselves assuming higher risk than necessary. Investors that understand the dynamics of inflation and the need for risk reduction will make better investment choices.

Simply stated, asset allocation is simply apportioning investment assets among various categories. The asset allocation determination is made without regard to specific stocks or bonds. The true test of asset allocation can be determined by the overall mix that, when combined with proper security selection within each asset category, meets the investor's needs within his or her acceptable risk-tolerance level. Many investors could be categorized as conservative, risk adverse and comfortable with consistent returns. By placing an emphasis on proper asset allocation, more consistent returns will be realized with more predictable risk forecasts.

Choosing Asset Allocation

Asset allocation could be called the most important variable annuity investment decision made. To decide on the specific asset allocation, the investor must first analyze their personal circumstances to establish a satisfactory model. It may be necessary to ask themselves: *What asset allocation will produce the maximum return within my risk tolerance?*

To help answer this question, an investor must explore the following:

Overall Wealth: The more wealth an investor has (called their net worth) the more he or she can potentially tolerate risk, but in all cases their sensitivity to risk must be considered. Just because the investor could conceivably tolerate a higher degree of risk does not mean he or she wants to.

Age: The younger an investor is when he or she begins to save, the longer their time horizon is for accumulating wealth. Interest earnings will take away the need to systematically save larger amounts. As a result, the investor can tolerate the up-and-down market cycles to a greater degree than someone without time on their side. The closer a person is to retirement, the greater the risk involved in a poor decision. He or she does not have the luxury of time to recover from a bad choice, so they must be more conservative in their investing, avoiding excessive risk when possible.

Current Income Needs: An investor's current income requirements need to be established as well as any long-term total returns. With the advances of modern medical technology, our life spans are increasing. Therefore we need to be prepared to support ourselves for 20 to 30 years in retirement. Obviously this means saving and investing sufficiently.

Goals: The goals of investors are basically the same: financial growth (more money). It really doesn't matter whether the goal is retirement income, a larger home, or college for the kids; it all comes down to having more money than the investor started with.

Investment Experiences: If any particular past investment yielded badly (lost money) it is likely that the investor will not want to try that investment again. Even if it was an isolated situation, it is unlikely that he or she will have any confidence. The reverse could also be true. If the investor did very well in any particular type of investment, he or she may want to put all their eggs in one basket. Of course it is usually best to have a varied portfolio.

Analyzing the Asset Allocation Model

An asset allocation model should be analyzed every quarter or twice per year. Any necessary or desired adjustments should then be made. The goal is to maximize performance if possible, while minimizing unnecessary risk. For investors utilizing expert money managers, the process may be quite simple. By making a course correction on a regular basis, an investor can make the asset allocation process most effective because it changes with time and circumstances.

Assets allocation need not require large amounts of time. Although the investor must initially consider income needs, his or her time horizon, capital appreciation, risk concerns and the interrelationships of each investment, once the strategy is put into place, it is usually just a matter of regular reviews. Generally any changes that need to be made relate to the current marketplace and how the investment is performing.

Each investor must construct his or her portfolio within the context of his or her risk tolerance. Once an investor has gauged their risk tolerance, everything else will fall into place. For the lay person, expert advice from professionals working in the field of financial planning and investments is a wise start. Establishing a good investment foundation works well for agents since they can lessen the investor's anxiety when the proper ground work has been established.

Risk & Return

The concept of risk and return is the cornerstone of the investing process. Without the potential for return, why would anyone invest at all? Investment decisions must consider both the risk involved and the potential reward (earnings). All investments involve an element of risk and an anticipated return. Risk should be measured and quantified to determine its compatibility with predetermined investment objectives.

Defining Risk

The definition of risk is not the same in all circumstances. As it relates to investments, risk is the ***exposure to the chance of loss***. For investors risk is the possibility of a loss in either the market value (the price decreases) or the income stream (dividends) or both. There are four basic risks that an investor must consider:

- Business risk,
- Market risk,
- Interest-rate risk, and

- Inflation (price) risk

Of the four listed above, three are important to understand when investing in sub-accounts.

Business Risk

An investor's income can decline for many reasons occurring naturally in the business environment. This is important to money managers when making individual securities investments but less important to investors who have hired money managers.

Market Risk

The market value of a sub-account can vary substantially over short periods of time. Market risk lessens over time, and variable annuities are long-term investments. Declines in market prices obviously reduce an investment's value.

Interest-Rate Risk

The value of fixed-income securities and interest rates can vary adversely. Interest rate fluctuations can severely affect bond values and certificate of deposit (CDs) rates. Rising interest rates will cause falling bond prices. Fixed-income investment unit values decrease periods of sharply rising interest rates.

Inflation Risk

Inflation risk is the most powerful risk investors face. Purchasing power risk is the risk that an investment's value will be eroded through inflation. Inflation risk is a major threat to fixed-income investments, particularly certificates of deposit (CDs). Once the investor reaches retirement, if he or she annuitizes his or her annuity, fixed rate products will not increase with inflation; variable annuities pay out a variable income, which may or may not keep up with the current rate of inflation.

Investors must understand how inflation affects investment markets but that does not mean they must look for earnings that equal or beat the current rate of inflation. No matter what the current inflation rate is, investors profit most with the same broad strategy that works in non-inflationary economies. Investments should be picked that have the best profit and risk considerations.

Protection Against Inflation

An individual can protect themselves against the risk of inflation by simply following three steps, which include understanding inflation, alternatives and a balanced portfolio.

The **first step** is an understanding of how inflation impacts investments. Most investors hopefully have a rough understanding of the workings of inflation (what causes it and how it affects various investments and areas of the economy in different ways) so that educated decisions can be made. Understanding inflation helps investors distinguish between the investments that can reduce financial uncertainty and those that will only make an investor's problems worse.

Inflation does not spare any particular investment field, although some may be affected more than others, depending on various conditions. There is no simple inflation hedge that will show profit because of inflation. One of the worst consequences of inflation is the chaos it creates in the economy and in the investment world. Because of inflation, almost all investments go through extreme cycles of boom and bust.

Some individuals might suggest that investors fold during an inflation hedge. Often, certain types of investments are recommended as inflation-protected. For example, while gold has been an excellent long-term investment in some years, it has not proven to be an inflation hedge. The relationship between the price of gold and the inflation rate has been overstated at times. Additionally, the price of a true inflation hedge would not stop during a period of declining inflation rates; it would merely go up more slowly.

Some traditionally-used inflation hedges have not proven to actually protect investors. The stock market has proven that it does not protect against inflation. Real estate used to be considered the best protection against inflation, but we discovered a few years ago that real estate does not always go up; it can go down with a loud bang. In fact, the real estate market's boom eventually caused great financial harm to many when values plummeted. No investment is guaranteed to withstand inflation.

The **second step** is to become acquainted with the range of investment alternatives and techniques available. Investors shying away from investments that performed poorly in the past may need to reexamine these investments today or in the future. Above all, an investor should be open to all the investment possibilities available to them. This may be an agent's toughest hurdle to overcome.

The third and **final step** in avoiding the risk of inflation is to construct a portfolio so well balanced that investors can feel comfortable with them. Investors should be able to live their lives without investment worry and be confident that their investments are protected and that they should profit no matter how inflation evolves over the years. The primary consideration should be proper balancing among several different investment types.

Variable annuities offer investors different investment fields providing a balanced portfolio. During times of inflation and high interest rates, tax deferral is more important for dollar investments than for any others, since high interest rates mean that dollar investments will be producing more taxable income. A way to defer taxes will be especially valuable if it can be used to shelter assets denominated in dollars.

Variable annuities have two *inflation-proofing* features:

- An interest rate that moves upward with open-market interest rates, and
- The tax deferral that allows the interest to compound without tax erosion.

Variable annuities also have two *deflation-proofing* features:

- Provides a way of holding dollars without a prohibitive loss of purchasing power, and
- A deflation could make the guaranteed minimum interest rate extremely valuable.

Understanding inflation, investment alternatives and how to acquire a balanced portfolio may be intimidating for many investors but since variable annuities have money managers, it need not be. Although investors must still participate in the variable annuity decisions they are not entirely on their own.

Measuring All the Risks

Professional money managers seek the maximum return for a given level of risk, while also seeking the lowest risk for a given level of return. A rational investment strategy dictates that investment options be ranked according to risk. This means that risk should be measured and quantified.

Measuring some risks comes intuitively. People understand that an aggressive growth stock has more risk than a Treasury bill or that the chances of being hit by lightning are higher than winning the state's lottery. It is likely that most investors understand obvious risks and opportunities for reward.

Unfortunately, the differences of investment risk are not so clearly stated or defined. Many investors would not know which was best given their levels of risk and return: Aggressive Growth or European equities? An investor's decision is most often based on asset allocation models or mutual fund and/or sub-account investing because of their choice of provisionally managed investments.

Those who invest in variable annuities must understand that sub-accounts have different risk and reward scenarios. For instance, aggressive growth sub-accounts have a higher risk/reward scenario than utility sub-accounts. That being the case, how would investors evaluate risk and reward as it relates to sub-account investing?

The investment industry has devised measurements for each. They are known as:

- **Alpha** (reward), and
- **Beta** (degree of risk).

Alpha is an investor's expected return for the level of risk assumed. *Beta* measures the quantified risk over a given time period. Of course there will be ups and downs in each case. These will be measured by the standard deviation. This anticipates the upside and downside potential at a given level of risk. By definition, **standard deviation** is the opportunity for gain versus the possibility of a loss at a given level of risk.

Alpha is important when measuring and comparing sub-accounts and money manager performance. The performance should be measured over a specified period of time and it should be measured and compared to its peers and industry averages.

The beta coefficient is one method of measuring risk. It relates the volatility of an investment to the market as a whole. The market, or measurement index, has a beta of 1. A sub-account with a beta greater than one has more risk than the market portfolio because its return is more volatile than the market. A sub-account with a higher beta would usually be classified as a growth or aggressive growth sub-account. Sub-accounts with betas less than one are more defensive and are often balanced or investment-grade, fixed-income sub-accounts.

Beta risk is an important consideration for both professional money managers and investors because the effective use of diversification could reduce residual risk. Beta derivation is a straightforward concept. Most sub-account betas are accessible to investors through numerous industry research publications and ratings services.

Lifecycle Beta

Beta can also be a measure of risk for an investor's stage in the lifecycle and general attitude toward risk. There is no quantifiable measurement for either because both are subjective. Preservation of capital is typically more important to older investors, while growth is normally more important to younger investors.

It is important for insurance producers and financial planners to provide a realistic evaluation of the worst-case scenario. Clients must always be aware of the risks involved.

Living With Risk and Return

The concepts of risk and return have been analyzed as separate entities. Hopefully most agents understand the positive correlation between risk and return. Increased risk offers increased return (or should do so); decreased risks mean decreased returns.

Whether they are aware of it or not, everyone practices asset allocation each day. Each month families around the globe allocate a portion of their current assets to necessary expenditures, such as mortgages and utility payments. Each person decides to save for a goal or spend their extra dollars today. Everyone makes these decisions, with little thought in many cases.

Managing Sub-Account Strategies

Insurers employ one or more strategies when managing sub-account assets. Most investment companies employ in-house money managers to manage their family of mutual funds. Managing the assets of an insurer's variable annuity sub-accounts can be complex. Insurers employ one or more of four distinct strategies:

1. Manage all sub-accounts internally. *Assets are managed by money managers employed by the insurer.*
2. Engage an independent investment advisor group as money manager for all sub-accounts. *Assets are managed by independent money managers contracted by the insurer to do so.*
3. Employ multiple independent advisors who specialize in a specific investment type and who manage a specific sub-account. *An insurer could contract a company to manage all equity sub-account for example, and a different company to manage all fixed income sub-accounts.*
4. Employ an independent investment advisor to manager a certain group of sub-accounts and manage some sub-accounts internally. *For example, an insurer could manage all fixed income sub-accounts internally, while contracting a company to manage all equity sub-accounts.*

The long-term investment results and records of consistency demonstrated by the financial advisors are very important. The asset management structure for managing sub-account assets is not necessarily as important.

Annuity investors must understand:

- The sub-account investment alternatives that are available,
- The investment objectives of each sub-account,
- The investment policies, and
- Whether there are sufficient numbers of investment alternatives available within a variable annuity sub-account structure to maintain an effective asset-allocation model.

Sub-Accounts

It is necessary for investors to understand the relationship between the separate accounts and the sub-accounts to effectively select the appropriate investment options. A separate account (accumulation account) is a master investment account that acts as a channel to the established accounts. All funds invested flow through the separate account's channel into various sub-accounts. Each sub-account has a specific investment objective, so combined with the other sub-accounts, the investor is provided choice and flexibility to select substantially different portfolios to meet asset-allocation and diversification demands requirements.

Mutual fund investors purchase **shares**, whereas *annuity sub-account investors* purchase **accumulation units**. Accumulation units are to variable annuities what fund shares are to mutual funds. Accumulation units are purchased by the investor at **net asset value (NAV)**, *without commissions*, in full or fractional units. No-load mutual funds are also purchased at net asset value (NAV). Load mutual funds charging commissions are purchased from the net proceeds after deducting commissions. In rare circumstances, mutual fund share certificates can be issued by the investment company if requested by the investor. Most financial experts do not recommend this. Sub-account accumulation unit certificates are never issued.

The net asset value (NAV) of each accumulation unit is determined at the close of trading of the New York Stock Exchange each day the Exchange is open. Accumulation unit values are determined each day by the insurer or the financial advisor. This is both extremely vital and necessary since daily purchases and daily redemption prices are based on the net asset value (NAV), or closing price, by either calling the insurer or consulting various financial publications.

Sub-Account Options

Variable annuity sub-account choices and numbers depend on the contract, but typically there is enough flexibility in variable annuities. Understanding the investment objectives of each sub-account is critical in choosing an asset-allocation mix that matches the financial objectives and investment risk tolerance of the individual investor. Most investors want consistent, competitive returns and the preservation of their investment.

People might understand the importance of financial planning and the security it provides, but few individuals seem to understand the variation of financial planning and asset-allocation techniques available. It is often an agent and/or financial planner that bring the many options to their attention.

Variable annuity sub-accounts can be divided into four broad categories:

- Those seeking capital appreciation (stocks),
- Those seeking fixed income (bonds),
- Those combining stock and bonds (referred to as balanced), and
- Those offering fixed income money market rates.

To make appropriate decisions, investors must understand the investments they participate in. Decisions should be based on *performance, risk control, expense minimization, investment options, family rating and management*. To fully understand the sub-accounts, it is necessary to understand how sub-accounts are ranked by various financial publications.

Performance

Return figures and the subsequent ratings are normally based on the three calendar years ending on a specified date. It is common, for example, to use December 31 as an ending date. In the event that two or more sub-accounts are competing for the same category, a five-year period might be used to compare and rate the sub-accounts. Performance figures represent total return figures; unit appreciation plus any dividends or interest payments are included.

Financial publications on variable annuity sub-accounts typically use a three to five-year period to rate their performance. This is because only a handful of variable accounts have been in existence for a ten-year time horizon. Performance over just one year is not used because results may be due to a one-time event, which would not provide an accurate financial picture.

All performance figures should include a tabulation showing how the sub-account has performed against a specific index. This kind of index comparison will show how a particular sub-account has performed against its appropriate benchmark over each of the past several years.

Risk Control

Risk-adjusted return looks at how well a sub-account performed, based on the amount of risk it took. As we know, variable annuities contain risk, especially when compared to their fixed rate counterparts. It is not possible to receive both high returns and low risk. Risk levels directly ties to the possible returns offered.

This does not mean investors should completely avoid variable annuities that are rated either fair or poor for risk control. A higher than normal risk can be counterbalanced by the addition of a low risk investment in the investor's portfolio. Again, an understanding of the individual sub-account's investment objectives will enable each investor to make important risk decisions that he or she can live with.

Expense Minimization

The impact of expense minimization is often exaggerated by the media and by investors and advisors who focus on statistics. It is true that an added expense will have an impact on the investor's total return in the long run but this is not nearly as important as selecting the right category to begin with, and an experienced and accomplished portfolio manager.

For investors wanting to know all their expenses, including the annual contract charge, there are certain publications that will post this. It is the most straightforward and objective of the rated categories, but it is also the least important aspect of the full investment picture.

Investment Options

The Investment Options category is the most complex to measure. Variable annuity sub-accounts should be rewarded with a favorable rating if they allow dollar-cost averaging (DCA) and/or allow a high number of transfers per year. This gives the investor the greatest amount of control over his or her investment. Most of the rating for this characteristic should be based on the number of sub-accounts available within the variable annuity "family" and the diversification of such choices or options.

Family Rating

Family ratings state the number of sub-accounts available within the various variable annuity contracts and the caliber of these investment options. This is based on their respective risk-adjusted returns. A **"family"** is the number of choices offered to the investor. The family might be quite small, yet get the highest rating if most or all of its sub-accounts performed excellently when viewed on a risk-adjusted return basis.

Management

A sub-account must either possess an excellent risk-adjusted return or have had superior returns with very low levels of risk. Assuming most investors are equally concerned with risk and reward this would be important to them. When looking at various annuity contracts, the foundation of the text should be based on which variable annuity sub-accounts have the best risk-adjusted returns. The rating for this characteristic should be based on the sub-account's performance and risk control, both of which tend to be heavily influenced by management.

Each of the following subaccount options are categorized into four broader categories:

- Aggressive Growth
- Growth

- Growth & Income
- International Stocks
- Balanced
- Corporate Bonds
- Government Bonds
- High-Yield Bonds
- Global & International Bonds (World Bonds)
- Specialty Portfolios (Sector Portfolios)

Aggressive Growth for Capital Appreciation

Aggressive growth sub-accounts hope to provide investors with maximum capital appreciation by investing in aggressive, less seasoned growth stocks. They focus strictly on appreciation, with no concern about generating income. Aggressive growth sub-accounts strive for maximum capital growth, frequently using such trading strategies as leveraging, purchasing restricted securities, or buying stocks of emerging growth companies. Diversification is gained through a stock portfolio of aggressive growth, emerging growth and small capitalization company stocks. The portfolio composition is almost always completely comprised of U.S. stocks.

Aggressive Growth for Maximum Growth

Aggressive growth sub-accounts seeking maximum investment growth can go up in value rapidly during times of strong market advances. These sub-accounts will often outperform other categories of U.S. stocks during ***bull markets*** (strong market advances), but experience worse than average losses during ***bear markets*** (market declines). Usually small company stocks are less volatile than the better known aggressive growth stocks. The term, **"small company,"** refers to stocks whose market capitalization is less than $1 billion.

Aggressive growth portfolios can provide low income distributions because they tend to be fully invested in common stocks paying small or no cash dividends. A small or nonexistent dividend stream is unimportant for the annuity investor because tax liabilities are not an issue (annuities are tax deferred). A high turnover rate can result in a large capital gains liability for the mutual fund investor, whereas the annuity investor does not share this same liability due to the tax-deferral on growth. Due to the risks involved, this is not something the new investor is likely to want. Only well-diversified portfolios investing for the long term should consider aggressive growth sub-accounts.

While aggressive growth sub-accounts present higher risks, they might still be appropriate for some investors. The risks on these types of investments tend to dissolve over longer periods of time and aggressive growth sub-accounts normally produce a highly competitive long term result.

Growth Sub-Accounts Seeking Capital Appreciation

The Growth variable annuity sub-account's objective is to provide steady capital appreciation by investing in diversified portfolios of well-seasoned and financially sound companies. Current income is generally a secondary concern. Growth sub-accounts usually invest in U.S. common stocks, avoiding speculative issues and aggressive trading techniques. Growth sub-accounts are invested into growth oriented firms that pay cash dividends. The concentration of assets is not as limited as the Aggressive Growth portfolios. The long-term approaches used to attain this appreciation can vary widely among these sub-accounts. The companies are normally included in the Standard & Poor's 500 and have demonstrated their ability to produce strong and consistent earnings, steady growth and regular dividend payments. Even though dividend payments are a secondary concern, these companies have generally paid dividends over a long period of time.

Since the Growth sub-account is considered safer and less volatile than Aggressive Growth sub-accounts, long term performance of these investments have a lower earnings ratio. A tolerance for moderate risk is still necessary, but when held ten years or longer, growth stocks have always out-performed other types of investments. This is especially true of bonds and certificates of deposit (CDs). Growth sub-accounts are suitable for investors wanting above-average return from seasoned stocks and those who are willing to accept reasonable long term risk.

During prolonged market declines, Growth portfolios can experience severe declines also. Since some portfolio managers of Growth sub-accounts attempt to time the market over a longer cycle, switching these funds often may be counterproductive. Although market timing is strongly discouraged, doing so with variable annuities will not trigger a tax liability that might occur with mutual fund market timing.

Growth & Income Sub-Accounts Combining Stock and Bonds

The Growth and Income variable annuity sub-account's objective is to provide investors with a competitive, long term total return by investing in a portfolio that combines both growth stock (equities) and bonds (fixed income). These sub-accounts hope to produce both capital appreciation and current income, with a priority given to appreciation potential in the stock purchased. The goal is to reduce risk and produce more consistent and competitive returns through diversification of asset classes. The sub-account provides long term growth without excessive risk in share price.

An equity income portfolio is designed to be conservative placing a high emphasis on the preservation of the sub-account's assets. It is almost exclusively comprised of U.S.

stocks with a majority invested in utility, computer, energy, retail, and financial common stocks. The sub-accounts also provide higher income distributions, fewer variations in return and greater diversification than Growth and Aggressive Growth sub-accounts. Typically growth stocks lean towards well-seasoned stocks that pay above-average dividends. The sub-account also contains high-grade convertible bonds and fixed-income securities. An equity income portfolio is considered successful if it produces consistent performance for a long period of time. Equity income, income and total return are sub-accounts that are characteristic of Growth and Income portfolios.

Investors like these sub-accounts for their performance. In fact, investors can expect to lower their risk while receiving consistent returns. During negative market conditions, dividends will boost overall growth and income sub-accounts.

While the investor may be offered a number of growth stock sub-account alternatives, the primary choices are Aggressive Growth, Growth, and Growth and Income. Within the three equity sub-account classes, there are multiple choices that include:

- Foreign sub-accounts,
- Global sub-accounts,
- Sector sub-accounts,
- Precious metals sub-accounts,
- Small capitalization sub-accounts,
- Emerging global sub-accounts, and
- Utility sub-accounts.

It is not possible for any variable annuity contract to offer an infinite array of investment choices and it is not necessary to do so. A good variable annuity contract should offer *sufficient* investment choices rather than an infinite number.

International Stocks

International stock variable annuity sub-accounts invest for capital appreciation through portfolios invested in foreign equity securities of companies whose primary operations are outside of the United States. International stocks invest in securities of foreign companies; they do not invest in U.S. stock at all. Global sub-accounts invest in both foreign and U.S. stocks.

Normally an international stock sub-account will diversify with securities from a number of foreign countries. Foreign markets have grown to represent over two-thirds of the world's capitalization and annualized returns during the past ten years. Funds are available for specific countries or specific regions. Investing in foreign securities requires specialized knowledge and should not be attempted by inexperienced investors. Those with experience who are willing to assume a greater degree of risk might want these for the opportunity to earn above-average returns. However, with above-average potential for returns come above-average risk (and returns are certainly not guaranteed). Returns are affected not only by a foreign company's earnings but also by currency transactions and the local political environment.

If an investor invests in the foreign markets directly, he or she would have to know and understand foreign brokerage processes, international taxes, and the various marketplaces and their economics. The investor must be aware of currency fluctuation trends as well as have access to reliable financial information enabling educated investment decisions. This is nearly impossible for an individual investor, which is why expert money managers are typically necessary.

The economic outlook of foreign countries is a major factor in the professional money manager's decision regarding international investing. The value of the U.S. dollar relative to the foreign currencies is also important:

A *strong* dollar will lower the foreign portfolio's return.

A *weak* dollar will enhance international performance.

Investors wanting to avoid currency swings might use a variable annuity sub-account that uses currency hedging. **Currency hedging** is basically an insurance policy protecting the investment if the dollar is making a killing in currency futures contracts. It only pays off if the dollar becomes strong, increasing in value against the currencies represented by the portfolio. The cost for this type of insurance becomes part of the cost of doing business. In the case of currency contracts, the contract expires and a new one is purchased, covering another period of time. When properly handled, the gains in the futures contracts (the insurance policy) can offset most or all of the security losses attributed to a strong U.S. dollar. Some believe that buying currency contracts is risky for the sub-account, but it can pay off if properly done.

Like all insurance policies, currency hedging only pays off if there is an "accident." Currency hedging pays off if the U.S. dollar *increases* in value against the currencies represented by the portfolio's securities. If the dollar remains level or even decreases in value, the insurance policy does not pay because the investment is not losing. If the foreign securities increase in value, the currency contracts become worthless when the U.S. dollar remains level or decreases in value.

Balanced Sub-Accounts Combining Stock & Bonds

Balanced sub-accounts, also referred to as Total Return sub-accounts, mix investments in common stocks, bonds and convertible securities to *decrease* volatility and stabilize market swings. Balanced sub-accounts hope to provide both growth and income. The Total Return basis (current yield plus or minus principal appreciation) is the net amount earned during a given period, normally measured annually. The reason for asset allocation and diversification is not only to reduce risk, but also to receive competitive returns from the best performing investments.

Balanced portfolios, such as growth and income accounts, provide a high dividend yield sheltered from taxation through the variable annuity. Growth and income, both primary goals, is accomplished by taking advantage of market rises through stock holdings and providing income with bond holdings. The portfolio composition is usually comprised of U.S. securities. Balanced subaccounts often out-perform the different categories of bond funds when things are good, but they also suffer greater percentage losses during stock market declines. When interest rates are on the rise, they will typically decline less than bonds. When rates are falling, they will typically outperform a bond portfolio if stocks are doing well. Basically one could say this type of subaccount sits in the middle of other options since they are neither the best, nor the worst of investments.

Balanced sub-account investing is important to wealth accumulation. They are a good choice for investors who cannot decide between stocks and bonds. This hybrid security is ideal for an investor who wants a sub-account manager to determine the portfolio's mix of stocks, bonds and convertibles.

Corporate Bond Sub-Accounts Fixed Income

Corporate Bond sub-accounts invest in debt instruments issued by corporations for building expansion, capital improvements, equipment purchases, and other projects that require corporations to borrow money. As the name implies, corporate bond subaccounts are primarily comprised of bonds issued by corporations. Portfolios are generally comprised of U.S. issues.

Bonds are the second most common fixed-income asset group that offer fixed rates of return and return of principal. All bonds have market and/or credit risk. There is the **credit risk** that the issuer might default on the interest and/or principal payments. **Market risk** involves the possibility that the market value of the bond might decrease as interest rates increase and/or credit risk concerns arise.

The only bonds considered to be without credit risk are those backed by the U.S. government and certain government agency securities. However, all fixed-income securities, including U.S. government bonds, are subject to market risk.

There are three major classifications of fixed-income securities:

- Corporate,
- Government, and
- Municipal bonds.

Each offers a predictable and reliable income stream; bonds tend to experience less market volatility than equities. The rate of return on fixed-income securities depends on three factors:

- The general interest rate environment,
- The creditworthiness of the bonds, and
- The maturity of the bonds.

No municipal bond sub-accounts are offered in variable annuity contracts because municipal bond interest is already exempt from federal taxes. There would be no point since a primary use of annuities is the tax deferral status they enjoy and bond interest is already exempt.

The major influence on bond prices, affecting the value of the underlying sub-account, is interest rates. There is an inverse relationship between interest rates and the value of the bond: when one goes up, the other goes down. Bonds often include other features such as conversion privileges, but are primarily purchased for their income stream.

Like most debt investments, corporate bonds have a stated maturity date and pay a fixed rate of interest. The amount of appreciation or loss of a corporate bond sub-account primarily depends on the average maturity of the bonds in the portfolio and the yield of the bonds in the sub-account's portfolio. These sub-accounts have a wide range of maturities. The name of the portfolio often indicates the term of the obligations:

- **Short-term** bond sub-accounts are comprised of debt instruments with an average maturity of five years or less and are subject to very little interest rate risk or reward.
- **Medium-term** bond sub-accounts are comprised of maturities averaging between 6 and 15 years and are subject to one-third to one-half the risk level of long term accounts.
- **Long-term** bond sub-accounts are comprised of maturities ranging from 16 to 30 years and will average an eight percent increase or decrease in share price for every cumulative one percent change in interest rates. The greater the maturity, the more the portfolio's unit price can change.

Often purchased because of its reinvested income stream, an investor's principal in a bond sub-account might fluctuate. Therefore, the issuer's creditworthiness must be a major consideration. For instance, blue-chip corporations rarely default on either interest or principal payments so they are able to borrow capital at the most favorable prevailing rate. For emerging companies and corporations with weaker balance sheets and shorter track records, lenders require higher rates and impose stricter borrowing conditions.

Corporate bonds issued to foreign companies are subject to the same credit risk conditions as are domestic corporations. Like domestic corporations, major foreign corporations borrow at a more favorable rate, while emerging and less financially stable foreign corporations pay higher rates to borrow capital. A major consideration before investing in foreign corporations is the **currency exchange risks**. Unless payment is required in U.S. dollars, currency fluctuations can greatly increase leverage and exposure. Many sub-account managers handle this additional risk by extensive country diversification and/or currency hedging.

Within this same category are **Investment-Grade Corporate Sub-accounts**. These look for current income, safety, and preservation of capital by investing in portfolios of high-quality corporate bonds. Investment-grade securities are defined as those that are rated investment grade by the various bond rating services. Bonds with the highest credit rating will pay the least interest on their fixed-income debt. As the quality of bonds *decrease*, interest rates *increase*. When the economy is thriving, fixed-income money managers often lower their average portfolio rating to receive additional yield. During less prosperous times, money managers have a tendency toward raising their portfolio's quality rating.

Sub-account money managers have a vast array of choices when purchasing investment-grade corporate bonds. All major U.S. and foreign corporations issue debt securities. The money manager's primary consideration is typically credit-worthiness. The second consideration is maturity dates. Investment-grade Bonds are issued with varying maturity dates; they are categorized as short, intermediate and long term. The importance of maturity cannot be overemphasized. Except in unusual market circumstances, bonds with longer maturities pay higher interest rates and carry more market risk. To lower this risk, fixed-income sub-account managers diversify their portfolios by purchasing bonds with varying maturity dates.

Government Bond Sub-Accounts Fixed Income

This type of sub-account invests only in direct and indirect U.S. government obligations, with the goal of providing current income and safety of capital. The investments can include one or more of the following:

- **Treasury Bills (T-Bills)**: Short term government obligations maturing in three months, six months, or one year. At maturity, the investor receives the face value. The profit is the difference between the face value of the Treasury bill and the lower auction price that is paid. The minimum denomination is typically $10,000, with additional $5,000 increments available.
- **Treasury Bonds (T-Bonds)**: Long term government obligations with maturities ranging from 10 to 30 years. They are issued at par and provide a specific interest rate that is paid every six months. They are normally issued in increments of $5,000, with a minimum investment of $1,000, and $1,000 additional increments available.

- **Zero Coupon Bonds (STRIPSs)**: Normally long term government obligations; interest payments are not distributed to the bondholder until maturity. The standard zero coupon bonds are sold at a discount reflecting the yield; they mature at par.
- **Treasury Notes (T-Notes)**: Intermediate term government obligations with maturities ranging from two to ten years. They are issued at par and give a specific rate of interest that is paid every six months. The minimum denomination is $5,000 for two and three year notes, plus $5,000 increments. They are also sold in increments of $1,000, with $1,000 additional increments available.

The coupon portion is the interest rate. So, a zero coupon means that no interest is paid currently on the bonds. Instead, an investor buys at a discount from the bond's face value. Every year the interest builds up within the bond itself, until it reaches face value at maturity.

These portfolios can be attractive to bond investors since they provide diversification and marketability that may not be readily available in direct bond investments. Investors must remember that government and corporate bonds are generally not a good investment when inflation and taxes are factored in. Investors should probably avoid government and corporate bonds <u>except</u> during retirement.

High-Yield Bond Sub-Accounts Fixed-Income

High-Yield Bond sub-accounts invest in lower-rated debt instruments. Bonds can be classified as either Bank Quality Bonds or High Yield Bonds.

Bank Quality Bonds (also known as Investment Grade Bonds), are rated highly by rating companies, such as A.M. Best and Standard & Poor; **High-Yield Bonds** (also known as Junk Bonds) are typically rated very low to moderate.

High-yield bonds are classified as junk bonds because of their lower ratings and additional risk of default. As with all investments having risks and rewards, the opportunity for highly competitive yields is counterbalanced by the exposure to higher credit risks and higher default rates when compared to investment grade bonds. Certain institutions and fiduciaries are forbidden to invest their clients' money in anything less than *investment grade*. Anything less than bank quality is considered junk.

High-yield or junk bonds may be subject to substantial price erosion during poor economic times or when questions arise about a bond issuer's creditworthiness. High-yield sub-accounts perform best during good economic times. Investors may want to avoid these junk bonds during recessionary times since the underlying corporations can experience difficulty making interest and principal payments when business slows down. Like common stocks, these bonds may perform better during the second half of a recession. Their volatility is normally substantially higher than that of investment grade bonds.

This type of sub-account is not suitable for many investors. The high-yield bond market should be left to professionals. As with aggressive growth stocks, high-yield bonds can have a positive effect and reduce risk through diversification. However, there is risk exposure.

Although high-yield bonds may exhibit greater volatility than their bank quality peers, they are safer when it comes to interest rate risk. That is because junk issues have high-yielding coupons and shorter maturities than quality corporate bond sub-accounts. They fluctuate less in value when interest rates change. During expansionary times when interest rates are rising, high-yield sub-accounts will generally drop less in value than investment grade corporate or government bond sub-accounts. When interest rates are falling, corporate and government bonds will often appreciate more in value than high-yield sub-accounts.

In terms of economic cycles and important technical factors, high-yield bonds resemble equities at least as much as they do traditional bonds.

Global & International Bond Sub-Accounts Fixed Income

International bond sub-accounts, also called **foreign sub-accounts**, are fixed-income equivalents of their foreign equity companions. Global sub-accounts, or World Bond sub-accounts, invest in securities all over the world including U.S. fixed-income securities; international sub-accounts invest in foreign fixed-income securities. This type of sub-account's objective is high current income, safety, and preservation of capital by investing in a portfolio of foreign fixed-income securities. International sub-accounts purchase securities issued in various foreign currencies such as Euros (€), the British Pound (£) and Yen (¥). The fixed-income markets do involve some risks which can be reduced through global diversification.

Global bond sub-accounts seek higher interest rates. International bond sub-accounts generally offer higher yields because of the possibility for higher risk. Like their foreign equity companions, these sub-accounts are subject to market risk, currency exchange risk and varying degrees of credit risk, depending on the portfolio mix. Prospective investors need to be aware of the potential changes in the value of the foreign currency relative to the U.S. dollar.

Global bond sub-accounts normally invest in bonds issued by stable governments in a handful of countries. These sub-accounts try to avoid purchasing foreign government debt instruments from politically or economically unstable countries. The objective is higher interest rates. Regardless of where they are purchased, inclusion is dependent upon the money manger's perception of the interest rates, the country's projected currency strength against the U.S. dollar, and the predicted political and economic stability.

Just as countries move in different economic cycles, so does the capital gain prospects of bonds issued in those countries. At any one time, the country offering the highest returns may change. As global economic cycles shift, the country offering the best opportunities will shift as well. Foreign markets do not necessarily move with the U.S. markets so each country represents varying investment opportunities. Using global accounts diversifies an investor's portfolio reducing the investor's risk level - or at least that is the intention. However, there are not many variable annuities that have international or global bond sub-accounts.

To evaluate the effect on interest rates and bond values in the economic environment requires an understanding of two important factors: inflation and money supply.

Inflation: During inflationary periods, when too much money is chasing too few goods, government tightening of money supply helps create a cushion between an economy's cash resources and its available goods.

Money Supply: Money supply refers to the amount of cash made available for spending, borrowing or investing. The money supply is controlled by the central banks of each nation. Money supply is a primary tool for managing inflation, interest rate and economic growth. A nation can tighten the money supply, helping to bring on disinflation, which is a decelerated loan demand, reduced durable goods orders and falling prices. During dis-inflationary times the underlying value of the existing bonds is strengthened because interest rates also fall. Dis-inflationary times mean lower yields for government bond investors even though such factors contribute to a healthier economy.

An enemy of bond investors is *inflation* because it drives interest rates higher. When nations put inflation-reducing policies into effect (such as reducing interest rates) it can undermine the goals of individuals who specifically invest for monthly income. Where bonds are concerned, falling interest rates mean higher bond values. The real enemy of bond investments is inflation because it drives interest rates higher. Inflation diminishes bond values and erodes the buying power of the interest income that investors receive. Investors seeking income look for economies where inflation is under control with interest rates high enough to provide favorable bond yields. Not all bond markets will peak at the same level, although they do tend to follow similar patterns. Investors must target countries where interest rates are at peak levels and inflation is falling. This not only results in higher income but also creates significant potential for capital appreciation when rates are ultimately declining.

A proven technique for controlling market risk: Diversification. Even if investors have a primary goal of high income, they must consider credit and market risk. By investing primarily in variable annuity sub-accounts that purchase government guaranteed bonds from the world's most creditworthy nations, investors receive an extra measure of credit safety for payment of interest and repayment of principal. Sub-account money managers are able to diversify across multiple markets to reduce market risk. Diversification is a proven technique for controlling market risk.

Global bonds offer more than just yield or income. They can potentially offer three different important components: capital appreciation, yield, and currency management.

While most investors understand the concept of investing in global sub-accounts for income, if investors only consider high **yields**, he or she may miss an opportunity for **capital appreciation**. Investors looking solely for capital appreciation, on the other hand, may give up current income. Investors who do not apply the principles of **currency management** may see their investments erode when exchange rates change adversely in global bonds.

As we have said, there is an inverse relationship between bond values and interest rates. Investing in global bonds provides the potential for capital appreciation during periods of declining interest rates. When interest rates fall, existing bond values climb. When interest rates rise, existing bond values decline.

Specialty Portfolios

Specialty sub-accounts, also called Sector sub-accounts, allow the variable annuity investor the opportunity to invest in a particular segment of the economy, such as timber, mining, airline, chemical, automotive, paper, real estate or banking industries. Some sources include metals and utilities as specialty portfolios, while other sources do not. Most, if not all, of the companies represented in these sub-accounts are domestic.

Specialty sub-accounts are the most volatile portfolios available. This micro-investment approach adversely affects the risk-reward investment scenario because it lacks diversification. The whole point of hiring expert money managers and diversifying investment assets is to increase the opportunity for more consistent and competitive long term investment results. With this in mind, specialty sub-accounts are basically counterproductive to diversification goals. If an investor wants to invest in a specialty sub-account, only a small portion should be used for that purpose. There are two reasons why this limitation may be recommended:

1. When the investor chooses a specialty/sector sub-account, he or she is tying the hands of his or her financial manager. The manager's ability to find worthy stocks is limited by prospectus to a certain industry. If this industry or sector is not performing well, the sub-account will not perform well either, regardless of how good the money manager is. As a result, the goal of diversification cannot be adequately met.

2. Specialty Sector portfolios are considered very risky. The entire sub-account is vulnerable to the fortune or misfortune of a particular industry, giving the investor a combined substandard performance and above-average risk.

Considering these two points, why would investors want to invest in specialty portfolios? They do so because these portfolios allow investors to invest in something specific, such as real estate, without the level of involvement that would otherwise be required. For example, if real estate is the investment, the person does not have to actually buy properties and then manage them. Additionally, this category may reduce the overall risk of the investor's portfolio because it has a random or negative correlation meaning it may go up when other parts of the portfolio are moving sideways or even going down.

An investor needs to determine their time horizon when considering whether or not to invest in a specialty portfolio. The longer the term, the better chance it has of succeeding. It is not unusual for a specialty sub-account to increase from 40 percent to 100 percent during the first year of ownership only to drop 25 percent to 50 percent the following year. The specialty portfolio typically has no consistency or predictability; there are no performance guarantees.

Metals Sub-Accounts Specialty Portfolios

The precious metals sub-accounts are often called gold sub-accounts even though they include other precious metals such as silver and platinum. The objective is aggressive capital appreciation by investing in precious metals and mining stocks worldwide. These portfolios are the most speculative sub-accounts available in most variable annuity contracts. Highly specialized, they are considered specialty or sector sub-accounts.

The proportion and type of metal held by a sub-account can have a great impact on its performance and volatility. Outright gold bullion ownership is usually less volatile than ownership in gold mining company stock would be. Up to the late 1970s many investment advisors recommended a percentage allocation to gold funds to offset inflation. The concept was expanded to include stock in and ownership of other precious metals.

Utility Stock Sub-Accounts Specialty Portfolios

Even though they are technically equity investments, utility sub-accounts are similar to fixed-income sub-accounts. Their goals are to provide competitive dividend yields through purchase of stocks in major utilities, while preserving capital assets and experiencing modest capital appreciation. Most of these sub-accounts have long term growth as their goal. Even though utility portfolios offer modest capital appreciation, they may offer attractive total returns and are attractive investments during market uncertainty and declining interest rates. Like metal sub-accounts, the financial standing of this category can change in a matter of months, but should still be considered as part of the portfolio. Money managers often consider utility stock during depressed economies.

The utility sub-account's objective is generally for both long-term growth and income as they invest in common stocks of utility companies across the country. Somewhere between one-third and one-half of the sub-accounts' total return comes from common stock dividends. Utility sub-accounts typically stay away from speculative issues focusing instead on well-established companies with a solid history of paying good dividends. Utility sub-accounts are considered safe investments. Stocks of any category relying on a high level of reinvested dividends has a built-in safety cushion since comparatively high dividend income means the investor will experience appreciation of the underlying issues.

Metal and utility sub-accounts only represent a couple specialty sub-account categories. Investors may want to avoid sub-accounts that invest only in one industry for two reasons:

1. Like metal sub-accounts, the utility sub-account's money manager is limited to his or her choice of securities from only one particular geographic area or industry.
2. Also like metal sub-accounts, the track record of specialty sub-accounts as a whole is not good. In fact, these specialty sub-accounts represent the worst of both financial worlds, meaning above average risk and substandard returns.

Utility sub-accounts are the one exception to this. Profitability of a utility company is often determined by four elements:

1. **How much the utility pays for energy:** *While the price of oil and gas is directly passed on to the consumer, the utility companies are affected by pricing because higher fuel prices mean the utility industry has less latitude to increase its profit share margins. As a result, investors investing in utility sub-accounts can expect smaller profits and/or dividends when higher prices occur.*
2. **The general level of interest rates:** *After energy costs are evaluated, interest is the industry's greatest expense. Utility companies are heavily in debt. Their interest costs directly affect their profitability. When interest rates go down, utility companies can refinance their debt for enormous savings. For example, a hundred million dollar loan at 9 percent interest, if refinanced down to 5 percent interest represents tremendous savings over the life of the loan. Lower interest rates translate into more money left over for shareholders.*
3. **The company's expected use of nuclear power:** *Nuclear power has been a hot-bed of opinions for the United States for several decades. The 2011 Japan-based earthquake and resulting tsunami will cause additional nuclear debates for many years. Other countries have come to grips with nuclear energy (often because that*

is their only viable option), but the United States is still divided on the issue. The venturing into nuclear energy has often not been successful. It always seems more expensive than anticipated by the utility companies and the independent experts they rely on for advice. As a result of the nuclear controversy, sub-account money managers have usually veered away from utility companies that are involved with nuclear energy. Avoiding nuclear facilities has kept share prices more stable and predictable.

4. **The political climate:** *The Public Utilities Commission (PUC) is very politically involved and may directly reflect the opinions of the state's government. Citizens are concerned with their utility bills and the state officials elected to their positions want to keep their constituents happy. As a result, they are more likely to be reelected if they are able to keep rate increases to a minimum. Modest or minimum increases can be healthy for the utility companies, while freezing rates for a couple of years is a bad sign.*

Utility stock prices follow the long-term bond market. If the economy is doing well and long term interest rates are up, utility stock prices are likely to be down. Utility stocks are also at risk to a general stock market decline, although they are considered less risky than other types of common stocks because of their dividends and the monopoly position of most utilities.

1997 Tax Law Hit Variable Annuities

New or revised tax laws sometimes affect investments. An example of this is the federal **Taxpayer Relief Act of 1997 (TRA '97)**, signed into law by President Clinton in early 1997. This tax law changed the way investments are taxed and made variable annuities less appealing to some investors.

Under TRA '97, investments in a stock index pay the investor a maximum of 20 percent capital gains rate when they cash it out, assuming the investor held the investment for at least 18 months. Even though a variable annuity accumulates tax-deferred, the investor's income will eventually be taxed at their ordinary income tax rate.

Variable annuities have annual insurance expenses. It is the insurance element of the annuity that provides the tax-deferral benefit. Some financial advisors consider insurance charges unnecessary since the investor can directly invest in mutual funds and other vehicles outside of the variable annuity (eliminating the insurer's charges). If an investor wishes to be their own money manager it may not be necessary to use a variable annuity. Investors not wishing to perform this function themselves may prefer others do it on their behalf – and yes, there are fees when others perform services on an investor's behalf.

Reallocation of Assets

Contract owners of variable annuities can switch assets between sub-accounts. Reallocations will not create a tax liability or be subject to commission charges. This is usually considered a large advantage when compared to other investment financial transactions. For instance, the sale of a mutual fund or security in an Individual Retirement Account (IRA) could incur a tax liability where it would not in an annuity.

Investors can transfer one fund complex to another using a 1035 exchange, without incurring a tax liability. A variable annuity is an attractive vehicle for market timers who want to switch aggressively. Normally, investors would not face any charges for switching, but they may be limited to a certain number of changes per specified time period.

No Sales Charges

Most variable annuities do not charge front-load sales charges. This translates into a benefit for the client since a hundred percent of the money they invested into an annuity is earning an immediate return. That does not necessarily mean that the selling agent did not earn a commission; merely that the client does not directly pay it. Annuity commissions are paid by the issuing insurers and are built into the insurer's overhead costs.

Withdrawals

Most annuities provide systematic payout options, called annuitization, and periodic withdrawal options without actually annuitizing the contract. These withdrawals are not subject to surrender penalties unless they exceed certain withdrawal limitations or restrictions.

Available variable annuity withdrawal options vary from contract to contract, but many have common features, including:

- A minimum account value to qualify for a withdrawal option.
- A minimum withdrawal amount for each distribution.
- A maximum number of withdrawals per contract year.
- Withdrawals will be deducted proportionally from each sub-account invested in unless otherwise directed by the contract owner.
- Any withdrawal is subject to federal income taxes on the taxable portion.
- A ten percent IRS penalty will be assessed on withdrawals if the contract owner is under the age of 59½.
- Withdrawals may be modified or discontinued at any time prior to annuitization.

If the contract owner makes regular, periodic withdrawals, part of each withdrawal is treated as taxable income. The rest is the nontaxable return of the contract owner's capital: the initial invested amount made with after-tax dollars.

If the contract owner makes occasional withdrawals, subject to no particular schedule, the entire withdrawal is treated as taxable income. Taxes are levied until the contract owner has taken all of the earned interest. After the interest portion of the annuity is withdrawn, the contract owner may start withdrawing the original investment tax free.

Early withdrawal penalties exist for variable annuities. To avoid IRS and insurer penalties one of the following must occur:

- Death,
- Disability, or
- Annuitization (defined as moving into a "contracting for a series of payments from an annuity").

Penalties can be avoided by limiting withdrawals to those allowed under the free withdrawal privilege, waiting until the penalty period lapses, or beginning a systematic withdrawal plan of up to ten percent per year.

IRS penalties cannot be waived by the insurer. IRS will levy penalties when withdrawals are made prior to age 59½.

Avoids Probate

Like all annuities, variable annuities avoid probate proceedings. Upon the death of the contract owner, the annuity's value will transfer to the designated beneficiaries or to the joint owner if applicable, avoiding probate proceedings. There are no delays and the beneficiary receives immediate access to the annuity funds. If the beneficiary is the surviving spouse of the contract owner, the spouse may assume contract ownership and continue the contract as if the contract owner had not died.

The Federal Tax Code sets certain distribution requirements for beneficiaries other than spouses:

- If the contract owner dies prior to the annuity maturity date, the proceeds must be distributed within five years following the contract owner's death.
- If the contract owner dies on or after the maturity date, but before the entire interest in the contract has been distributed, the remaining interest must be distributed at least as rapidly as it was currently being distributed to the contract owner.

Although the annuity bypasses the proceedings of probate, the annuity values are still included in the estate of the deceased for federal estate tax purposes. Both of the requirements are considered met if the portion of the proceeds is payable to the beneficiary over a period not exceeding their life expectancy or distributions begin within one year after the death of the previous contract owner.

Although the beneficiary inherits the annuity proceeds tax-free, the value of the annuity is still included in the estate of the deceased for federal estate tax purposes. Only under strict circumstances would annuity proceeds pass completely tax-free. A tax specialist should be consulted for the most accurate and up-to-date information. All states allow the direct transfer of annuity assets to the listed beneficiaries. Policyowners must always keep their beneficiary designations current in their variable annuity contracts.

Safety

Annuities are backed by the insurer with legally required reserves. Reserve requirements may vary from state to state but whatever the state's requirements happen to be, they are for the consumer's protection.

The preservation of capital and the return of capital are major concerns of investors. Non-annuitized annuities guarantee that the beneficiary will receive either the original principal amount invested, less withdrawals, the current market value of the account or the guaranteed stepped-up value, whichever is greater at the contract owner's death. If the annuity has been annuitized, it will depend upon the annuitization selected upon payout whether or not beneficiaries receive any funds.

Variable annuities have an additional safety feature in that the securities for the underlying portfolios in which the annuitant invests are held by a trustee. Regulations required by the various state insurance commissions assure annuity owners that their principal and earnings are protected and that their annuity contractual obligations are met.

Reserve Requirements

An understated benefit of annuity investments is the reserve requirement. For every dollar the investor invests into the annuity contract, the insurer must set aside over a dollar into its reserves. The insurer can only use these excess reserves to settle withdrawals and redemption of annuity owners.

States require insurers doing business in that state to become part of their legal reserve pool. This reserve pool protects annuity investors and others who purchase life insurance products. In the United States, there are over 2,000 different life insurance companies. Collectively, the insurers own, control or manage more assets than all the banks in the world combined. This translates into financial clout that is advantageous to the investors they represent.

In the early 1920s, the U.S. government began using annuities to fund government retirement accounts, as did labor unions. Obviously insurer safety was likely a primary reason for choosing insurance products for their retirements. Due to requirements the government mandated, the insurance industry came up with two safety features:

1. A guaranteed minimum interest rate built into the annuity contract and
2. The reinsurance network.

Backed by the insurance companies' reserves, a reserve system for annuities was first introduced during the 1920s. The legal reserve system required then and now that insurers keep enough surplus cash on hand to cover all cash values and annuity values that may come due at any given time. It is the reserves that enable the minimum interest rate guarantees to exist on fixed rate products.

The reinsurance network was designed so that if there was a large run on the money in the insurance industry, no one company would be required to take the brunt of the loss. The insurance companies spread the risk out among all companies offering similar products.

Liquidity

The availability of assets is a major concern for investors. Annuities are not typically considered a liquid account since it is subject to certain distribution restrictions and penalties for early withdrawals or surrender. Investors who are looking for liquidity would not want to invest in annuities in most cases. Annuities offer some penalty-free distribution options including:

- After one year, cumulative earnings can be withdrawn without penalty.
- After one year, all or part of the accumulated earnings or up to ten percent of the total account value, whichever is greater, can be withdrawn; or
- Annuitization can be enacted providing systematic income.

It is important to emphasize that withdrawals of gains are taxed at ordinary income rates and may also be subject to a ten percent IRS penalty tax if made prior to the contract owner reaching the age of 59½.

Even though there are withdrawal options, variable annuities, like all annuities, do best when held for a long period of time. Any type of annuity should not be purchased for a short-term need.

It is difficult to predict future changes in federal tax laws and how they might affect annuity owners. If an investor is considering a large investment in a variable contract, it would certainly make sense to seek competent tax advice.

Inflation Protection

Variable annuities have two inflation-proofing features:

1. An interest rate that moves upward with open-market interest rates, and
2. The tax deferral that allows the interest to compound without tax erosion.

When trying to inflation-proof investments, there must be proper balancing between portfolios. This applies to variable annuities as well as other types of investments. Since variable annuities offer multiple investments fields they provide an opportunity to seek a balanced portfolio. During times of inflation and high interest rates, tax deferral is more important for dollar investments since high interest rates mean dollar investments may produce more taxable income. Therefore, a device for deferring taxes will be especially valuable if it can be used to shelter assets denominated in dollars.

Variable annuities also have two deflation-proofing features:

1. Provides a way of holding dollars without a prohibitive loss of purchasing power, and
2. A deflation could make the guaranteed minimum interest rate extremely valuable.

No Investment Ceiling

Unlike tax-qualified retirement plans, an investor faces no maximum on what they can invest during the pay-in or accumulation period of variable annuities. Experts recommend that investors first invest as much as they can in regular retirement plans, such as their 401(k), IRA and Keogh before considering a variable annuity.

Major Variable Annuity Features

There are features of variable annuities that make them a unique investment including:

- 1035 Tax-Free Exchange,
- Free-look Period,
- Social Security Income Exclusion,
- Investor Control,
- Professional Money Management,
- Unlimited Contributions,
- No Commission Charges, and
- Reserve Requirements.

Moving Money from one Vehicle to Another

If an investor determines that his or her current insurer's interest rate or company rating is too low, they have the option of a **tax-free 1035 exchange**. It is not wise to continually exercise changes, but when necessary or prudent to do so, the option exists. It is not wise to exercise this option needlessly because each new insurer or policy begins new surrender periods. A 1035 Exchange is basically the exchange between two different products or insurance companies. It is ***tax-free*** since the investor does not pay any taxes related to the exchange, but this only applies if the investor does not see or touch any of the money. The transfer must be between insurance companies or products. While a 1035 tax-free exchange will not incur a tax liability, the investor may incur insurer surrender penalties. An investor can do as many 1035 Exchanges as they want since there are no limits.

Before exchanging one annuity contract for another, there are some questions to be asked, including:

- Does the change represent advancement for the policyowner?
- Is the new annuity contract offering a more competitive and/or diversified program?
- Does the new annuity contract increase the guaranteed death benefit?
- Is the new insurer rated highly by more than one insurance rating company?

A 1035 tax-free exchange is not without some drawbacks, as we have discussed. There is the disadvantage of starting a new surrender term all over again and any current insurer penalties for early withdrawal. The investor may be liable for early withdrawal penalties making the transferred assets subject to surrender charges. Insurance companies continually improve their products hoping investors will not exchange or surrender their policies, but improvements may not apply to existing contracts.

Free-look Period

Most annuity contracts include a provision that allows the investor a certain period of time to cancel the annuity contract. The issuing state may set the actual free-look period of time, but usually the buyer has up to 30 days to return their policy for a refund. This "right to examine" (free look) allows the investor to change their mind and return the policy; no stated reason for the return is required. For fixed rate products, a full refund will be received of all money paid into the annuity. For variable annuity contracts, the owner/investor (in most states) will receive the greater of the purchase price or the value of the accumulation account, less certain charges for mortality and expense risk charges, administration fees and states taxes.

Social Security Income Exclusion

Social Security retirement income may be subject to federal income tax when Social Security benefits are added to other income and the amount exceeds certain limits. Among revenue sources included as "other income" are earned income, dividends, capital gains, interest, and tax-free interest. Investors should consult their tax professionals regarding dollar limitations.

Non-distributed annuity earnings are not included in any Social Security taxation calculations. This allows Social Security recipients to continue accumulating tax-deferred wealth in their variable annuities without creating a tax liability.

Investor Control

There must be sufficient assets to maintain a reasonable lifestyle during retirement and obtaining those assets should be a primary pre-retirement goal. Annuities offer investors the ability to accumulate wealth, the opportunity to maintain control over their assets, and the final decision on asset distribution. The annuitant or contract owner determines the amount of contributions, investment options, asset allocation models, investment time periods, when and how assets are distributed, and who receives their assets upon their death.

Professional Money Managers

Assets in variable annuity sub-accounts are managed by some of the most qualified and successful money managers available in the insurance industry. They offer investors access to institutional management, competitive and consistent returns over the long term and the assurance of expert oversight. Each sub-account is managed to meet specific investment objectives. Investors can decide between aggressive growth, growth, balanced, fixed-income, and money market sub-accounts to develop diversified portfolios. Investors are assured that each money manager of each sub-account seeks to maximize the investment for the least amount of possible risk to meet the sub-account's objectives.

Unlimited Contributions

Unlike some retirement plans, the purchase of a nonqualified annuity is not limited by federal statute. No portion of a nonqualified annuity contribution is tax deductible. This is attractive for many investors wanting to defer income until either their income has declined or they wish to pass the proceeds on to beneficiaries while avoiding probate procedures (though the annuity is included in the estate of the deceased for federal estate tax purposes).

Commission Charges

Annuities do not have visible commission charges. Insurers do pay their agents commissions when they sell annuities, but these costs are factored into the company's overhead. Therefore, 100 percent of the invested amount is immediately working for the intended goals of the investor. The investor will not lose any principal and/or interest earned to pay a commission when the money is partly or completely withdrawn. The insurer pays the commissions. For these reasons, annuities are referred to as no-load or commission-free since any commission paid comes from insurer directly. Variable annuities do have fees and charges, however, so it is necessary to understand what they are.

Annuity Riders

Product Riders

While it is possible to link just about any type of insurance product to another, there would be no point in doing so unless it benefited the buyer (annuity owner in this case). For example, those who need life insurance typically buy a life insurance policy, not an annuity with a life insurance rider. Some annuities have guaranteed death benefits but that is typically not considered life insurance. Even though the annuity may have a guaranteed death benefit, it is unlikely that it would be sufficient to fulfill a family's need for financial independence.

Some annuity riders do provide a benefit that may uplift the annuity owner's situation. The role of the producer is to suggest only those riders with real benefit.

Long-Term Care Benefits

There are **two** types of annuities with long term care benefits. One requires health underwriting and one does not. Both types are typically single premium fixed annuities with a long-term care rider designed to cover long term care expenses. A long-term care benefit refers to the care provided in a nursing home, assisted living facility, or similar types of home or facility care.

Life insurance products also offer long-term care riders and these usually have greater benefits than annuities do. Universal life insurance with long term care riders provides more benefits (higher leverage) than the underwritten annuity with long term care riders.

The annuity with no underwriting provides access to long term care benefits without depleting the vehicle's principal, and without invasive medical questions; some may also offer in-home care. Without underwriting anyone can get long-term care benefits regardless of health but usually the applicant may not have previously needed or received such care within one year prior to the starting date. Annuities that do not require underwriting will have a quick approval process but those requiring underwriting will have greater benefits because they are underwritten. Both annuities will provide the applicant with financial security and long-term care benefits, sometimes with extended care protection. The underwritten annuity with underwriting will have better leverage (benefits) than the annuity without underwriting, but if the investor cannot health-qualify it may be the only available choice.

Most professionals feel those who want long-term care benefits are better off applying for an individual long-term care policy that is written specifically to cover this type of risk. Premium costs can be high but coverage is more likely to be adequate. Riders are seldom going to provide full coverage because the rider is not the focus of the policy; they are merely attachments to something else.

A Long-Term Care Rider is not a Premium Waiver

A rider is different than a nursing home waiver of withdrawal charge. The rider is providing nursing home or community care benefits while the other is merely waiving any surrender or early withdrawal fees that would otherwise apply to money removed from the annuity product. Under the withdrawal penalty waiver, the investor is removing money from his or her annuity and using the funds to directly pay for long-term care needs. Under the long-term care rider, it is the rider that is paying some portion of the long-term care expenses, not the annuity funds.

Guaranteed Minimum Withdrawal Benefit Rider (GMWB)

Unlike fixed rate annuities, variable annuities are an investment product that involves risks and the possibility of loss. Problems with variable annuities have given rise to the Guaranteed Minimum Withdrawal Benefit (GMWB), a rider that guarantees the holder of an annuity will always receive a specific amount of money for a certain number of years without surrendering the principal.

Variable annuities are also known as “mutual funds in an insurance wrapper.” They combine characteristics of fixed annuities with some of the benefits of owning mutual funds. Investors pay a premium to the issuing insurance company, similar to how they pay for a fixed rate annuity and the insurance company then invests the premium in sub-accounts.

A GMWB guarantees to return 100 percent of the premium paid into the contract, which constitutes the principal in an annuity, regardless of the investment's performance, through a series of annual withdrawals. The withdrawals are limited to a percentage of premiums, typically 5 to 7 percent per year. If the annual limit is 5 percent, for example, the investor would need to receive 20 annual withdrawals to recover 100 percent of their premiums.

GMWBs usually must be elected when the contract is issued, and in some cases they are non-cancelable, which means their costs continue even if there is no chance they will ever pay off. The cost is charged annually as a percentage of separate account assets, generally from 40 to 75 basis points.

Each year over a continuous period of many years, the contract holder must *need and request* withdrawals up to the maximum percentage allowed by the GMWB rider. Deferring the start of withdrawals, skipping withdrawals or just plain forgetting to take them won't help the rider pay off.

The contract owner must live long enough to take the required series of withdrawals. For example, if the owner dies 15 years after buying the annuity, the GMWB will have had little chance of paying off. The annuity's guaranteed minimum death benefit rider, if one existed, may pay off in this case, but that is a separate contract feature and has no relation to the GMWB.

The annuity's tax deferral status is a major selling point of annuities, but GMWBs make little sense for buyers who are over age 65 and want tax deferral. Older buyers would need to begin taking immediate and continuous annual withdrawals if they expect the rider to pay off in their lifetimes. In most cases annuity withdrawals in the early years of contract ownership are 100 percent taxable.

The contract owner should not plan to exchange or surrender the contract for many years (annuities are nearly always a long-term investment). If a better annuity contract comes along, or if a large amount of cash is needed for an unexpected reason, receiving the GMWB may not have been advantageous.

While the GMWB can protect 100 percent of premiums paid into the contract, it doesn't offer any inflation protection for retirement income. On a present value basis, taking into account the time value of money, a GMWB actually guarantees to return only about 62 percent of premium value (assuming a 5 percent discount rate and 20-year withdrawal period).

GMWBs can be useful for investors planning to invest through a variable annuity using somewhat risky stocks. In this case, the insurance protection could pay off if a loss is suffered. However, for buyers who select living benefits, some insurance companies may not allow access to the riskiest investment choices in their variable annuity menus. Therefore, investing in GMWBs makes little sense for conservative investors who choose a balanced mix of blue chip stocks and bonds.

A final caution: in some contracts, the amount protected under the GMWB can "step up" to a higher contract value after the contract is issued. If investment performance is good in the early years, this type of GMWB can protect more than 100 percent of premiums. For example, an investor purchases a variable annuity for $50,000 and five years later it is worth $60,000, at which time the investor elected to step up his or her GMWB protection. In this case, the investor would be guaranteed to receive at least $60,000 through a series of annual withdrawals (starting after the step-up date). However, it is important to note that exercising this step-up feature can (in some cases) permanently increase the cost of the GMWB.

Guaranteed Minimum Income Benefit (GMIB)

At a continuing cost that ranges from 50 to 75 basis points of contract value, a GMIB rider guarantees the right to annuitize an annuity contract into a payout program with a specified minimum periodic income, after a waiting period, regardless of the annuity investment performance. For example, an investor puts $50,000 into his or her contract; the GMIB guarantees that he or she can annuitize it into monthly payments of at least $420 per month, with these payments starting at a time of the investor's choosing after 10 years. This establishes what is referred to as a "floor" of future retirement income into which the contract can convert at the holder's option.

There are specific circumstances that must be met before the GMIB floor will pay off, including the investor living and holding his or her contract long enough to be able to use the annuitization option. Typically, a 10-year waiting period after the annuity is purchased is required although it is always important to refer to the contract for actual details.

Later in retirement, if the investor decides annuitization is a better choice than continuing to accumulate money in the contract or cashing it in there may be some important contract elements to consider as a result of the GMIB. Some contracts limit GMIBs to annuitization methods that include a lifetime payout with no "period certain." For people with poor health during retirement, a lifetime payout may not be attractive since their expectation of longevity may not be promising. Remember that straight lifetime annuitization options do not forward remaining funds to beneficiaries; remaining funds belong to the insurer. Only if the payout option contains a "period certain" are beneficiaries included in lifetime annuititzations.

Most importantly, for the GMIB to pay off, it should guarantee more periodic income than can be obtained (at the time of annuitization) from a comparable insurance carrier. Today's immediate annuity industry is highly competitive. Quotes can easily be obtained from many companies and payouts are constantly changing based on prevailing interest rates and other contract factors, such as company mortality experience and how anxious companies are to attract new business.

A competent agent or financial planner may be able to convert annuity quotes into an equivalent interest rate. For example, suppose a person wants to annuitize an annuity with a balance of $100,000 into a lifetime income of $640 per month at age 65. If a standard mortality table indicates that this person's annuity life expectancy is 19.2 years, the internal rate of return of this payout over this life expectancy is approximately 4.3%. Generally, if a variety of different contracts are analyzed at once, it becomes clear that:

1. Among insurance companies with comparable financial strength, interest rate quotes on annuity payouts commonly can vary by 1 percent to 2 percent.
2. The floor rates built into GMIBs often do not offer the most attractive payouts available in a competitive market.

When it comes to annuitization it pays to shop around; all insurers do not figure payout options equally. The GMIB can only recover its cost if the investor is willing to give up his or her right to shop and take the payout plan guaranteed (long in advance) by their annuity insurer.

Annuity living benefit riders are not necessarily the "seat belts" they are advertised as. They involve separate purchase decisions (apart from the annuity itself) that should make sense based on their own merits. GMWBs and GMIBs always generate extra continuing costs, and they can only repay this cost many years in the future, under specific circumstances that may depend more on the buyer's needs and circumstances than on stock market performance.

Much can change during retirement years. If health declines several years from now, or if the investor has opportunities that make exchanging or cashing in their annuity contract advisable, the total cost of these riders may be wasted.

For the riders to make sense, investors must plan to hold their annuity for at least twenty years with a GMWB rider or for the required waiting period, such as ten years, with a GMIB rider. These riders need to also be compatible with other income tax planning strategies. A tax advisor may be able to give insight into whether these riders make investment sense.

Riders are often sold as a "peace of mind" goal, but it may not achieve that. The idea that having them will provide comfort even if they don't pay off just doesn't make sense. Investors wouldn't buy an extra car just in case their car was stolen. Why should they pay extra dollars out when it may not be necessary? Don't accept the argument that these riders will help your clients sleep better, even if they don't pay off. If losing sleep is an issue, choose investments (inside or outside an annuity) that will help the buyers feel secure on the investments own merits. None of the basic benefits of an annuity are compromised by refusing to pay extra for riders.

No two investors are identical so it is always advisable to seek the advice of a tax specialist or a financial planning specialist.

Guaranteed Minimum Death Benefit Rider (GMDB)

Variable annuities have a death benefit. If the investor dies before he or she has started making annuity withdrawals, their beneficiary is guaranteed to receive a specified amount – typically at least the amount of the purchase payments (principal). The beneficiary receives a benefit from this feature if, at the time of the investor's death, the account value was less than the guaranteed amount.

Some people in the insurance industry feel the guaranteed minimum death benefit rider helps maintain the death benefit coverage despite the potential risks associated with variable life insurance products. The GMDB rider guarantees that the death benefit protection of the annuity policy won't lapse even if the cash surrender value is insufficient to cover monthly deduction charges. In short, the policy's death benefit is guaranteed, no matter how the market is performing.

The GMDB rider:

- Helps protect the policy's death benefit from potential market risks;
- Offers protection for the base policy's face amount and for eligible riders that are included with the policy; and
- Offers a choice of GMDB rider coverage periods (each with a required premium level) to meet the individual's needs.

Required Premium

The monthly premium for a policy with the Guaranteed Minimum Death Benefit rider is determined when the policy is issued. The investor must make premium payments for at least this amount to pass the monthly **"GMDB premium test."** As long as the investor does so, the GMDB rider's death benefit protection remains intact.

How the GMDB Rider Works

On any monthly deduction day when the policy's cash surrender value is not sufficient to cover the required monthly deduction charges, the GMDB rider is activated to pay these charges - which are necessary to maintain the policy's death benefit protection. If any part of the monthly deduction charges exceeds the policy's available cash surrender value, the GMDB rider covers these charges, as well as the charges for the rider itself and any other riders included with the policy. By doing this, the GMDB rider protects the policy's death benefit even if market fluctuations reduce the policy's cash surrender value.

Separate account charges are not covered by the GMDB rider. They are deducted from the fund returns before returns are credited to the policy.

Available Benefit Periods

Investors have a choice of rider coverage periods. The GMDB rider must be elected for a minimum of ten years. The longer the coverage period selected, the greater the required premium for the rider.

Policy Loans

To maintain the guaranteed death benefit provided by the GMDB rider, limitations on policy loans exist. If a loan is taken during the first two policy years, the rider ends. Loans are permitted after the first two policy years but may be limited. If the amount of the loan would cause the GMDB rider to end, the investor will be notified before the loan is processed.

The GMDB rider ends:

- On the policy anniversary when the insured covered under the policy reaches the age on the rider benefit period that was selected;
- If the GMDB premium test is not satisfied on a monthly deduction day, and any required payment is not received by the next monthly deduction day;
- If a policy loan is taken during the first two policy years, or if a loan is requested after the first two policy years in excess of the available amount; or
- If the policy is terminated, surrendered, or cancelled by the policyowner.

Life Insurance Riders

Life insurance tackles numerous needs at different stages in one's life. With increased income and a much higher standard of living, it becomes crucial to maintain the most suitable insurance protection for the insured and his or her family. Individuals should avoid purchasing excessive insurance however. To cut premium costs, some professionals advise the purchase of a rider if the rates are economical. Riders provide several kinds of insurance protection and they are not necessarily right for everyone. Of course, the applicant must meet the rider's underwriting conditions.

What is a Life Insurance Rider?

Riders are additional benefits purchased from the issuing insurer and added to a life insurance policy. These options allow the insured to increase their insurance coverage or limit the coverage set down by the policy. Riders can be blended, for an additional cost, according to the owner's present and future insurance needs. However, buying a rider means paying an extra premium for this supplementary benefit. Generally, this premium is low because relatively little underwriting is required but it may also not fully cover the risk it is intended for. This might especially be true for such things as long-term care medical needs.

When a claim for the rider's benefits is made, it can result in the termination of the rider, while the original policy continues to insure as usual. The insurance coverage available, premium rates, terms and conditions of riders is likely to differ from one insurer to another. Those selling such products and those interested in buying them are wise to do some comparison shopping.

The most common life insurance riders and what agents need to know about them include the following.

Guaranteed Insurability Rider (Renewal Provision)

This rider allows the insured to purchase additional insurance coverage along with his or her base policy in the stated period without the need for further medical examination. This rider is most beneficial when there has been a significant change in the insured's life, such as the birth of a child, marriage, divorce or an increase in income. This rider can be a big advantage if the insured's health declines with increasing age since the insured will be able to apply for extra coverage without giving any evidence of insurability. Sometimes this rider may also provide a renewal of the base policy at the end of its term without medical checkups. This rider may end at a specified age.

Spouse Insurance Rider

As the name suggests, this rider offers term insurance (no cash values) for the insured's spouse for an additional premium.

Accidental Death or Double Indemnity Rider

This rider pays out an additional amount of death benefit if the insured dies as a result of an accident. Normally, the additional benefit paid out upon death due to accident is equivalent to the face amount of the original policy, so it doubles the benefit. The insured's family ends up getting twice the amount of the policy. That's why this rider is called a **double indemnity rider**. There are typically restrictions on this rider, however, since many insurance companies limit the meaning of the term "accident." For those who are the sole income provider for the family, this rider is ideal because the double benefit is typically inexpensive to buy and can potentially double the death benefits if death is due to an accident.

Waiver of Premium Rider

The waiver of premium rider is used in many types of insurance contracts. In life insurance policies future premiums are waived if the insured becomes permanently disabled or loses his or her income as a result of injury or illness prior to a specified age. Disability of the main income-earner generally has a severe financial effect on the family. In these circumstances, this rider exempts the insured from paying premiums due on the base policy until he or she is ready to work again. This rider can be valuable, particularly when premiums on the policy are high. Without this rider, the insured is at risk of lapsing their life insurance policy because of the inability to continue paying premiums. Again, the definition of the term "totally disabled" is vital. It may vary from one insurer to another, so agents need to be aware of the terms and conditions of this rider. An agent should never sell or recommend any product that he or she does not fully understand.

Family Income Benefit Rider

If the insured dies, this rider will provide a steady flow of income to family members. When considering this rider, the buyer must determine the number of years his or her family is going to receive the income benefit. The merit of having this rider is obvious: in case of death, the surviving family members will face fewer financial difficulties thanks to the regular monthly income received from the rider.

Accelerated Death Benefit Rider

An insured person can use the death benefits under this rider if he or she is diagnosed with a terminal illness that will considerably shorten the insured's lifespan. While it varies, often insurers advance 25 percent to 40 percent of the death benefit of the base policy to the insured. Insurance companies may subtract the amount received, plus interest, from the death benefits. This may eventually reduce the death benefit under the policy. Most often, a small amount of premium or, in some cases, no premium is charged for this rider. Different insurers come out with different versions of the definition of "terminal illnesses" unless the term is dictated by the state where the policy is issued. Agents are wise to check what the rider offers before recommending it to their clients.

Child Term Rider

This rider provides a death benefit in case a child dies before a specified age. After the child attains maturity, the term plan can be converted into permanent insurance with coverage multiplying up to five times the original face amount without the need for medical exams.

Long-Term Care Rider

In the event that the insured's bad health compels him or her to stay at a nursing home or receive home care, this rider offers monthly payments. Although long-term care insurance can be bought individually, insurance companies also offer riders that take care of some long-term care costs. In this instance, the problem may be one of offering false security. Seldom would the LTC riders be sufficient to cover a long-term illness that often lasts two to three years (that's why it is called "long term"). Most health insurance professionals recommend that individuals purchase a separate policy to cover these costs.

Return of Premium Rider

The primary goal of this rider is to give back most of the premiums paid into the policy. Under this rider, the insured must pay a marginal premium and at the end of the term, the premiums are returned in full. In the event of death, beneficiaries will receive the paid premium amount. Insurers sell this rider with many variations so verify the phrasing of the rider to minimize misunderstandings with clients.

Other Riders

Besides those we have mentioned, there are many other riders on the market. Agents can analyze policyholder circumstances to help them choose appropriate riders for their circumstances.

Annuitization Options

Annuities were developed with payout in mind. Although statistically many annuities are never annuitized, the intent was to provide systematic income over a number of years. Annuitization provides even distribution of both principal and interest growth over a selected period of time. The time period selected is based on the choice made by the contract owner at the time of annuitization. Annuitization is tax favored; other forms of liquidation or withdrawal generally are not.

When a contract owner decides to begin a systematic payout (annuitization) several choices are made at that time. The owner decides how payments will be received: monthly, quarterly, semiannually, or annually. The most common selection is monthly. Both fixed and variable annuities may be annuitized.

There is one disadvantage to annuitization: it locks in the payout decision for the lifetime of the annuity product. Regardless of how other circumstances may change, regardless of how high inflation might rise, the systematic payout does not change.

An annuitized variable annuity will have a "variable" payout; a fixed rate annuity will have a "fixed" payout each pay period.

One element that many agents fail to realize about insurers is that the annuitization income is not necessarily the same for all insurers. In other words, insurers determine the amount to be received each month based on a specific formula they use. Some insurers will use formulas that provide more income each month than other insurers. Whatever formula is used, it will be computed on a "per thousand" dollar basis. It is often possible to receive information on what the computation is per thousand dollars; this allows some amount of company comparison. It is sometimes better to select an annuity paying a lower interest rate but a higher payout rate upon annuitization.

Once the systematic payout amount is determined in a fixed rate annuity, the payment will be the same each and every pay period. It will not vary based on inflation, changing interest rates or the stock market. It will be contractually set for the life of the payout period. The interest rate at the time of annuitization will affect the payout for the lifetime of the annuitant.

Withdrawal Privilege Options

Most contracts allow contract owners to withdraw some amount from the annuity values without penalty; this would not apply to IRS penalties, only insurer penalties. Typically stated as a percentage, most companies allow an annual 10 percent annuity value withdrawal without imposing surrender or early withdrawal fees. In some products, withdrawing funds will reduce the final financial outcome since any funds withdrawn may not earn interest (indexed annuities primarily).

There are primarily four ways to access annuity funds:

1. By annuitizing the contract. When a contract is annuitized it begins the payout phase. Once the contract has been annuitized there is no turning back. Whatever was selected as the payout option, once it is initiated and money has been received, it is contractually set.
2. By taking a lump sum payout, which means the policy was surrendered. The lump sum distribution ends the annuity contract because there are no longer any funds in it.
3. By taking withdrawals, but not through annuitization. As we said, most annuities allow for a yearly 10 percent withdrawal of the account values without any penalties. However, contract owners can withdraw more than the 10 percent if they wish and are willing to pay any fees that might be imposed.
4. As a death benefit to the beneficiaries, assuming the annuity allows for that. If the death occurs after annuitization has occurred there may not be any funds available for beneficiaries under some of the annuitization options.

If the insured chooses to annuitize the contract, there is a table of guaranteed benefit rates in each annuity contract. Most companies have current rates that are greater than the guaranteed benefit rates.

Annuities have specified maturity dates. When an annuity reaches its maturity date, the contract may automatically expire or renew. Investors are given what is called a "window" to decide if he or she wants to renew or surrender the annuity. If it is surrendered during the window there is no surrender charge. If renewed, surrender and withdrawal charges could potentially begin again.

Annuitization Ramifications

Annuitization is the even distribution of both principal and interest or growth of the annuity over a specified period of time. That period of time is selected by the contract owner upon annuitization of the contract. He or she may select a specified time period, such as twenty years or a lifetime income. The payout option selected will impact any beneficiaries so it is important to understand all elements of the choice.

There is a distinct advantage to annuitization inasmuch as the disbursements are tax-favored. There would be no tax favor when withdrawals are sporadic. When the annuity contract is annuitized the owner chooses how he or she wishes funds to be paid out, such as monthly, quarterly, semi-annually or annually. Variable contracts and fixed rate contracts may both be annuitized.

There can be a disadvantage to annuitization: once the process begins it cannot be changed except in very rare circumstances. For variable annuities, the disadvantage is the lack of uniformity. Since it is a "variable" annuity, the payments are also "variable" because they are based on the results of the sub-accounts selected and the amount of money allocated to these sub-accounts. Variable annuities place the risk on the contract owner; fixed annuities place the risk on the issuing insurer. The more aggressively the money is invested, the less predictable the payout stream will be for variable annuities.

Many financial advisors feel fixed rate annuitization presents another disadvantage: the amounts of payout might depend upon the competitiveness of the issuing insurer. Some simply offer better products than others and by the time annuitization is right it is too late to shop around in many cases. Additionally, the amount received from the fixed rate annuity will depend upon the current market rates, the duration of the withdrawals (ten years, twenty years, lifetime, or whatever option is selected) and the principal amount to be annuitized. Obviously if too little is saved, the systematic payout will reflect that.

The **annuitant** is the person named as the insured in the annuity; it is this person whose life is measured for the purpose of determining how much may be received in the annuitization process. As previously stated, this is often called the **"measuring life."** Although it is possible to annuitize using the life of more than the annuitant, such as the joint-and-survivorship option, the majority of annuity vehicles are annuitized based on a single life.

It is very important to select the proper payout option to avoid later selection remorse. The lifetime payment option, for example, does not give unused funds to beneficiaries.

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 (401(k), 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 gave preferential treatment in respect to taxes that favorably affected 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 plan maintained by non-governmental tax-exempt entities, most notably charities and private universities. Government 457(b) plans are a type of tax-favored retirement plan.

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 they are distributed, these 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 January 1, 2006, a qualified plan or a Section 403(b) plan (not a governmental 457(b) plan) may allow employees who make salary reduction contributions to designate some or all of 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 the 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.

Annuitizing the Contract

Most annuities have several withdrawal or annuitization options. Most annuities will allow the investor to withdraw portions of his or her earned interest once or twice each year without actually annuitizing the annuity contract.

There are several annuitization options offered by most insurance companies. It is important to realize that not all companies will offer all options.

- **Life-time income**, which provides income *only to the annuitant*. It is often referred to as a **Straight Life Income option**. If the annuitant dies before all invested funds are collected, the insurer keeps any balances. There is no beneficiary designation because beneficiaries do not receive any leftover cash. This option is selected by those who want to maximize monthly income for their lifetime. It provides higher income than lifetime options containing "certain" periods (such as ten or twenty years). This should not be surprising since beneficiaries will not receive anything. This allows the insurer to provide higher systematic payout amounts.

- **Life-time and Period Certain**, which guarantees income for a specific time period selected by the annuitant. There are several time periods offered, such as 5, 10 or 20 years, plus a life-time income if the annuitant lives beyond the time period that is guaranteed. If the annuitant dies within the guaranteed period certain, his or her beneficiaries will receive the balance of that guaranteed time period. Only the annuitant can receive a life-time income; beneficiaries would receive nothing beyond the specified time period. This payout option will provide less income each month than the life-time option because there are beneficiaries listed that may receive income if the annuitant dies prematurely. These may also be called **Guaranteed and then for Life annuities**, but they are really a payout method rather than a type of annuity.

- **Period Certain**, (also called term payouts) which pay for the time period selected but stops paying once that point or term is reached. For example, if a twenty-year payout is selected, the annuity company will pay for twenty years only. Once that has been accomplished payments cease. These typically continue to pay beneficiaries according to the payout selected by the annuitant so if the annuitant selected a 10-year payout, died after receiving 7 years of income, the beneficiary would continue receiving the same income for the remaining three contract years. This option will pay more than the Life-time and Period Certain because the insurer knows it will not pay beyond the time period selected. These may be called Twenty Year Term annuities (or Ten Year Term, depending on the time period selected),

- **Lump Sum**, which is exactly what the name implies – the annuitant takes the entire amount in the annuity in a single lump sum payment.
- **Joint-and-Survivorship**, which covers the lives of two or more named individuals. These annuities are often used by married couples, but they can be utilized by any two or more individuals.

Agents and consumers will see payout options with a variety of names, but usually each type is more a description of the payout than a new type of annuity. Many of the other options have to do with additions added to the standard five payouts, such as an attached life insurance policy or inflation protection.

It is common to see annuity payout options listed as the annuity type. For example, a brochure may call an annuity a Guaranteed-and-then-for-Life annuity. This is actually the payout option described as the annuity. The annuity is a fixed annuity that will pay for a period certain and then for the lifetime of the annuitant if he or she lives beyond the time period selected. It could just as easily be called a Ten-Year Annuity or a Twenty-Year Annuity. It each case, however, it is actually a fixed rate annuity with a payout term of ten or twenty years.

How does the annuitant determine whether a life-time income (that pays less each month) or a specific term (that pays a higher amount each month) is the best selection? Since the retiree has no way to know how long he or she will live, it may be more a question of looking at the entire retirement income picture when making the decision. Many retirement specialists automatically favor a lifetime payout option since that ensures income up to the time of death and will also mean the highest amount of income each month if no period certain is attached. It is unlikely that monthly living costs will go down, so it is unlikely that less income will be needed in the final years of life. Obviously less income is what would result once a term annuity payout met the end of its term and stopped providing income. A lifetime annuity guarantees retirement income until death. On the other hand, family members are seldom happy to find out that there will be no inheritance if the retiree dies prematurely. No one likes knowing the insurance company will keep any remaining funds. Many annuitants end up selecting a life-time with Period Certain payout option to get life-time income while still guaranteeing either the annuitant or the beneficiaries will receive their investment principal. This option will pay less than the straight life-time option.

Annuities are designed for payout after age 59½ since the Internal Revenue Service considers them to be retirement designated vehicles. They may still be used for other goals, but primarily they are considered retirement vehicles. Although annuities were designed for payout, they are overwhelmingly used for accumulation. In other words, the majority of annuities are not annuitized (turned into an income stream). Instead most investors accumulate funds in their annuity, and then simply withdraw the entire value or exchange it tax-free for another annuity, with the accumulation process starting over again. Often annuities are simply left intact year after year, eventually going to heirs.

Even though many annuities are not annuitized, it is always important for agents 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).
>
> 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.
>
> Annie also begins receiving $1,000 per month on January 1 just as Alvin did. However Annie Annuitant lives to a very 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's 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 very 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 agents must be certain their clients understand the advantages and disadvantages of each payout option.

It is very 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 to be a human being under the settlement option, 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 policy. As previously discussed, annuities were designed to provide a systematic income at some point in time. When a policy owner annuitizes their contract, 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 equity indexed annuities 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 a 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 very important that annuitants and annuity contract owners realize that the lifetime income option does not consider beneficiaries. 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 will 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 will 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 agents and insureds should refer to their policy.

Specific Dollar Amount Annuitization

Although not very common, some contracts allow the contract owner to annuitize based on the specific dollar amount he or she requires each payment period, usually monthly. The length of payment will depend upon how far the amount of money in the annuity lasts. For example, if the contract owner wants to receive $5,000 per month, he or she will receive payments in that amount until the funds in the annuity are depleted. If it is depleted in five years, then that will be the length of payout. This type of payout is often selected when the annuitant is waiting for something else to begin, such as a pension plan.

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 their annuity into a new contract, which would meet mandatory distribution requirements of the contract but avoid any IRS penalties. If the annuity was 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.

As we continue to live longer we are justified in fearing we might run out of money before we run out of life. In other words, Americans are at risk for having too little money set aside for the last years of their life. As we continue to have smaller families we may not be able to count on our children to care for us both physically and financially in our last years. A major cost to our Medicaid system is nursing home care for our nation's elderly. As our senior Americans spend all they have, they must turn to Medicaid (which is basically medical welfare) for their health care needs. Few people are saving adequately for their retirement years so annuities, with lifetime annuitization options, make good sense.

Loan Provisions

While many insurance companies allow loans in their annuity products, but there are reasons an insurer might not. The primary factor discouraging annuity loans is the Internal Revue Service since they have persuaded Congress to enact legislation restricting the amounts and periods of policy loans. Additionally some companies require a certain minimum loan amount with a specified amount remaining in the vehicle after the loan is made. In other words, the annuity funds may not be depleted.

When loans are permitted, there may be some type of loan fee levied. Some companies do not charge investors who take out policy loans but this should never be assumed. Some contracts charge interest on the amount taken as a loan while other contracts charge nothing. Loan rates could be a flat fee or tied to some index rate. Most companies do not allow second loans unless the first is fully repaid.

Due to the potential of adverse tax and penalty consequences on annuity loans, prospective borrowers would be wise to contact a tax specialist first and it might even be best to seek other avenues of cash before turning to their annuity.

While loans from nonqualified annuity contracts are treated as taxable distributions, the loans from an annuity issued as part of a tax-favored retirement plan can be made on a pre-taxable basis if the loans are permitted under the plan and the loans satisfy IRS requirements.

As a general rule, loans are permissible if they do not exceed specific amounts. The loan must be repaid within five years and must be amortized in substantially level payments. There are exceptions for loans used to purchase a principal residence.

If IRS loan requirements are not met, the loan will be considered as a distribution for income tax and reporting purposes. When the participant's benefit is offset to repay the loan, the loan amount is called a **loan offset amount**.

Guaranteed Principal

Fixed rate annuities guarantee the annuity principal. This is a major reason investors purchase them. Annuities are an investment, issued by insurance companies that contractually guarantee all the premiums deposited into the annuity vehicle. Those premiums constitute the principal.

Actual contract guarantees depend on the contract purchased. Specific guarantees depend on the issuing insurance company, and the type of annuity chosen. There are three ways to categorize an annuity:

1. By type of annuity chosen (fixed or variable);
2. By the income desired (immediate or deferred); and
3. By how premiums are paid (single or flexible premium payments).

Fixed rate annuities have traditionally been considered very safe; they do not create exceptionally high gains but neither will they lose any principle. Fixed annuities are the safest of all the annuity types. Fixed equity indexed annuities represent moderate risk and variable annuities have the highest risk.

Fixed annuities guarantee the entire principal (all premiums paid in) plus the contractually guaranteed minimum rate of interest stated in the contract. Variable annuities, those representing the highest amount of annuity risk, will not have the same guarantees because performance is based on a specific stock index. Investors could lose if the market performs poorly.

An indexed annuity is different from other fixed annuities even though equity indexed annuities are fixed rate vehicles. Other fixed annuities credit a fixed rate of interest that the insurer guarantees. Indexed annuities credit interest using a formula based on changes in the performance of an equity, bond or commodity index. This formula determines how the interest, if any, is calculated and credited to the investor's annuity. Even so, the indexed annuity does offer a guarantee that a declared minimum interest rate will be credited on part of the initial premium if the investor surrenders the contract or if the index it is linked to performs poorly. However, unlike traditional fixed annuities, this guarantee is not necessarily credited annually. Many indexed annuities do not credit earnings until the surrender period ends.

Some indexed annuities guarantee the minimum value of the annuity will not be less than 87.5 percent of the premiums paid in plus at least 3 percent interest, less any partial withdrawals. Even if the investor surrenders the product, withdraws the full amount and pays any surrender penalties that are due, he or she will not receive less than the guaranteed minimum value. An indexed annuity with a minimum guaranteed surrender value of 87.5 percent of premiums credited with 3 percent interest would provide a return of 101.43 percent at the end of a six-year term (87.5%x1.03%x5). It would be higher for longer periods of time. If the investor surrendered such an annuity before the fifth year, however, he or she would receive less than the premiums paid for the contract – a loss in other words.

When it comes to equity indexed annuities, the floor is the minimum interest rate earned on the annuity. All indexed annuities have a floor of at least 0 percent (zero percent). This assures that even if the index decreases in value, the index-linked interest earned will be zero rather than a negative, preventing premium loss.

As we previously stated, an equity-indexed annuity is a fixed annuity, not a variable annuity. The investor deposits an amount of money, which the insurer will pay back to the investor at some future date, often through installment payments. It is possible to take a lump sum at contract maturity but that would make little sense. The point of an annuity is to provide income over a long period of time. Taking a lump sum would defeat that goal. Many annuities are never annuitized but they were designed with annuitization as the product's final phase.

Most equity-indexed annuities are a **declared rate fixed annuity**, 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 3 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 with past experience in the stock market.

While annuity contracts are not all the same, generally EIAs do not have internal expenses, meaning there are no fees, or front-end or back-end loads that could retard 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**.

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.

All EIAs 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. EIAs 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 investors.

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 well 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 principle 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.

Life Insurance

There are various types of life insurance. A whole life insurance policy, also referred to as permanent insurance, involves coverage effective for the entire life of the insured. It pays a death benefit when the policyholder dies regardless of his or her age. The contract provides a fixed amount of life insurance coverage and a fixed premium amount. Benefits are payable upon the death of the insured or on the maturity date (often the insured's 100th birthday). Coverage can increase only with the purchase of an additional policy or through additional riders or dividends, if offered. Coverage is for the life of the insured. Premiums are paid at a fixed rate throughout the insured's lifetime, if the policy remains active.

Cash values accumulate from premiums paid into the whole life policy and increases over the years. The earnings for tax purposes include only the amount accumulated in excess of the premiums paid. The policyowner may owe taxes on these earnings if he or she surrenders the policy. In most cases, the insured will not owe taxes on the earnings if he or she does not surrender the policy but it is always smart to check with a tax specialist.

Policies with cash values include provisions allowing the insured to take out loans on their policies for up to the cash value amount. The loans accumulate with interest but repayment is not necessarily required prior to death. If the insured dies and the loan has not been repaid, the amount owed plus interest will be deducted from the death benefits paid to beneficiaries.

Participating Whole Life

Some whole life policies are called "participating" or "par" policies. This means they earn dividends. Policy dividends can be taken in cash, used to pay premiums or used to buy more insurance. They are essentially refunds of excess premiums, so they are usually not taxable but as always, it is wise to check with a tax specialist.

A policy that is surrendered early, especially during the first or second, year, may not return any cash to the contract owner.

Interest Sensitive Whole Life

Interest sensitive whole life is also known as either *excess interest* or *current assumption* whole life. The policies are a mixture of traditional whole life with universal life features. Instead of using dividends to augment guaranteed cash value accumulation, the interest on the policy's cash value varies with current market conditions. Like whole life, death benefits remain constant for life. Like universal life, the premium payment might vary, but not above the maximum premium guaranteed within the policy.

Universal Life

Universal life is often thought to be a specific type of life insurance but in fact it is merely a variation of cash value contracts, in this case a whole life policy. This product is known for its flexibility. Universal life allows the insured to increase or decrease the “face amount” of the insurance, within policy limitations of course. If increasing the coverage, it may be necessary to prove insurability.

Policyholders can decide, within policy guidelines, on the amount of premiums and the schedule of payments. There may be limits on premiums because of tax laws however. Insureds may select a policy that is interest sensitive or one that has a guaranteed rate.

Universal life products are often used to meet various financial obligations, such as protection for family members in case of the insured’s premature death. Interest sensitive products put the least amount of risk on the insured.

Term Life

A term life insurance policy, as the name indicates, involves a “term” of death coverage. It covers the insured for a specified period of time (or term) and pays a death benefit only if the insured dues during that term.

Term life products do not provide cash benefits. Such products provide more life coverage per dollar than do cash value products because all premium dollars go to the coverage rather than cash reserves. Benefits will be paid only if the insured dies during the coverage period. Once the policy period ends, all contractual guarantees end also. This is the type of life insurance traditionally recommended for young families that need lots of coverage but cannot afford a large premium.

Indexed Life

Indexed life is a policy with a face value that varies according to a prescribed index of prices; otherwise benefits provided are similar to ordinary whole life. The death benefit is based on the particular index, such as the Consumer Price Index (CPI). The policyowner has the choice of having the index applied either automatically or on an elective basis. With an **automatic index** increase, the premium remains level since it has already been loaded to reflect the automatic increase. If the policy allows for an **optional index increase**, an extra premium is charged when this option is exercised by the policyowner. Regardless of which index is selected (automatic or optional) the increased death benefit does not require another physical examination or other evidence of insurability.

Equity indexed life insurance, like all permanent life insurance, generally offers three distinct tax advantages that in combination are not found in any other insurance or cash accumulation product. These include:

1. Tax deferred accumulation of cash values;
2. Potential for tax managed income for retirement or other goals; and
3. Tax free proceeds transferable at death.

Equity indexed universal life insurance offers a unique combination of affordable life insurance with the ability to accumulate cash values that grow with the upward movement of a stock index without the normal downside risk associated with the equities market. Combine the benefits of upside cash value growth potential with the tax deferred benefits associated with life insurance and a minimum guaranteed interest rate and buyers have an optimum vehicle for accumulating cash.

Whether the individual's objective is to obtain a flexible low cost life insurance policy, to maximize retirement income in the most tax efficient way or to provide liquidity in estate planning, equity indexed life insurance can help meet goals in many cases.

Variable Life Insurance Products

There are two kinds of variable life products: scheduled premium variable life, with set payment times and amounts and flexible premium variable life insurance that allows changes in payment time and amount. An individual who sells variable life products, whether it happens to be life insurance or annuities, must typically be registered as a representative of a broker-dealer that is appropriately licensed and registered. Of course he or she must also be a licensed insurance agent.

Variable Life

Variable life is defined as a form of permanent life insurance that has both a death benefit as well as an investment component called a "cash value." Policy owners have the option of investing a percentage of their insurance premium in an investment account. This percentage can be invested in bonds, stocks, money market funds and other securities in the insurer's portfolio, thereby building a cash value in the life insurance policy. There is a definite element of risk to this option, because the policy's face value at any moment depends on how successfully these investments are performing.

Like other cash-value policies, the policy can accumulate a substantial cash value over time. With this benefit comes the risk that if the investment component performs poorly, the cash value and/or death benefit will shrink proportionally.

The policy owner can borrow the accumulated funds without having to pay any taxes on the borrowed gains. So long as the policy remains in force, he or she does not need to actually repay the borrowed funds, although there may be interest charged on the policy's cash value account.

Another benefit of the variable life policy is that the policy owner can apply their gains toward paying premiums, which may lower the amount he or she has to pay out-of-pocket. On the other hand, if the invested funds don't perform successfully, the policy owner may have to pay more out-of-pocket in order to keep the policy in force.

Variable Universal Life

Variable Universal Life Insurance (often shortened to VUL) is a type of life insurance that builds cash value. In a VUL, the cash value can be invested in a wide variety of separate accounts, similar to mutual funds. The policyowner may choose from the available separate accounts when investing. The "variable" component in the name refers to this ability to invest in separate accounts whose values vary; they vary because they are invested in stock and/or bond markets. The "universal" component in the name refers to the flexibility the owner has in making premium payments.

The premiums can vary from nothing in a given month up to maximums defined by the Internal Revenue Code for life insurance. This flexibility is in contrast to whole life that has fixed premium payments that typically cannot be missed without lapsing the policy (although the policy owner may exercise an Automatic Premium Loan feature, or surrender dividends to pay a Whole Life premium).

Variable universal life is a type of permanent life insurance because the death benefit will be paid if the insured dies any time as long as there is sufficient cash value to pay the costs of insurance in the policy. With most if not all VULs, unlike whole life, there is no endowment age (which for whole life is typically 100). Some professionals consider this an important advantage of VUL over Whole Life, but not all agree with this assessment.

With a typical whole life policy, the death benefit is limited to the face amount specified in the policy, and at endowment age, the face amount is all that is paid out. Therefore, with either death or endowment, the insurance company keeps any cash value built up over the years. However, some participating whole life policies offer riders that specify that any dividends paid on the policy be used to purchase "paid up additions" to the policy which increase both the cash value and the death benefit over time. With a VUL policy, the death benefit is the face amount plus the build up of any cash value that occurs (beyond any amount being used to fund the current cost of insurance.)

If investments made in the separate accounts out-perform the general account of the insurance company, a higher rate-of-return can occur than the fixed rates-of-return typical for whole life. The combination over the years of no endowment age, continually increasing death benefit, and if a high rate-of-return is earned in the separate accounts of a VUL policy, this could result in higher value to the owner or beneficiary than that of a whole life policy with the same amounts of money paid in as premiums.

Indexed Life and Indexed Annuities

When two products share the same characteristics, there will certainly be similarities, in this case indexed annuities and indexed life insurance.

Introduced in 1995, equity indexed products are relatively new to the financial services world. Purchasing equity indexed products, however, first means understanding what they are, how they are designed to work and for whom they are tailored.

The most significant advantage of Equity Indexed Life Insurance (EIL) is that it combines most of the features, benefits and security of traditional life insurance with the potential to earn interest based on the upward movement of an equity index. Instead of the Company declaring a specific interest rate or dividend as with traditional life insurance, interest earnings are credited based on increases in value of a specific equity index. The Standard & Poor's 500® Composite Stock Price Index* (excluding dividends) is used as the index for Indianapolis Life's EIL products. The S&P 500 Index is currently the most commonly used index for EILs. Credited interest is linked to increases in the S&P 500 Index without the downside risks associated with investing directly in the stock market. Because EILs are permanent life insurance plans, they provide features which give you a sense of stability through:

- A guaranteed minimum interest rate;
- Tax-deferred interest accumulation; and
- Access to cash value through withdrawal and loan provisions.

In addition, the equity indexed link in EIL products offers important benefits:

- Equity index-linked returns with the potential to beat inflation, and
- Protection in the contract against downside market risk.

Basic Interest Crediting Strategy

Net premium is initially paid into the Basic Interest Strategy, from which insurance and administrative charges and policy expenses are paid. This strategy earns interest (as declared by the company) and, as long as premiums continue, certain amounts will be held in this crediting strategy to cover future insurance and administrative charges. The premiums in the Basic Interest Strategy will earn an interest rate, which may fluctuate on a daily basis, but will never be less than the minimum rate guaranteed in the contract. The investor elects how the excess Basic Interest Strategy values will be directed to the other available strategies.

Five-Year Fixed-Term Interest Strategy

Each premium directed to this strategy creates a distinct fixed-term segment. Over time, the investor will generally have a number of fixed term segments within the plan. The interest rate for the Five-Year Fixed-Term Strategy is not guaranteed.

Five-Year Equity Indexed Strategy

In this strategy, interest earnings are linked to growth in the S&P 500 Index (excluding dividends) and are subject to a participation rate that is guaranteed to be 100 percent for the life of the contract, with a maximum earnings rate that can change annually for each segment. In addition, the Five-Year Equity Indexed Strategy will include additional features, such as principal protection and lock-in of earnings.

Principal Protection

Under principal protection, if the principal is protected the premiums directed to the Equity Indexed Strategy will be protected from downturns in the index.

Annual Lock In of Earnings

Annual earning lock-ins provides the investor with protection he or she might not have otherwise. Generally, index linked interest earnings are calculated and credited periodically on the funds in a segment. In effect, the insurer locks in any index-linked interest earnings every 12 months within a segment and protects them from potential future downturns in the equity index.

Interest Rate Guarantee

Each five-year segment has a minimum guaranteed interest rate. Interest is credited at the end of the five-year segment under this guarantee if the value of the segment at that time is not at least equal to the premium (less any withdrawals or deductions) compounded annually at the minimum guaranteed interest rate.

Guarantees Among Strategies

Companies will offer various strategies, with Basic Interest, Five-year Fixed Term and Five-year Equity Indexed strategies being common. Each strategy and each segment within that strategy, works independently from other strategies and segments.

Basic Interest Strategy

The credited interest rate for this strategy may change periodically with market conditions. This rate will never be less than the minimum stated in the contract.

Five-Year Fixed-Term Strategy

The credited interest rate for a segment within this strategy is set when the segment is created. This rate will never be less than the minimum stated in the contract.

Five-Year Equity Indexed Strategy

Credited interest earnings for this strategy are usually linked to the performance of the S&P 500 Index. If the S&P 500 Index is flat or declines when measured at the segment anniversary, zero percent will be credited to the segment for that year. At the end of an Equity Indexed Strategy segment's five-year term (or when the contract terminates if different), the insurer will credit any additional interest needed to increase the value of the segment at that time to at least the premium (less any withdrawals or deductions) compounded annually at the minimum interest rate guaranteed in the contract.

Equity Indexed Life Insurance Loans/Withdrawals

When properly structured, the cash accumulation in a cash-value life insurance policy can be accessed through policy loans or withdrawals on a tax-free basis under current tax laws. Equity index life insurance may be the fastest growing type of universal life insurance because cash in the policy is credited interest based on stock market performance with no risk of declines.

Most equity indexed universal life insurance (EIUL) policies credit interest based on the performance of the S&P 500 index (or some other major market index or indexes) subject to a cap on annual crediting (usually stated in the contract) as well as a floor of interest credits (usually 0%-2%) when the index itself has a negative performance. So when the index performs positively but below the cap, the cash in the policy will be credited with that same amount of interest. If the index performs better than the cap, the policy would be credited with the interest amount subject to the cap. In years when the index is negative, the policy would be credited with the "floor" amount of interest but the cash accumulation does not go backwards due to the negative performance.

In 2008, when the S&P 500 index lost some 37 percent, investors in indexed life products were credited with zero interest so there were no earnings, but neither were there principal losses. Zero growth is easier to live with than principal loss.

One reason for the shift towards some types of equity indexed universal life insurance is that (just like ROTH IRAs) there are no minimum required distributions. Perhaps more importantly, regardless of one's income level, the insured can fund a policy to almost any amount of money that they wish to. For those who earn more than the ROTH income limits allow, as well as those who don't want to be limited in their annual retirement funding, just about any amount of money may be deposited into the policy for retirement. Of course, it is always wise to seek the opinion of a tax specialist.

It should be noted that we are not recommending life insurance products for retirement funding; there are many good vehicles for that purpose. Life insurance should always be used for its intended purpose: protection against premature death. However, for some individuals, equity indexed life policies have a place in his or her overall portfolio.

Equity indexed policies come with a death benefit, as all life insurance policies do. Some policies structure the contract for cash accumulation, but purposely minimize the death benefits to the lowest level the IRS allows to keep the policy mortality charges as low as possible. If the insured dies prematurely the death benefit could be substantially greater than the cash in the policy. Some professionals consider this an advantage of the life insurance policy over a ROTH, but not all agree. Each product has a place in retirement planning if appropriately used.

Similarities

The obvious similarity between indexed life and indexed annuities is the fact that both use an index to determine growth. Both the life insurance and the annuity will have the potential of additional growth if the index on which the product is based does well in the financial markets. On the other hand, if the markets perform poorly, there are contractual guarantees that protect the principal, assuming the product is not surrendered early and that early withdrawals have not been made.

Differences

Of course, there are basic differences between life insurance and annuities; these differences will appear in indexed products just like they would in other types of life and annuity products. Simply stated, an annuity is a vehicle designed for living while a life product is designed for premature death. One pays the contract owner during his or her life and the other pays following his or her death. The annuity is designed to prosper the insured while he or she lives and life insurance is designed to prosper the beneficiary following the death of the insured.

Indexed annuities are taxed as ordinary income while indexed life is taxed based on life insurance tax laws. Some consider the taxing of annuity earnings in general to be a disadvantage. Crediting caps on equity index annuities are generally much lower as well than on the index life insurance. Most caps on these types of annuities are about half of what the EIUL policies offer, and annuities don't get the additional benefit of tax-free access to the earnings.

Paying for the Life Insurance Contract

Single Premium

A Single Premium universal life policy (UL) is paid for by a single, substantial, initial payment. Some policies do not contractually allow more than the one premium, and some policies are casually defined as single premium because only one premium was intended to be paid, even though more premiums will be accepted. The policy remains in force so long as the Cost of Insurance (COI) charges have not depleted the account. These policies were very popular prior to 1988, as life insurance is generally a tax deferred plan, and so interest earned in the policy was not taxable as long as it remained there. Further withdrawals from the policy were taken out principal first, rather than gain first and so tax free withdrawals of at least some portion of the value were an option. In 1988 changes were made in the tax code, and single premium policies purchased thereafter were Modified Endowment Contracts (MEC) and subject to less advantageous tax treatment. Policies purchased previous to the change in code are not subject to the newer tax law unless they have a “material change” in the policy (usually this is a change in death benefit or risk). It is important to note that a MEC is determined by total premiums paid in a seven-year period, and not by single payment. The IRS defines the method of testing to determine whether a life insurance policy is a MEC.

In a MEC, the premiums and accumulation will be taxed just like an annuity upon withdrawal. The accumulations will grow tax deferred and will still transfer tax free to the beneficiary under Internal Revenue Service Code 101a under certain circumstances.

Fixed Premium

A Fixed Premium UL is paid for by periodic premium payments associated with a no-lapse guarantee in the policy. Sometimes the guarantees are part of the base policy and sometimes the guarantees are an additional rider to the policy. Generally, these payments will be for a shorter period of time than the policy is in force. For example, payments may be made for 10 years, with the intention that thereafter the policy is paid-up. It can also be a permanent fixed payment for the life of policy.

Since the base policy is inherently based on cash value, the fixed premium policy only works if it is tied to a guarantee. If the guarantee is lost, the policy reverts to its flexible premium status and may no longer be sufficient to keep the coverage active. If the experience of the plan is not as good as predicted, the account value at the end of the premium period may not be adequate to continue the policy as originally written. In this case, the policyholder may have the choice to either:

1. Leave the policy alone, and let it potentially expire early (if COI charges deplete the account), or
2. Make additional or higher premium payments, to keep the death benefit level, or
3. Lower the death benefit.

Many universal life contracts taken out in the high interest periods of the 1970s and 1980s faced this situation and lapsed when the premiums paid were not enough to cover the cost of insurance.

Flexible Premium

Flexible Premium UL allows the policyholder to vary their premiums within certain limits. Inherently UL policies are flexible premium, but each variation in payment has a long-term effect that must be considered. In order to remain active, the policy must have sufficient available cash value to pay for the cost of insurance. Higher than expected payments could be required if the policyholder has skipped payments or has been paying less than originally planned. It is recommended that yearly illustrative projections be requested from the insurer so that future payments and outcomes can be planned.

Premium Load

A premium load is a monetary amount deducted from each life insurance premium payment, which reduces the amount credited to the policy.

No-load policies allow cash values to accumulate faster inside the policy because of their lower cost. However, although its lower cost allows no-load life insurance to provide an affordable alternative to lower-income policyholders, carriers of no-load policies should be examined for financial stability. No-load policies typically offer very little in the way of customer service since they have less money to contribute to wages and other costs of running their business.

"No-load" or "low-load" life insurance policies have fewer expenses built into them, such as agent commissions and fees, than other life insurance policies. This can mean low cost life insurance. For variable life insurance, these lower expenses mean a higher percentage of the premium goes to work for the investor right away, allowing him or her to build cash values quicker.

Not many companies sell no-load or low-load policies. No-load policies can be purchased mainly through financial advisors who charge flat fees rather than collecting commissions from insurance companies. Such policies may not be available in all states.

Monthly Life Insurance Deductions

The cost of a life insurance policy is determined by the insurer, which calculates the policy prices based on anticipated claims to be paid and administrative costs. Obviously, the insurer wishes to make a profit in the process. The cost of insurance is determined using mortality tables calculated by actuaries. Actuaries are professionals who employ actuarial science based on probability and statistics. Mortality tables are statistically based tables showing expected annual mortality rates to determine life expectancy estimates.

In the past, the three main variables in a mortality table have been age, gender, and use of tobacco products in some way. More recently in the US, preferred class specific tables were introduced. The mortality tables provide a baseline for the cost of insurance. Other life style habits are included when an individual applies for a life insurance policy, such as whether they exercise or keep their weight within recommended guidelines. Mortality tables used in conjunction with health and family history determine premiums and insurability.

When a person buys a life insurance policy, his or her premium and the cash value of the policy can be affected by a wide variety of fees and charges. These are often referred to as the "load" with some policies considered "low-load" because the fees and commissions paid by the investor are relatively low. Other life insurance policies might be considered "high load" because the commissions, administration fees and other charges are higher than other product types.

Certainly agents must become familiar with policy charges and fees associated with the products they offer. It is also important to know how and when these expenses are charged; some are deducted from the premium payment and others are deducted from the policy values.

Insurance agents, brokers and other investment professionals earn their money three ways:

1. **Commission:** Money paid to the agent for selling you the policy, which is usually calculated as a percentage of the premium
2. **Fee-based:** When life insurance salespeople or brokers charge a flat fee for their services
3. **Fee plus commission:** Occurs when you pay a fee to meet with an investment professional and a commission if you purchase a product they've recommended

According to the Insurance Information Institute, most agents and brokers are paid by commission but some also work on a fee basis. No matter how one is paid, however, it is their responsibility to know the products being recommended.

The agent's commission is just the beginning of the fees and charges that go into a life insurance policy. Here is a breakdown of some additional charges that may be in a policy:

- **Administration fees:** The amount deducted from the policy to pay for the marketing, accounting and record-keeping expenses associated with the policy. Administration fees usually are deducted from the policy value once each month.
- **Mortality and expense risk charges:** This compensates the insurance company for the risk it assumes. For example, there is a risk that the insured individual might pass away sooner than the insurer anticipated.
- **Cost of insurance:** This actual cost of insurance protection is based on the insured person's age, gender, health and the amount of the death benefit.
- **Surrender charges:** The amount deducted from cash values if the insured cashes in or surrenders the policy early, while the surrender charge period is in effect. The amount varies among insurance companies, but in many cases the amount of the surrender charge drops annually until it disappears altogether
- **Monthly per thousand charge:** Although there may be variations, this monthly fee is based on the insured person's age, gender and underwriting classification.
- **Fund management fees:** These are paid to investment fund managers for selecting investments, and doing all the paperwork needed. The fees are typically taken from the price paid for the shares of underlying fund options, not from the investor's cash values. Fee amounts vary by company.

Some insurance companies prefer investors to pay their life insurance premiums annually (once per year) and give a discount for doing so. If it is difficult for the policy owner to budget for one large payment, preferring to pay monthly or quarterly, he or she may face what is known as a "**fractional premium**" or "**convenience charge**" added on to monthly, quarterly, or semi-annual payments. The amount, like many fees, varies by company.

Bands in Life Insurance Policies

There are premium bands or groupings that almost all life insurance companies use. This creates pricing issues that agents may not be aware of. Certainly consumers are unlikely to be aware of them. These bands vary by the type of policy as well as company. They are most prevalent in term insurance policies.

Life insurance companies band premiums by policy size. An example of banding would be:

- Band 1: $100,000-$249,99.
- Band 2: $250,000-$499,999.
- Band 3: $500,000-$999,999.
- Band 4: $1 million and above.

The premium per $1,000 of coverage decreases as the amount of coverage purchased moves into the higher bands. Consider it similar to buying in bulk at the local warehouse store. The previous example is not necessarily exact to any particular company.

Similar to Break Points

Most people are more familiar with mutual funds than insurance premium methods. Think of premium bands as break points. With 'load' funds the consumer pays a sales charge - usually at purchase. The most popular and widely used 'load' funds are called "A" shares. These have the highest upfront load with the lowest annual expenses. The typical upfront load for "A" shares is 5.75 percent of the purchase price. As a person buys or owns larger quantities of "A" shares within a mutual fund family the investor receives a discount, or reduced load.

Life insurance companies work much the same way. As the buyer purchases larger amounts of insurance he or she qualifies for reduced rates. However, life insurance is not as clear cut as mutual funds in that premiums within each band vary by gender (male/female/unisex), issue classification, issue age and policy year.

How does this affect the insured? If the insured is nearing a band then it will most likely be cheaper to purchase a larger amount of insurance. From the example of bands above, it is probably cheaper to purchase $100,000 of coverage rather than $87,000 for example. It is also probably cheaper to purchase $250,000 of coverage than $229,000.

Consumer Awareness

It is important to understand the depth of understanding your insurance buyer has. As we know, equity indexed products are complex, but it applies to other areas as well. Even calculating the amount of insurance an agent feels his client needs must be understood. A confused person may not buy a product, or even if he buys it, may not keep it long term.

When determining an amount of insurance, if a calculator is used be prepared to round up or down as needed and explain why this is significant to the insurance buyer. If the number comes up as $962,000 for example, understanding banding will help the buyer decide the actual amount of insurance he or she may want to purchase, going up or down as needed. When a company is being chosen, part of the decision might even involve how they band their life insurance and the costs in relation to the amount of insurance it purchases. It is sometimes more important to understand where a company's bands are than some other features. In the case of our $962,000 example, if the company has a band at $1 million of coverage then it will most likely be cheaper to purchase $1 million of coverage than to buy less.

Policyholder Risk

Interest Rate Risk

UL is a complex policy with risk to the policyholder. Its flexible premiums include a risk that the policyholder may need to pay a greater-than-planned premium in order to maintain the policy. This can happen if the expected interest paid on the accumulated values is less than originally assumed at purchase. This happened to many policyholders who purchased their policies in the mid 1980's when interest rates were very high. As the interest rates lowered, the policy did not earn as expected and the policyholder was forced to pay more to maintain the policy. If any form of loan was taken on the policy, this may have caused the policyholder to pay greater than expected premiums because the loaned values were no longer in the policy earning income. If the policyholder skipped payments or made late payments, it was possible that premiums had to be made in later years to make up for the shortage. Market factors relating to the 2008 stock market crash adversely affected many policies by increasing premiums, decreasing benefits, or decreasing the term of coverage.

No Lapse Guarantees or Death Benefit Guarantees Risk

A well informed policyholder should understand that the flexibility of the policy is tied irrevocably to risk to the policyholder. The more guarantees a policy has, the more expensive its cost. With UL, many of the guarantees are tied to an expected premium stream. If the premium is not paid on time, the guarantee may be lost and cannot be reinstated. For example, some policies will offer a "no lapse" guarantee, which states that if a stated premium is paid in a timely manner, the coverage will remain in force, even if there is not sufficient cash value to cover the mortality expenses. It is important to distinguish between this **no lapse guarantee** and the actual **death benefit coverage**. The death benefit coverage is paid for by mortality charges (also called cost of insurance). As long as these charges can be deducted from the cash value, the death benefit is active. The "no lapse" guarantee is a safety net providing coverage in the event that the cash value isn't large enough to cover the charges. This guarantee will be lost if the policyholder does not make the premium as agreed, although the coverage itself may still be in force. Some policies do not provide for the possibility of reinstating this guarantee. Sometimes the cost associated with the guarantee will still be deducted even if the guarantee itself is lost (those fees are often built into the cost of insurance and the costs will not adjust when the guarantee is lost). Some policies provide an option for reinstating the guarantee within certain time frames and/or with additional premiums (usually catching up the deficit of premiums and an associated interest). No Lapse guarantees can also be lost when loans or withdrawals are taken against the cash values.

Withdrawals

Most Universal Life Policies come with an option to withdraw cash values rather than take a loan. The withdrawals are subject to contingent deferred sales charges and may also have additional fees defined within the contract. Withdrawals will permanently lower the death benefit of the contract at the time of the withdrawal.

It is important to understand how withdrawals from any cash value life insurance policy affects the contract. While cash shortages can be difficult to weather, removing life insurance policy cash values is not always the best answer, since taking money from a policy could leave beneficiaries short on funds if the insured dies after a withdrawal has been made. Other avenues should first be explored.

When polies have cash values available, there are four ways to obtain it: cancel the policy leaving no protection for beneficiaries, withdrawing funds (as we are talking about in this section), borrowing funds which will be repaid at some future time, and paying only the premiums from the existing policy. Using cash values only to keep the premiums paid is often the least damaging and could reduce monthly expenditures enough to allow the policyowner to financially recover.

Withdrawals are taken out of premiums first and gains second, so it is possible to take a tax-free withdrawal from the values of the policy (this assumes the policy is not a MEC). Withdrawals are considered a material change and cause the policy to be tested for MEC. As a result of a withdrawal, the policy may become a MEC and could lose its tax advantages.

Withdrawing values will affect the long-term viability of the plan. The cash values removed by loan are no longer earning the interest expected, so the cash values will not grow as expected. To some extent this issue is mitigated by the corresponding lower death benefit. Policyholders need to fully understand what a withdrawal from a life insurance policy means, which is sometimes shown with an illustration at the time of the withdrawal request by either the insurer or the insurer's representative.

Life insurance should never be considered a source of cash. The point of life insurance is to protect the listed beneficiaries. When values are withdrawn, beneficiaries may have less protection than originally intended. Policyowners should always explore other options, using life insurance values only as the last option. Since the policy may lose tax advantages withdrawing funds are seldom a good choice.

Collateral Assignments

Collateral Assignments will often be placed on life insurance to guarantee the loan upon the death of a debtor. If a collateral assignment is placed on life insurance the assignee will receive any amount due to them before the beneficiary is paid. If there is more than one assignee, the assignees are paid based on date of the assignment. In other words, the earlier assignment date gets paid before the later assignment date.

Bucket Investing

In some years, such as 2007 and 2010, we witnessed significant and historic market fluctuations. There is little doubt that many investors re-thought their portfolios and strategies. Not everyone worried, however. Some people felt their investing strategies would withstand the variances.

There are ways to ease people's negative emotional reaction to their financial situation when there is market volatility, including diversification, proper income planning, and a "buckets of money" strategy. Essentially "bucket planning" requires educating investors on having at least four different buckets of money:

- One for immediate income and
- Three others that grow and provide income down the road.

At least one of the buckets should be guaranteed income that the client cannot outlive. Ideally it would also pass any remaining money on to children, grandchildren, or charities. As it relates to annuities, the lifetime income option will provide income that cannot be outlived but it will *not* pass anything on to beneficiaries.

Despite market declines when investments are properly diversified, there will be some measure of market protection; although no investment is completely guaranteed since inflation can erode even a good investment. A good bucket strategy can be the difference between a significant decline and increases in the investor's portfolio.

When multiple annuities are used in diversification, it is often called **laddering**. Laddering is the technique used in investments where the investors purchase multiple financial products at a time that have separate maturity dates. Since they mature at different times, the investors have continual income, often without utilizing lifetime income options. Because lifetime income payout options are not used, beneficiaries will receive any left-over funds.

"Laddering" or "Buckets of Income"

There are multiple bucket strategies, and every investor or financial planner will probably have his or her favorites. It is important to differentiate one strategy from another.

One type might be referred to as the "buckets of income" strategy. This strategy involves using four different fixed or fixed indexed annuities, all with unique terms and benefits. This means the investor is unlikely lose money, is always gaining money, and will always have guaranteed income. The mainstream media has caught wind of this strategy, so readers are able to read additionally on the subject. For example, Kiplinger's Personal Finance magazine ran an article on bucket strategies in its November 2009 issue. As a result, many people are curious to see what utilizing this type of strategy could mean for them.

One way to understand this approach is to think of a well for obtaining water. It is a well that is always providing water, and, if set up properly, the water automatically flows right to the investor and never runs dry. The buckets represent stages in the investor's life, with a bucket of money for each stage. If appropriately funded, the water never runs out.

The main goal is to provide the investor with an annual stream of income for 15 years. At the end of that 15-year period, the final bucket still contains an income account with a value equal to or greater than the total amount the investor began with. The final bucket is always built with a guaranteed income withdrawal benefit option to carry the investor the rest of the way (to his or her death). This will help investors enjoy a predictable and guaranteed yearly income.

It is important to utilize annuities from highly rated and quality insurance companies, (which may not be the ones that pay the highest commissions). A wise agent or financial planner will always put the client first and their commissions second. Investors will be less likely to worry about their retirement income vanishing due to market shrinkage and agents will know the likelihood of lawsuits will be lower when proper investment tools have been put in place.

Some people like the water wheel analogy. The first bucket in the wheel is pouring out water (income). There are more buckets right behind the first one and they are continuing to fill up, preparing to pour water (income) once the first bucket empties. This example shows there is constant motion and consistent and predictable cash flow as one bucket empties and another full bucket follows behind it.

As we know, some investors have a greater risk tolerance than others and are willing to take more of a gamble than others. For those willing to dabble in risk, it is often recommended that they create four or five buckets, with a couple of the later buckets reserved for accounts with some risk attached. When risk vehicles are utilized it is best not to depend on the income they hold, at least no totally. There should be other funds to back the "risk buckets" up in case they do poorly, perhaps even losing principal.

Because each client is different, agents must problem-solve in order to help their clients build, preserve, and transfer their wealth in the way desired, with the goal of having the money they need, when they need it. Multiple types of investment vehicles will likely be used, including IRAs of various types (especially Roth IRAs), annuities, probably some life insurance to protect those who need financial protection, employer-sponsored plans if they exist, plus any other type of vehicle that is appropriate.

Strategy Development

There will always be different views on investing. The "bucket" strategy was developed in most cases by examining a variety of fixed indexed annuities and comparing the results to the S&P 500. Other investments must also be considered for appropriate diversification. Many fixed indexed annuities perform quite well. In fact, they tend to do as well or better than the other alternatives often considered for investing, but often without the level of risk. Many industry professionals feel has been backed up by a recent Wharton School of Business study titled, "Un-Supermodels and the FIA - Guaranteed Living Income Benefit Insurance Products," by Dr. David F. Babbel.

Strategies for Buying Equity Indexed Universal Life Insurance

With equity indexed universal life insurance, a clear strategy, or policy objective, should always be identified before making any purchase. Premiums for all universal policies are flexible, so the policyholder's objective has a significant impact on how the policy is funded. There are a number of different strategies for buying an indexed universal life policy including paying the minimum premium, paying the no-lapse premium to guarantee the policy for the insured's lifetime, or paying the maximum premium, also known as **over-funding**. The strategy selected will be determined by the investor's personal goals and objectives, but the strategy most effective for equity-indexed universal life insurance is the retirement income strategy or over-funding strategy.

Over-funding an Equity Indexed Life Policy

To "**over-fund**" an indexed universal life insurance policy means to maximize the policy's cash value growth potential and minimize its net insurance costs over time. When the maximum premium is paid into the policy, cash values grow faster so it leverages the net amount of life insurance at risk. The net amount of life insurance at risk is the difference between the actual face amounts of the policy less the current cash value. *With all universal life policies, insurance costs are calculated based on the amount of life insurance at risk at any given point in time.* As the net amount of insurance at risk decreases, the costs of insurance decrease and a higher portion of the premium payment can be directed to the indexed account. By over-funding the policy, cash values can leverage the cost of insurance thereby maximizing the cash value growth potential.

The Internal Revenue Code and Over-funding Life Insurance

To better grasp the powerful concept of over-funding a life insurance policy, one must clearly understand the IRS regulations that must be met to avoid unnecessary taxation. Some of the legislation affecting the strategy of over-funding indexed universal life includes Internal Revenue Code Section 7702A, the Deficit Reduction Act of 1984 (DEFRA), and the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).

Internal Revenue Code Section 7702A describes the seven-pay test requiring that cumulative life insurance premiums over any seven-year period cannot exceed the seven-pay premium limitation. The seven-pay premium limitation is the maximum cumulative gross premium payment over any seven-year policy period. Seven-pay premiums are calculated based on the specific insurance company's cost structure and the insured's age, health class, sex and benefit amounts. If the policy is over-funded up to or within the seven-pay premium requirements, then it will meet the Internal Revenue Code and policy cash surrender values may be accessed at any time tax-free. If premiums exceed the seven-pay test maximum, the life insurance policy becomes a modified endowment contract (MEC) and may incur taxes on distributions of cash values.

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA)

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) first defined a modified endowment contract (MEC) as a life insurance policy that fails to meet the premium limitations established under the seven-pay test. Once a policy is classified as a MEC, any policy cash value distribution above the policy's premium basis will trigger a taxable event which includes a 10 percent penalty tax on any gain received prior to the policy holder's age 59½. The policy's premium basis is usually the sum of all premium payments less any dividends received. Policy distributions are any surrenders, withdrawals or policy loans. The intention of over-funding any universal life policy is to access cash values at some point in the future, so a MEC should be avoided at all costs with this strategy.

The Deficit Reduction Act of 1984 (DEFRA)

The Deficit Reduction Act of 1984, DEFRA, sets the minimum policy death benefit based on the sum of the premiums paid and the age and gender of the insured. Sometimes referred to as "the cash value corridor test" or "guideline premium test" this requirement in effect limits the amount of premium payments for a given minimum face amount of insurance. Complying with DEFRA limitations is required for a policy to maintain its status as life insurance. If over-funding an indexed universal life policy is a strategy being considering, DEFRA will in effect establish the minimum death benefit based on any maximum premium payment.

How to Over-fund Equity Indexed Universal Life Insurance

Over-funding is a life insurance cash accumulation strategy that leverages the maximum allowable policy premiums with the smallest life insurance death benefit to achieve highest return on premium payments net of policy costs over a given time period. There are essentially three steps to determining the combination of maximum premiums and minimum death benefits necessary to selecting the most leveraged indexed universal life policy:

1. The first step is to determine the maximum premium commitment over the given time horizon. The premium amount selected should be an amount the buyer can consistently and easily make without interruption. Universal life insurance polices offer the capability for flexible premium payments, but to get the maximum leverage the buyer must stick to his or her premium commitment for a given face amount of insurance.
2. Secondly, the buyer must determine the minimum insurance face amount for the DEFRA commitment and age and gender. The insurance company's sales illustration will provide the actual premium amount limits that meet the DEFRA minimum requirements.
3. Finally, determine the maximum premiums allowable under Internal Revenue Code 7702A and the TAMRA seven-pay premium limitation. As long as the total premiums or any seven-year period are equal or less than the maximum allowable premium for the seven-pay test, cash surrender values may be accessed ay any time tax-free.

Once each of the IRS regulations above are met, the maximum premium allowable for the minimum death benefit is defined and the equity indexed universal life policy can be constructed with the optimum policy premium for the over-funding strategy. By choosing the over-funding approach, a policy holder can take complete advantage of all tax advantages of the life insurance policy and with reasonable index interest credits accumulate a significant cash value that may be accessed in retirement tax-free.

Like annuities, equity indexed universal life insurance policies should be considered a long-term strategy. Because of the insurance costs and expenses associated with buying equity indexed universal life policies and the likely fluctuations in indexed interest credits, the time horizon for growing and accessing cash values should be at least ten years or longer. It will take some time for the leveraging effect to reduce the costs of insurance and thereby increase the net rate of return on policy premiums. Keep in mind, policy costs are a necessary evil to maximize tax advantages and the bottom line is return over time on the premium payments.

Monthly Deductions

All monthly policy deductions are first deducted from the basic interest strategy. If sufficient values are not maintained in the basic interest strategy, deductions are next taken from the five-year fixed term strategy. Deductions are made starting with the most recently established segment to the oldest segment, then from the five-year equity indexed strategy segments in order of the most recent to the oldest. If sufficient plan values are still not available and any minimum premium requirements have not been met, the plan will lapse.

Bonus Rate Annuity

A bonus rate annuity is an extra percent of interest credited to an annuity (usually during the first year that it is in force). The extra amount is above the interest rate to be credited beginning the second year and the remaining years that the annuity is in force. The extra rate is paid to attract new policyholders.

Cash Surrender Values (Life Insurance)

The cash value of an insurance contract, also called the cash surrender value or surrender value, is the cash amount offered to the policyowner by the issuing life carrier upon cancellation of the contract. This term is normally used with a life insurance contract. Usually the policy must be turned in to the insurer when the policy is surrendered. If it cannot be located, there may be additional paperwork involved.

Guaranteed Cash Value

The determination of the cash value (both the base amount and the applicable surrender charge) in the contract can be explicit by determining the value for each surrender date (guaranteed cash values), by referring to the value of specific investments or subject to the discretion of the insurance company, which is often executed to bring cash values in line with values of the investments of the insurance company. Guaranteed cash values can result in significant risks for the insurance company, if the guarantee exceeds the economic value of policyholders' rights under the contract and the value of reserves held.

Liquidity and Transfer Provisions: Access to Cash Values

Surrenders

Although it is seldom recommended, investors and contract holders may access their life insurance policy's cash value by surrendering either all or part of the policy. The contract owner may surrender his or her policy for the total surrender value at any time after the policy has been issued. *The surrender is a taxable event*. As a general rule, the policy owner is responsible for paying ordinary income taxes on the difference between the surrender value and the premiums paid. If the policy is classified as a MEC, any surrenders prior to age 59½ will also be subject to a 10 percent penalty. A partial surrender will reduce the Accumulation Value by the amount of the surrender and will reduce the total death benefit and the guaranteed death benefit proportionately.

Loans

Policies will vary on how they handle loans, but generally contract owners may take a policy loan of up to 75 percent of the surrender value in the first three years or 90 percent of the surrender value thereafter. Policy loans are charged interest at an annual rate of 6 percent. An amount equal to the amount borrowed is maintained separately from the contract's invested cash values and continues to earn 4 percent interest, resulting in a net cost to the owner of only 2 percent. When a policy is surrendered, for tax purposes, loans are considered distributions from the policy and are subject to ordinary income tax. If the loan is made prior to age 59½, a 10 percent penalty may also apply. A policy loan may cause additional taxation if it causes the policy to lapse. This could occur if market conditions caused the cash value of the policy to fall below the outstanding loan amount. An outstanding policy loan will be subtracted from the total death benefit in the event of the death of the insured and will be subtracted from the total surrender value in the event the policy is surrendered.

1035 Exchanges

A Section 1035 exchange permits a policyowner to transfer the cash value from one life insurance or annuity contract to another without income tax consequences, provided proper procedures are followed and the policyowner does not receive any money (property) in the exchange. The goal is typically to move the funds without having them "touch" the contract owner's hands. In other words, one holding institution moves the funds to another without the physical involvement of the contract holder.

Even if there is no gain in the policy to be exchanged, a 1035 exchange permits the adjusted cost basis of the old policy to be carried over to the new policy. To qualify, however, it is very important to remember that the insured and owner must be the same on both policies.

Section 1035 IRS policy exchanges are used to exchange one life insurance contract for another life insurance contract or for an annuity contract if the insured no longer desires the death benefit element. An annuity may also be moved to another annuity using the 1035 exchange.

An exchange of an annuity for a life insurance policy is not a 1035 exchange and may result in income tax consequences. The exchange of two *single* life policies for a single policy insuring two lives (survivorship policy) does not qualify as a non-taxable exchange. However the IRS has permitted an exchange of a survivorship policy where the first insured has died for a single life policy insuring the life of the surviving insured. An endowment contract may be exchanged for an annuity contract in many cases. Oddly, an endowment to endowment is not allowed by IRS 1035 rules.

Important 1035 Exchange Procedures

1. **Non-Citizen Rule:** Theses rules do not apply to any exchange having the effect of transferring property to any non-United States person.
2. **New Product Requirements:** In order to accommodate the transfer of values, the life insurance product must be able to accept unscheduled deposits.
3. **Loans:** The product for an exchange of a policy "with no outstanding loan" would be best suited into a new Universal Life plan. There may also be a carrier who will allow an individual to transfer a policy loan into their product, but this type of 1035 exchange may be questioned by the IRS.
4. **Underwriting:** Full evidence of insurability based on age and amount still applies in most exchange products now available.
5. **Replacement Compliance:** Full compliance with appropriate state replacement regulations always applies.
6. **Agent Procedures:** In order to process an exchange, an FSI representative or associated representative will obtain:
   a. The completed state-specific application with wording in the "Special Instructions" section to indicate *"This is a 1035 exchange."*
   b. Evidence of insurability based on the insured's age and amount applied for.
   c. The applicable new carrier 1035 Exchange Form should be signed (original signatures only) by the owners, collateral assignee, or whoever it involves. This agreement contains a number of conditions and should be read carefully by the owners before signing. It serves as a legal "assignment with limited power of attorney rights" for direct cash value transfer purposes.
   d. If the owner is a corporation or other business entity, the full name of the entity must be provided followed by the signature and title of the authorized party. If the owner is a trust, the full name of trust and trust date must be provided,

followed by the signatures of the trustees. A copy of the trust agreement may also be required.

e. The old policy or policies should be returned with the applicable Exchange Form.

f. All state-specific replacement paperwork is always required.

g. Money down on application depending on product and circumstances. If so, a Conditional Insurance Receipt or Temporary Insurance Receipt (issued on a state specific basis) will be issued for any money taken with the application. Money would not necessarily be required or necessary.

h. A copy of any sales proposal, study used to make a decision to re-issue any policy or terminate any policy as well as a copy of any sales illustration used to predict future values on new plans implemented is typically required.

Upon receipt of the above requirements, the following will generally occur:

1. If the insurer approves the new policy for insurance in a standard or better rating class, or in a rated class that had previously been requested and accepted in writing, the company will automatically request a surrender of the old policy or policies.
2. If the new policy is approved with a rated premium, the insurer likely will await the confirmation of acceptance by the owner prior to beginning the surrender process.
3. The insurer will issue the new policy for delivery upon receipt of the 1035 proceeds.
4. If surrender cannot be affected the old policy will be reassigned to the policy-owner and the insurer's obligations under the exchange agreement will terminate.
5. If the policy-owner declines acceptance or returns the new policy under the "Free Look" provision (state specific for time to return a policy purchased), the insurer will, in its discretion, either cooperate with the policy-owner in attempting to reinstate the policy with the prior insurer or deliver all payments made with respect to the new policy to the policy-owner. (Tax trouble can result in cases of cash values exceeding premiums paid and then changing their mind after the fact!).

Approximate processing time for exchanges is 30 days from receipt of paperwork in good order at the company that issued the contract to be exchanged. Clearly, conservation will be attempted, so investors and agents should be prepared for a significant delay before the surrender proceeds are received and applied to the new policy.

The new insurer will not pay premiums if any become due on the old policy. If the insured wishes assurance that there is no break in coverage before issue of the new policy, he or she should be instructed to pay the premiums on the in-force policy, although it might be prudent to pay the minimum modal amount permitted.

Some insurance carriers will not transfer the outstanding loan balance on life insurance products. These insurers will surrender the loan first, with the balance of the funds transferred to the new policy. This treatment may create an adverse tax consequence. A pre-request to any carrier with a policy loan is a smart step prior to requesting a re-issue via 1035 provisions.

While 1035 exchanges allow for tax-free treatment, some situations can result in immediate taxation. For example, the receipt of any cash or "boot" not poured into the new contract will result in income tax to the extent of any gain in the contract.

All involved parties would be wise to seek the independent advice of a competent tax advisor before proceeding with any 1035 life insurance exchange. This is true even when the insurers involved are cooperating fully.

Withdrawal Tax Treatment

Over the years, Congress has recognized the importance of life insurance by enacting legislation that gives it a number of favorable tax attributes. These tax attributes and the important risk management features of life insurance make it an excellent financial planning tool.

Income Tax-Free Death Benefit

As a general rule, when the insured dies and the beneficiary of the insurance policy receives the proceeds, the proceeds are not subject to income taxation. In contrast, when the proceeds of a retirement plan are distributed to a beneficiary following the death of the retirement plan participant, the proceeds are almost always subject to income taxation at ordinary rates.

Income Tax-Free Internal Buildup

With many types of permanent life insurance, such as whole life and universal life, there is a buildup of cash value over time inside the policy. All income and capital gains generated inside the life insurance policy are excluded from the policyowner's income. With investments in mutual funds, for example, the income generated inside the fund are currently taxable to the owner even if the owner does not make withdrawals from the fund. At the death of the insured, as discussed above, generally there also is no income tax assessed on the proceeds.

Withdrawals of Cash Value

A portion of the cash value of certain types of permanent insurance can often be withdrawn by the owner while still keeping an insurance death benefit in place. The amount that is protected depends on how long the policy has been in existence and certain other rules, such as how much premium has been paid and how much gain has accumulated inside the policy. When considering the withdrawal of the cash value of any insurance policy, the wise owner will consult his or her income tax advisor to make sure the income tax consequences are fully considered.

Estate Taxation

Life insurance death benefits are subject to estate taxes if the insured's estate is large enough. However, planning techniques of various kinds can make a great difference. It is relatively simple to structure the ownership of life insurance so that its death benefits will not be subject to estate taxation upon the insured's death. Knowledgeable advisors can provide advice as to how to properly plan life insurance so that it will not be subject to estate tax.

Investing in life insurance has the ability to manage risk in many cases and financially protect those we love by providing a predetermined death benefit. The death proceeds of most policies are income tax-free. For more affluent clients with estate tax concerns, ownership of life insurance can be structured to avoid estate taxes. Finally, through careful planning, the owner of permanent life insurance may access some or all of the cash value buildup for immediate needs without incurring income tax liability on the amounts withdrawn. In all cases when dealing with life insurance, it is imperative that the insured/owner work with highly trained and experienced financial professionals.

Annuities and Taxation

Tax Deferred Annuities issued by life insurance companies have for years been a popular alternative for people who want growth and tax relief at the same time. In the last 20 years, billions of dollars have been moved into annuities by savers seeking safety with predictability, competitive interest rates and favorable tax treatment. Annuities are not perfect, but they do offer many features that investors want.

One important feature of fixed rate annuities is the tax deferral. By eliminating the current tax cost of accumulation, investors can build a much larger account value than with a typical interest bearing vehicle such as bank CDs. When this feature is combined with a slightly higher interest rate than might be found in bank saving accounts, it is easy to see why tax-deferred annuities are so popular.

Annuities allow the investor to safely accumulating money to be used at some future date to enhance income. It must be understood, however, that when the investor begins to withdraw annuity money he or she must then pay taxes on the gains. The manner in which the income is taken will determine the method used to calculate taxable income. A simple partial withdrawal is usually the most desirable method, but it is treated as *interest first*, which often means the entire withdrawal will be taxable. Only if the investor sets up a systematic annuity income payment will he or she get some tax relief by spreading out the taxable gain over the anticipated number of years that annuity payments will be made. This does not reduce the amount that will ultimately be taxable, but it does spread it out making the burden easier to plan for.

Tax Surprises

No investor wants an unpleasant surprise associated with his or her financial vehicles but if the investor is not fully educated in the taxable investment events, it can happen. It is at the time of the total withdrawal of funds, which most often occurs upon the death of the annuitant or owner that, in this case, the surprise occurs.

A deferred annuity is the only asset an investor can own that does not get a "step-up in basis" at the time of death. It is quite common today to see real estate and stocks that have been owned for years and that have appreciated ten-fold to a hundred-fold be passed on to heirs upon the death of the owner with no income tax whatsoever. An annuity does not enjoy this tax feature. Specifically excluded from the step-up-in-basis rule, the entire gain in the annuity is subject to income tax when received by the beneficiary.

Since a vast majority of the billions of dollars now residing in annuities is destined to be passed on to the children of the annuitants, the tax bills will come as a tremendous shock to many. In fact, it is not uncommon to see proceeds from an annuity that has been accumulated and tax deferred in a relatively low tax bracket (15% or 20%), incur taxes of 33 percent or more when added to the existing income of the beneficiary. This, of course, was not the intent of the contract owner who failed to realize annuities were not intended for beneficiaries; they were intended to produce income during the annuity owner's life. The majority of annuities are not annuitized, so the majority fails to do what they were created for: provide income during the owner's life.

Withdrawal Impact on Death Benefits

Both annuities and life insurance (except for term policies) have cash values. A cash withdrawal from a life insurance policy reduces the death benefit by the amount of the withdrawal plus interest earned. When a cash withdrawal is made from an employee benefit, such as a pension plan, the employee usually forfeits all benefits purchased on the employee's behalf by the employer.

Some types of cash value life insurance policies may not allow withdraws from the values. If the policy does allow such withdrawals, any withdrawal made will typically be tax free up to the basis in the policy. The **basis** is the amount of premiums paid into the policy, minus any prior dividends paid or previous withdrawals. The owner already paid income tax on those dollars once, so they won't be taxed again when withdrawn from the policy.

The policy's cash value consists of the basis in the policy, plus any earnings. Because the earnings grow tax deferred while inside the policy, they will be subject to income tax when withdrawn. If multiple withdrawals are made over and above the policy's basis in the policy, a portion of the withdrawal will be considered taxable income. Withdrawals are generally treated as coming out of the policy basis first.

Consider a life insurance policy with a cash value of $18,000. The basis in the policy in this example is $12,000. If the owner makes a withdrawal of $12,000 or less, there will be no income tax consequences. However, if he or she withdraws $15,000 from the policy, income tax on $3,000 will be due (at ordinary income rates, not at capital gains rates).

Surrender charges may also apply when a withdrawal is made from a policy, even if the owner withdraws only the basis. One way to avoid this and still access policy money is to take a policy loan from the insurance company, using the cash value in the policy as collateral.

To Avoid Surrender Charges, Take a Policy Loan

To avoid life insurance surrender charges, the policy owner can take a policy loan rather than simply withdrawing cash from the policy. The amount borrowed is generally not treated as taxable income as long as the loan is repaid. There are no surrender charges because the owner is not actually withdrawing any money; he is borrowing from the insurer using the policy as collateral. The owner will have to pay interest on the loan, which is not tax deductible.

For the most part, the owner of a life insurance policy can borrow some or all of the cash value in the policy at no or very little interest. The amount borrowed is not subject to income taxation, except for certain types of policies. The ability to borrow the cash value tax-free can be an important element of financial, estate, and risk planning. As in any transaction involving life insurance, the owner should always work closely with his or her financial consultant and other advisors to understand the impact of borrowing the cash value. The borrowing can affect the amount of proceeds that are received on the death of the insured, as well as premiums.

A common belief is that an insurance policy can only be used to shield the policy holder against losses upon its maturity. However, policy holders can benefit from their insurance policies even before policies reach their maturity stage.

People opt for policy loans because of the relatively low interest as compared to other loans. Some people borrow on their policies with lower interest rates and then repay other loans that are high interest-bearing with the funds. Some individuals borrow on their policies so they will get more dividends when the time for dividend distribution comes and they have paid up their loans. It is always easier to borrow under a policy loan because of the hundred percent approval-rating provided the amount loaned is not greater than the total cash value of the life insurance or the premiums paid. Taking an insurance policy loan is usually the fastest way to get a loan and there are no restrictions as to how the funds are spent.

In most cases, taking a policy loan is better than terminating the insurance policy to obtain existing cash values. Besides maintaining the policy, terminating the policy might cause a taxable event.

While policy loans may have some advantages, there are also disadvantages for the policy holder. If he or she does not know the basic rules on policy loans it can result in a greater financial problem. Policy loans are just like regular loans in the sense that the borrower must repay the funds at a specified period. If the contract owner does not repay the policy loans with the total cash value it will result in a lower or even zero cash value in the long run. When this happens, the insurance company can terminate the insurance contract and the owner will be forced to either pay the policy loans or surrender the policy. The latter choice will result in more financial problems since it requires the contract owner to pay charges as well as taxes.

Some people who can no longer pay their premiums resort to taking a policy loan and allowing their insurance policies to be terminated. This is not necessarily the best choice. Taking a policy loan is advisable only when absolutely necessary and should not be done without good reason. Cash values should not be used for vacations, luxuries or any purpose that is not an emergency.

Borrowing on an insurance policy should not be done capriciously because it can endanger coverage potentially leaving dependents vulnerable if the insured dies prematurely. When taking a policy loan, the policyowner must make sure he or she can repay it. Otherwise there is the risk of having cash values depleted, the insurance policy terminated, or the family's lifeline reduced or even removed when needed due to the insured's death.

Does the Policyowner Understand the Purchase?

There is no way to know the number of policies that are purchased by people who have no idea what they actually bought. Sometimes the selling agent has no idea the buyer does not understand the product; other times the agent knew but didn't care. An agent who does not understand indexed products, for example, should never sell them and a buyer who does not understand indexed products should never buy one.

The purpose of the Life Insurance Illustrations Model Regulations is to provide rules for life insurance policy illustrations that will protect consumers and promote consumer education. It provides illustration formats, prescribes standards to be followed when illustrations are used, and specifies the disclosures that are required I connection with illustrations. The goal is to use materials that are understandable by the normal person without a background in insurance products.

This regulation does not apply to variable life insurance, individual and group annuity contracts, credit life insurance and life insurance policies with no illustrated death benefits on any individual exceeding $10,000.

LIFE INSURANCE ILLUSTRATIONS MODEL REGULATION

Section 1: Purpose

The purpose of this regulation is to provide rules for life insurance policy illustrations that will protect consumers and foster consumer education. The regulation provides illustration formats, prescribes standards to be followed when illustrations are used, and specifies the disclosures that are required in connection with illustrations. The goals are illustrations that do not mislead purchasers of life insurance and make illustrations more understandable. Insurers will, as far as possible, eliminate the use of footnotes and caveats and define terms used in the illustration in language that would be understood by a typical person within the segment of the public to which the illustration is directed.

Section 2: Authority

This regulation is issued based upon the authority granted the commissioner under state laws corresponding to Section 4 of the NAIC Unfair Trade Practices Act.

Section 3: Applicability and Scope

This regulation applies to all group and individual life insurance policies and certificates except:

1. Variable life insurance;
2. Individual and group annuity contracts;
3. Credit life insurance; or
4. Life insurance policies with no illustrated death benefits on any individual exceeding $10,000.

Section 4: Definitions

For the purposes of this regulation:

"Actuarial Standards Board" means the board established by the American Academy of Actuaries to develop and promulgate standards of actuarial practice.

"Contract premium" means the gross premium that is required to be paid under a fixed premium policy, including the premium for a rider for which benefits are shown in the illustration.

"Currently payable scale" means a scale of non-guaranteed elements in effect for a policy form as of the preparation date of the illustration or declared to become effective within the next ninety-five (95) days.

"Disciplined current scale" means a scale of non-guaranteed elements constituting a limit on illustrations currently being illustrated by an insurer that is reasonably based on actual recent historical experience, as certified annually by an illustration actuary designated by the insurer. Further guidance in determining the disciplined current scale as contained in standards established by the Actuarial Standards Board may be relied upon if the standards:

1. Are consistent with all provisions of this regulation;
2. Limit a disciplined current scale to reflect only actions that have already been taken or events that have already occurred;
3. Do not permit a disciplined current scale to include any projected trends of improvements in experience or any assumed improvements in experience beyond the illustration date; and
4. Do not permit assumed expenses to be less than minimum assumed expenses.

"Generic name" means a short title descriptive of the policy being illustrated such as "whole life," "term life" or "flexible premium adjustable life."

"Guaranteed elements" and **"Non-guaranteed elements"**

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

"Non-guaranteed elements" means the premiums, benefits, values, credits or charges under a policy of life insurance that are not guaranteed or not determined at issue.

"Illustrated scale" means a scale of non-guaranteed elements currently being illustrated that is not more favorable to the policy owner than the lesser of:

1. The disciplined current scale; or
2. The currently payable scale.

"Illustration" means a presentation or depiction that includes non-guaranteed elements of a policy of life insurance over a period of years and that is one of the three (3) types defined below:

1. **"Basic illustration"** means a ledger or proposal used in the sale of a life insurance policy that shows both guaranteed and non-guaranteed elements.
2. **"Supplemental illustration"** means an illustration furnished in addition to a basic illustration that meets the applicable requirements of this regulation, and that may be presented in a format differing from the basic illustration but may only depict a scale of non-guaranteed elements that is permitted in a basic illustration.
3. **"In force illustration"** means an illustration furnished at any time after the policy that it depicts has been in force for one year or more.

“Illustration actuary” means an actuary meeting the requirements of Section 11 who certifies to illustrations based on the standard of practice promulgated by the Actuarial Standards Board.

“Lapse-supported illustration” means an illustration of a policy form failing the test of self-supporting as defined in this regulation, under a modified persistency rate assumption using persistency rates underlying the disciplined current scale for the first five years and 100 percent policy persistency thereafter.

“Minimum assumed expenses” means the minimum expenses that may be used in the calculation of the disciplined current scale for a policy form. The insurer may choose to designate each year the method of determining assumed expenses for all policy forms from the following:

1. Fully allocated expenses;
2. Marginal expenses; and
3. A generally recognized expense table based on fully allocated expenses representing a significant portion of insurance companies and approved by the National Association of Insurance Commissioners or by the commissioner.

Marginal expenses may be used only if greater than a generally recognized expense table. If no generally recognized expense table is approved, fully allocated expenses must be used.

“Non-term group life” means a group policy or individual policies of life insurance issued to members of an employer group or other permitted group where:

1. Every plan of coverage was selected by the employer or other group representative;
2. Some portion of the premium is paid by the group or through payroll deduction; and
3. Group underwriting or simplified underwriting is used.

“Policy owner” means the owner named in the policy or the certificate holder in the case of a group policy.

“Premium outlay” means the amount of premium assumed to be paid by the policy owner or other premium payer out-of-pocket.

“Self-supporting illustration” means an illustration of a policy form for which it can be demonstrated that, when using experience assumptions underlying the disciplined current scale, for all illustrated points in time on or after the fifteenth policy anniversary or the twentieth policy anniversary for second-or-later-to-die policies (or upon policy expiration if sooner), the accumulated value of all policy cash flows equals or exceeds the total policy owner value available. For this purpose, policy owner value will include cash surrender values and any other illustrated benefit amounts available at the policy owner’s election.

Section 5: Policies to Be Illustrated

Each insurer marketing policies to which this regulation is applicable shall notify the commissioner whether a policy form is to be marketed with or without an illustration. For all policy forms being actively marketed on the effective date of this regulation, the insurer shall identify in writing those forms and whether an illustration will be used with them. For policy forms filed after the effective date of this regulation, the identification shall be made at the time of filing. Any previous identification may be changed by notice to the commissioner.

If the insurer identifies a policy form as one to be marketed without an illustration, any use of an illustration for any policy using that form prior to the first policy anniversary is prohibited.

If a policy form is identified by the insurer as one to be marketed with an illustration, a basic illustration prepared and delivered in accordance with this regulation is required, except that a basic illustration need not be provided to individual members of a group or to individuals insured under multiple lives coverage issued to a single applicant unless the coverage is marketed to these individuals. The illustration furnished an applicant for a group life insurance policy or policies issued to a single applicant on multiple lives may be either an individual or composite illustration representative of the coverage on the lives of members of the group or the multiple lives covered.

Potential enrollees of non-term group life subject to this regulation shall be furnished a quotation with the enrollment materials. The quotation shall show potential policy values for sample ages and policy years on a guaranteed and non-guaranteed basis appropriate to the group and the coverage. This quotation shall not be considered an illustration for purposes of this regulation, but all information provided shall be consistent with the illustrated scale. A basic illustration shall be provided at delivery of the certificate to enrollees for non-term group life who enroll for more than the minimum premium necessary to provide pure death benefit protection. In addition, the insurer shall make a basic illustration available to any non-term group life enrollee who requests it.

Section 6: General Rules and Prohibitions

An illustration used in the sale of a life insurance policy shall satisfy the applicable requirements of this regulation, be clearly labeled "life insurance illustration" and contain the following basic information:

1. Name of insurer;
2. Name and business address of producer or insurer's authorized representative, if any;
3. Name, age and sex of proposed insured, except where a composite illustration is permitted under this regulation;

4. Underwriting or rating classification upon which the illustration is based;
5. Generic name of policy, the company product name, if different, and form number;
6. Initial death benefit; and
7. Dividend option election or application of non-guaranteed elements, if applicable.

When using an illustration in the sale of a life insurance policy, an insurer or its producers or other authorized representatives shall not:

1. Represent the policy as anything other than a life insurance policy;
2. Use or describe non-guaranteed elements in a manner that is misleading or has the capacity or tendency to mislead;
3. State or imply that the payment or amount of non-guaranteed elements is guaranteed;
4. Use an illustration that does not comply with the requirements of this regulation;
5. Use an illustration that at any policy duration depicts policy performance more favorable to the policy owner than that produced by the illustrated scale of the insurer whose policy is being illustrated;
6. Provide an applicant with an incomplete illustration;
7. Represent in any way that premium payments will not be required for each year of the policy in order to maintain the illustrated death benefits, unless that is the fact;
8. Use the term "vanish" or "vanishing premium," or a similar term that implies the policy becomes paid up, to describe a plan for using non-guaranteed elements to pay a portion of future premiums;
9. Except for policies that can never develop nonforfeiture values, use an illustration that is "lapse-supported"; or
10. Use an illustration that is not "self-supporting."

If an interest rate used to determine the illustrated non-guaranteed elements is shown, it shall not be greater than the earned interest rate underlying the disciplined current scale.

Section 7: Standards for Basic Illustrations

Format:

A basic illustration must conform to the following requirements:

1. The illustration shall be labeled with the date on which it was prepared.
2. Each page, including any explanatory notes or pages, shall be numbered and show its relationship to the total number of pages in the illustration (*e.g.*, the fourth page of a seven-page illustration shall be labeled "page 4 of 7 pages").
3. The assumed dates of payment receipt and benefit pay-out within a policy year shall be clearly identified.

4. If the age of the proposed insured is shown as a component of the tabular detail, it shall be issue age plus the numbers of years the policy is assumed to have been in force.
5. The assumed payments on which the illustrated benefits and values are based shall be identified as premium outlay or contract premium, as applicable. For policies that do not require a specific contract premium, the illustrated payments shall be identified as premium outlay.
6. Guaranteed death benefits and values available upon surrender, if any, for the illustrated premium outlay or contract premium shall be shown and clearly labeled guaranteed.
7. If the illustration shows any non-guaranteed elements, they cannot be based on a scale more favorable to the policy owner than the insurer's illustrated scale at any duration. These elements shall be clearly labeled non-guaranteed.
8. The guaranteed elements, if any, shall be shown before corresponding non-guaranteed elements and shall be specifically referred to on any page of an illustration that shows or describes only the non-guaranteed elements (*e.g.*, "see page one for guaranteed elements.")
9. The account or accumulation value of a policy, if shown, shall be identified by the name this value is given in the policy being illustrated and shown in close proximity to the corresponding value available upon surrender.
10. The value available upon surrender shall be identified by the name this value is given in the policy being illustrated and shall be the amount available to the policy owner in a lump sum after deduction of surrender charges, policy loans and policy loan interest, as applicable.
11. Illustrations may show policy benefits and values in graphic or chart form in addition to the tabular form.
12. Any illustration of non-guaranteed elements shall be accompanied by a statement indicating that:
    (a) The benefits and values are not guaranteed;
    (b) The assumptions on which they are based are subject to change by the insurer; and
    (c) Actual results may be more or less favorable.

If the illustration shows that the premium payer may have the option to allow policy charges to be paid using non-guaranteed values, the illustration must clearly disclose that a charge continues to be required and that, depending on actual results, the premium payer may need to continue or resume premium outlays. Similar disclosure shall be made for premium outlay of lesser amounts or shorter durations than the contract premium. If a contract premium is due, the premium outlay display shall not be left blank or show zero unless accompanied by an asterisk or similar mark to draw attention to the fact that the policy is not paid up.

If the applicant plans to use dividends or policy values, guaranteed or non-guaranteed, to pay all or a portion of the contract premium or policy charges, or for any other purpose, the illustration may reflect those plans and the impact on future policy benefits and values.

Narrative Summary:

A basic illustration must include the following:

1. A brief description of the policy being illustrated, including a statement that it is a life insurance policy;
2. A brief description of the premium outlay or contract premium, as applicable, for the policy. For a policy that does not require payment of a specific contract premium, the illustration shall show the premium outlay that must be paid to guarantee coverage for the term of the contract, subject to maximum premiums allowable to qualify as a life insurance policy under the applicable provisions of the Internal Revenue Code;
3. A brief description of any policy features, riders or options, guaranteed or non-guaranteed, shown in the basic illustration and the impact they may have on the benefits and values of the policy;
4. Identification and a brief definition of column headings and key terms used in the illustration; and
5. A statement containing in substance the following: "This illustration assumes that the currently illustrated non-guaranteed elements will continue unchanged for all years shown. This is not likely to occur, and actual results may be more or less favorable than those shown."

Numeric Summary:

Following the narrative summary, a basic illustration shall include a numeric summary of the death benefits and values and the premium outlay and contract premium, as applicable. For a policy that provides for a contract premium, the guaranteed death benefits and values shall be based on the contract premium. This summary shall be shown for at least policy years five (5), ten (10) and twenty (20) and at age 70, if applicable, on the three bases shown below. For multiple life policies, the summary shall show policy years five (5), ten (10), twenty (20) and thirty (30).

1. Policy guarantees;
2. Insurer's illustrated scale;
3. Insurer's illustrated scale used but with the non-guaranteed elements reduced as follows:
   a. Dividends at fifty percent (50 percent) of the dividends contained in the illustrated scale used;

b. Non-guaranteed credited interest at rates that are the average of the guaranteed rates and the rates contained in the illustrated scale used; and
c. All non-guaranteed charges, including but not limited to, term insurance charges, mortality and expense charges, at rates that are the average of the guaranteed rates and the rates contained in the illustrated scale used.

In addition, if coverage would cease prior to policy maturity or age 100, the year in which coverage ceases shall be identified for each of the three bases.

Statements

Statements substantially similar to the following shall be included on the same page as the numeric summary and signed by the applicant, or the policy owner in the case of an illustration provided at time of delivery, as required in this regulation. A statement to be signed and dated by the applicant or policy owner reading as follows: *"I have received a copy of this illustration and understand that any non-guaranteed elements illustrated are subject to change and could be either higher or lower. The agent has told me they are not guaranteed."*

A statement to be signed and dated by the insurance producer or other authorized representative of the insurer reading as follows: *"I certify that this illustration has been presented to the applicant and that I have explained that any non-guaranteed elements illustrated are subject to change. I have made no statements that are inconsistent with the illustration."*

Tabular Detail

A basic illustration shall include the following for at least each policy year from one (1) to ten (10) and for every fifth policy year thereafter ending at age 100, policy maturity or final expiration; and except for term insurance beyond the 20th year, for any year in which the premium outlay and contract premium, if applicable, is to change:

1. The premium outlay and mode the applicant plans to pay and the contract premium, as applicable;
2. The corresponding guaranteed death benefit, as provided in the policy; and
3. The corresponding guaranteed value available upon surrender, as provided in the policy.

For a policy that provides for a contract premium, the guaranteed death benefit and value available upon surrender shall correspond to the contract premium. Non-guaranteed elements may be shown if described in the contract. In the case of an illustration for a policy on which the insurer intends to credit terminal dividends, they may be shown if the insurer's current practice is to pay terminal dividends. If any non-guaranteed elements are shown they must be shown at the same durations as the corresponding guaranteed elements, if any. If no guaranteed benefit or value is available at any duration for which a non-guaranteed benefit or value is shown, a zero shall be displayed in the guaranteed column.

Section 8: Standards for Supplemental Illustrations

A supplemental illustration may be provided so long as:

1. It is appended to, accompanied by or preceded by a basic illustration that complies with this regulation;
2. The non-guaranteed elements shown are not more favorable to the policy owner than the corresponding elements based on the scale used in the basic illustration;
3. It contains the same statement required of a basic illustration that non-guaranteed elements are not guaranteed; and
4. For a policy that has a contract premium, the contract premium underlying the supplemental illustration is equal to the contract premium shown in the basic illustration. For policies that do not require a contract premium, the premium outlay underlying the supplemental illustration shall be equal to the premium outlay shown in the basic illustration.

The supplemental illustration shall include a notice referring to the basic illustration for guaranteed elements and other important information.

Section 9: Delivery of Illustration and Record Retention

If a basic illustration is used by an insurance producer or other authorized representative of the insurer in the sale of a life insurance policy and the policy is applied for as illustrated, a copy of that illustration, signed in accordance with this regulation, shall be submitted to the insurer at the time of policy application. A copy also shall be provided to the applicant.

If the policy is issued other than as applied for, a revised basic illustration conforming to the policy as issued shall be sent with the policy. The revised illustration shall conform to the requirements of this regulation, shall be labeled "Revised Illustration" and shall be signed and dated by the applicant or policy owner and producer or other authorized representative of the insurer no later than the time the policy is delivered. A copy shall be provided to the insurer and the policy owner.

If no illustration is used by an insurance producer or other authorized representative in the sale of a life insurance policy or if the policy is applied for other than as illustrated, the producer or representative shall certify to that effect in writing on a form provided by the insurer. On the same form the applicant shall acknowledge that no illustration conforming to the policy applied for was provided and shall further acknowledge an understanding that an illustration conforming to the policy as issued will be provided no later than at the time of policy delivery. This form shall be submitted to the insurer at the time of policy application.

If the policy is issued, a basic illustration conforming to the policy as issued shall be sent with the policy and signed no later than the time the policy is delivered. A copy shall be provided to the insurer and the policy owner. If the basic illustration or revised illustration is sent to the applicant or policy owner by mail from the insurer, it shall include instructions for the applicant or policy owner to sign the duplicate copy of the numeric summary page of the illustration for the policy issued and return the signed copy to the insurer. The insurer's obligation under this subsection shall be satisfied if it can demonstrate that it has made a diligent effort to secure a signed copy of the numeric summary page. The requirement to make a diligent effort shall be deemed satisfied if the insurer includes in the mailing a self-addressed postage prepaid envelope with instructions for the return of the signed numeric summary page.

A copy of the basic illustration and a revised basic illustration, if any, signed as applicable, along with any certification that either no illustration was used or that the policy was applied for other than as illustrated, shall be retained by the insurer until three (3) years after the policy is no longer in force. A copy need not be retained if no policy is issued.

Section 10: Annual Report; Notice to Policy Owners

In the case of a policy designated as one for which illustrations will be used, the insurer shall provide each policy owner with an annual report on the status of the policy that shall contain at least the following information:

For universal life policies, the report shall include the following:

(a) The beginning and end date of the current report period;

(b) The policy value at the end of the previous report period and at the end of the current report period;

(c) The total amounts that have been credited or debited to the policy value during the current report period, identifying each by type (e.g., interest, mortality, expense and riders);

(d) The current death benefit at the end of the current report period on each life covered by the policy;

(e) The net cash surrender value of the policy as of the end of the current report period;

(f) The amount of outstanding loans, if any, as of the end of the current report period; and for fixed premium policies.

For **fixed premium policies**:

If, assuming guaranteed interest, mortality and expense loads and continued scheduled premium payments, the policy's net cash surrender value is such that it would not maintain insurance in force until the end of the next reporting period, a notice to this effect shall be included in the report; or

For **flexible premium policies**:

If, assuming guaranteed interest, mortality and expense loads, and the policy's net cash surrender value will not maintain insurance in force until the end of the next reporting period unless further premium payments are made, a notice to this effect shall be included in the report.

For **all other policies**, where applicable:

(a) Current death benefit;

(b) Annual contract premium;

(c) Current cash surrender value;

(d) Current dividend;

(e) Application of current dividend; and

(f) Amount of outstanding loan.

Insurers writing life insurance policies that do not build nonforfeiture values shall only be required to provide an annual report with respect to these policies for those years when a change has been made to non-guaranteed policy elements by the insurer.

If the annual report does not include an in-force illustration, it must contain the following notice displayed prominently:

*"**IMPORTANT POLICY OWNER NOTICE:** You should consider requesting more detailed information about your policy to understand how it may perform in the future. You should not consider replacement of your policy or make changes in your coverage without requesting a current illustration. You may annually request, without charge, such an illustration by calling [insurer's phone number], writing to [insurer's name] at [insurer's address] or contacting your agent. If you do not receive a current illustration of your policy within 30 days from your request, you should contact your state insurance department."*

The insurer may vary the sequential order of the methods for obtaining an in-force illustration.

Upon the request of the policy owner, the insurer shall furnish an in-force illustration of current and future benefits and values based on the insurer's present illustrated scale. This illustration shall comply with the requirements of Section 6A, 6B, 7A and 7E. No signature or other acknowledgment of receipt of this illustration shall be required.

If an adverse change in non-guaranteed elements that could affect the policy has been made by the insurer since the last annual report, the annual report shall contain a notice of that fact and the nature of the change prominently displayed.

Section 11: Annual Certifications

The board of directors of each insurer shall appoint one or more illustration actuaries. The illustration actuary shall certify that the disciplined current scale used in illustrations is in conformity with the Actuarial Standard of Practice for Compliance with the NAIC Model Regulation on Life Insurance Illustrations promulgated by the Actuarial Standards Board, and that the illustrated scales used in insurer-authorized illustrations meet the requirements of this regulation.

The illustration actuary must be a member in good standing of the American Academy of Actuaries; be familiar with the standard of practice regarding life insurance policy illustrations and not have been found by the commissioner, following appropriate notice and hearing to have:

a) Violated any provision of, or any obligation imposed by, the insurance law or other law in the course of his or her dealings as an illustration actuary;
b) Been found guilty of fraudulent or dishonest practices;
c) Demonstrated his or her incompetence, lack of cooperation or untrustworthiness to act as an illustration actuary; or
d) Resigned or been removed as an illustration actuary within the past five years as a result of acts or omissions indicated in any adverse report on examination or as a result of a failure to adhere to generally acceptable actuarial standards;

Additionally the illustration actuary must not ail to notify the commissioner of any action taken by a commissioner of another state similar to that under Paragraph (3) above; disclose in the annual certification whether, since the last certification, a currently payable scale applicable for business issued within the previous five (5) years and within the scope of the certification has been reduced for reasons other than changes in the experience factors underlying the disciplined current scale. If non-guaranteed elements illustrated for new policies are not consistent with those illustrated for similar in force policies, this must be disclosed in the annual certification. If non-guaranteed elements illustrated for both new and in force policies are not consistent with the non-guaranteed elements actually being paid, charged or credited to the same or similar forms, this must be disclosed in the annual certification; and disclose in the annual certification the method used to allocate overhead expenses for all illustrations:

a) Fully allocated expenses;
b) Marginal expenses; or
c) A generally recognized expense table based on fully allocated expenses representing a significant portion of insurance companies and approved by the National Association of Insurance Commissioners or by the commissioner.

The illustration actuary shall file a certification with the board and with the commissioner annually for all policy forms for which illustrations are used; and before a new policy form is illustrated.

If an error in a previous certification is discovered, the illustration actuary shall notify the board of directors of the insurer and the commissioner promptly.

If an illustration actuary is unable to certify the scale for any policy form illustration the insurer intends to use, the actuary shall notify the board of directors of the insurer and the commissioner promptly of his or her inability to certify.

A responsible officer of the insurer, other than the illustration actuary, shall certify annually that the illustration formats meet the requirements of this regulation and that the scales used in insurer-authorized illustrations are those scales certified by the illustration actuary; and that the company has provided its agents with information about the expense allocation method used by the company in its illustrations and disclosed as required.

The annual certifications shall be provided to the commissioner each year by a date determined by the insurer. If an insurer changes the illustration actuary responsible for all or a portion of the company's policy forms, the insurer shall notify the commissioner of that fact promptly and disclose the reason for the change.

Section 12: Penalties

In addition to any other penalties provided by the laws of this state, an insurer or producer that violates a requirement of this regulation shall be guilty of a violation of the state's unfair trade practices act.

Section 13: Separability

If any provision of this regulation or its application to any person or circumstance is for any reason held to be invalid by any court of law, the remainder of the regulation and its application to other persons or circumstances shall not be affected.

Section 14: Effective Date

This regulation become effective [January 1, 1997, or effective date set in regulation, whichever is later] and shall apply to policies sold on or after the effective date.

Compare Equity Indexed Insurance

It is always an excellent idea to comparison shop but when it comes to equity products, it can be especially important. When comparing equity index life insurance policies, there are specific questions that must be answered before a buyer can make the right policy choice. The answers to these questions allow an individual to compare competing policies on an "apples to apples" basis. There are a number of highly rated life insurance companies that offer excellent equity indexed policies. By reviewing all available policy options on a level playing field the applicant can be assured of making the best policy choice for their personal situation.

What is the financial rating of the insurance company?

Financial ratings are available from the independent ratings services such as *AM Best*, *Standard & Poor's*, *Moody's*, *Fitch and Weiss Research*. Each of the independent rating services has its own criteria for ranking insurance companies. In all cases be sure the rating indicates a financially sound insurer.

What is the illustrated index credited interest rate?

Pay careful attention to the index credit rate that is "projected" on the actual life insurance illustration. When comparing policies, this rate should be equal. A 1% difference in illustrated rates will have a significant difference in cash value projections over a 20- or 30-year time period.

Is there a guaranteed minimum interest rate?

With most equity index policies, the insurance company will guarantee a minimum interest rate over a specified period of time. In other words, even if cash values are placed in indexed accounts that earn no interest over the index segment, most insurance companies will credit at least a minimum guaranteed interest rate. The minimum rate varies with insurance companies and how they apply it but can be up to 2% a year compounded annually over the index segment.

What is the current index cap rate? What is the guaranteed minimum cap rate?

Index cap rates vary by insurer. If a current index cap rate is significantly higher than the average of other insurers, the projection may be unrealistic. The index cap rate is variable and subject to increases or decreases based on economic conditions, but the cap rate cannot be reduced below the guaranteed minimum rate stated in the policy. Understand the minimum policy guarantees and the potential impact of policy changes. For example, as soon as the cap rate is reduced, cash value growth potential is reduced.

What is the current participation rate? What is the guaranteed participation rate?

With most companies, the current and guaranteed participation rate is 100 percent. If the participation rate is not guaranteed to be 100 percent, the policy may be inferior assuming identical interest crediting strategies.

What is the index floor?

The index floor with all companies should be 0 percent. Equity indexed universal life insurance is not a security and therefore doesn't invest in any instruments that risk principal. In no way can any interest credit be less than 0 percent.

How many index account options are available?

The primary index account option offered by all insurance companies is the S&P 500 Index® (1). However, insurers may offer other indexes, such as the Dow Jones Industrial Average as well as the S&P 500 Index® option. Each index is made up of different companies and measures a slightly different mix of industries. Buyers will want to select the index account option that meets their overall objectives.

How many index crediting methods are available?

The index crediting method is the process used to determine the actual index credit at the end of an index segment. There are basically two index crediting methods utilized by companies offering indexed life: the *annual point-to-point method* and the *daily averaging method*.

The annual point-to-point method is the most widely used method but there is no guarantee that one method will return a higher interest credit over time.

How long are the index segment periods?

The indexed segment period is the length of time over which funds allocated to an index account or index strategy must remain. Index interest rate credits are usually credited annually at the index segment anniversary. At the end of the index segment period, account values can be moved to the fixed account or another index strategy. Many companies offering equity-indexed life policies have more than one index segment period option. The shortest index segment is one year but some companies require up to a 6-year index segment period. As a general rule, the shorter the indexed account period the better.

What are the transfer provisions among accounts?

Transfers are movements of cash values among account options. Many companies restrict the movement of cash values from one account option to another before the end of the account segment period. Other companies will allow transfers among accounts but any transfer before the end of the index segment will probably result in any interest credits being forfeited. Most companies do not allow partial index credits on transfers prior to the end of a given index segment period.

What are the policy charges and fees associated with equity indexed life policies?

Policy fees associated with indexed life include premium loads, administrative fees, sales charges, and costs of insurance. As is the case with universal life, the policy fees and expenses associated with equity indexed life can be isolated and easily compared. Fees and costs will vary among insurance companies so careful analysis makes sense.

How long are the policy surrender charges?

Surrender charges are actually policy charges upon a surrender of cash values during the first several years of any universal or whole life policy. Surrender charges are generally a percentage of cash values that decreases over a specified time period and eventually become zero at the end of the surrender period. Surrender periods vary among insurance companies but usually range from the first 10 to 15 policy years.

How are loans treated? Do the companies offer fixed or variable loans or both?

Companies may offer a current fixed loan interest rate of 2.25 percent to 5 percent. At the same time, cash values of loaned funds may be around 2 percent to 3 percent. Therefore, there is essentially a 0.25 percent to 3 percent spread on fixed loan funds. These rates can vary, and agents should not assume they are current to the products they sell. Rather the rates stated here represent what has been the case.

In some policies it is possible to borrow funds at a zero rate. While requirements vary, there may be a time requirement on policy ownership before such loans are available. Preferred loans actually credit an interest rate on the cash value of borrowed funds that matches the interest loan rate on these same funds essentially netting a zero-cost loan. Some companies offer preferred loans after the first five policy years while others may offer them after the first 10 policy years. As always, it is necessary to refer to the actual policy.

How long is the death benefit guaranteed?

The death benefit guarantee period is the period the insurance company will guarantee the insurance as long as a minimum premium is paid in a timely manner. Many companies offering equity indexed universal life offer a minimum death benefit guarantee of at least the first five policy years. Some companies, subject to age limitations, will offer policy guarantees up to 15 years. There are also a few companies that will allow buyers to pay a higher premium and get a lifetime guaranteed policy. Policies guaranteed for life are guaranteed never to lapse as long as the required policy premium is paid on time.

What policy riders are available?

Insurance policy riders are additional policy benefits that can be added to the policy for an additional fee. All companies offer a selection of policy riders. These riders may or may not be important to the buyer's circumstances; riders should only be purchased when they make financial sense for the policy participants.

Final Analysis

Equity indexed insurance policies have many variables to review and consider before buyers make purchase decisions. Evaluating each policy option and comparing policies based on a list of established criteria will help buyers identify the best equity indexed universal life policy given their particular goals and objectives. Of course, any type of policy should be fully investigated prior to purchase but the more complicated the contract, the more important it is for the selling agent to be completely and fully educated in the contracts he or she is representing. With that full and complete education must come full disclosure so that clients also understand the product.

Annual Statements

The insurer must annually provide a 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.

Insurance Ethics

Ethic Subject Matter for Continuing Education

Ethics is important in all aspects of life, but in some industries, they are especially important because unethical people can cause severe harm to others. Insurance is one of those fields that especially need ethical conduct since some types of insurance can impact the future of those who buy the products. Annuities are purchased to protect retirement income; when inappropriate products or inappropriate payout options are utilized, annuity owners may find themselves with too little to live on and no way to correct the problem.

Every agent has an ethical duty to his or her client and even to the insurers the agent represents. Agents also have an ethical duty to the state that licensed them. In all cases, agents must obviously be truthful; it would be illegal and certainly unethical to lie to any participating party. Additionally, agents must act in their client's best interest, doing all they can to present and place products that improve the buyer's financial situation. Earned commissions may never be the primary focus.

When some states first began to mandate the subject of ethics to meet license renewal requirements much of the subject matter seemed obvious: it is certainly wrong to lie, cheat or steal. Even children understand the concept of lying and stealing. However, the states can only do so much to mandate ethical behavior. By including this subject as part of CE requirements in some states, they were removing the *"I didn't know"* excuse.

Of course, there is no excuse for any agent to intentionally misrepresent any type of insurance product, but often misrepresentation is not intentional. Even when it is done without malice, the outcome can be severe in some cases. We have seen mandated education in several areas, including long-term healthcare products (nursing home insurance). Generally such continuing education requirements follow multiple incidents of wrongful actions on the part of agents reported to the insurance departments. When state insurance departments witness multiple cases of product misuse it is their duty to attempt to correct the situation. Since many incidents of negligence (including placing inappropriate products) end up in court it is always best to try to correct the problem before a consumer finds themselves harmed. There are few ways the states can prevent such problems; mandated education is one way they might be able to prevent inappropriate product placement.

Meeting Education Requirements in a Timely Manner

Every agent surely knows he or she has continuing education requirements that must be met prior to renewing his or her insurance license. Some producers are lucky enough to work for a company or agency that handles that for them, perhaps even selecting the courses they are required to take to meet renewal requirements. Most agents must keep track of their own education completions however.

Professionals understand that education is required and they organize themselves in some manner to meet those requirements with plenty of time to spare. Many simply mark their calendar so that when the time arrives they are reminded to begin completing continuing education credit hours. Whether that happens to be in a classroom or through an internet company, this organized professional will not find themselves working until midnight the day before their credits are due.

For example:

> Christine lives in a state that requires continuing education to be completed for each two-year renewal period. In Christine's case, her license renewal is due in December of even numbered years. This means she must have her 24 credit hour requirement completed at the time she sends in her fees to renew her license in December. As she renews her license, she accesses her computer calendar and makes a notation to begin her next term's CE requirement in June of the next even-numbered year. In other words, when Christine renewed her license in December 2010, she entered the words "education now" on her internet calendar in June of 2012. When June 2012 arrives, she begins to research which courses she wants to take and begins testing for them by the end of June. By July she will have met her 24-credit hour requirement and will be ready to renew her license the following December.
>
> Christine also knows that her state does not allow her to repeat a course for a three-year period (agents must know the rule for their particular state). She keeps an education file where she stores her past Certificates of Completion. When she begins to research which courses she wants to complete, she pulls out her file of past courses completed. She compares what she took the previous licensing term to ensure she does not repeat a course, costing her time delays (she would have to take something else if she repeats a course too soon). Although Christine always uses the same education provider, she realizes that most companies do not have the ability to prevent her from taking the same course she completed the previous licensing term. Christine understands that it is her responsibility as a career professional to monitor past CE completions.

The organization techniques used by Christine are probably the most common, but whatever method is used, professionals will be ready and compliant when the time comes to renew their insurance license.

As educators we are often amazed at what we hear agents say:

"My office manager failed to notify me that my education was due this month."

"My wife/husband is supposed to handle this for me."

"Why didn't your company notify me that I didn't do all that was required?"

"Why didn't your website tell me what I need to complete? Now I've done the wrong course."

"I am due to renew my license tomorrow. What can you do to help me?"

"I wanted the same test my buddy received, but the test I got was different so I want to exchange it for that one."

"I don't understand why I have to take this course; I've been selling insurance for years and I know what I am doing."

Every agent is required to know his or her licensing and license-renewal requirements. As professionals, each agent must accept responsibility for meeting their state's education requirements in a timely manner; it is not the responsibility of the office receptionist, the state insurance department, or the continuing education provider. While these entities might be willing to offer suggestions ultimately only the licensed agent has responsibility for meeting the requirements of his or her state. It is part of being a professional.

The Doctrine of Utmost Good Faith

Breach of Utmost Good Faith

Insurance works on the principle of mutual trust. It is the responsibility of all parties to disclose all relevant facts to the insurer. This responsibility rests not only on the applicant, but also on the agent.

Normally, a breach of the principle of utmost good faith arises when the applicant, whether deliberately or accidentally, fails to disclose important facts. There are two kinds of non-disclosure:

- An innocent non-disclosure relates to information the applicant or agent did not know about, so failed to disclose.
- Deliberate non-disclosure means someone purposely and intentionally did not disclose pertinent facts or stated incorrect material information.

For example, suppose the applicant is unaware that his grandfather died from cancer and, therefore, did not disclose this material fact in the family history questionnaire when applying for life insurance. This would be an innocent non-disclosure. On the other hand, if he knew about this material fact and purposely held it back from the agent or insurer, then he is guilty of fraudulent non-disclosure.

The doctrine of utmost good faith is a key principle in insurance contracts. This doctrine emphasizes the presence of mutual faith between the insured and the insurer.

Duty of Disclosure

Applicants for insurance are legally obliged to reveal all information that would influence the insurer's decision to cover the risk and enter into the insurance contract.

Some factors increase insurer risk. These would include, but are not necessarily limited to, previous losses and claims under other policies, insurance coverage that has been declined in the past, the existence of other insurance contracts, full facts and descriptions regarding the property or the event to be insured. These facts are called **material facts**.

Depending on these material facts, the insurer will decide whether to insure the applicant and what premium to charge. For instance, in critical illness insurance, smoking habits are an important consideration or material fact for the insurer. Therefore, the insurer may decide to charge a significantly higher premium if the applicant uses tobacco products in any form.

Representations and Warranty

In most kinds of insurances, the applicant must sign a declaration at the end of the application form stating that the given answers to the questions in the application form and other personal statements and questionnaires are true and complete. Therefore, when applying for any type of insurance the applicant should make sure the information he or she provided was correctly recorded if the agent fills out the application. Even if the applicant physically records the answers he or she should review them for accuracy.

Depending on their nature, these statements may either be representations or warranties.

Representations

Representations are the written statements made by the applicant on their application form, which represent the proposed risk to the insurance company. For example, on a life insurance application form, information about age, details of family history, occupation, and so forth are representations and should be true in every respect.

Breach of representations occurs only when the applicant gives false information (age for example) in important statements. If breach of representation occurs the contract may or may not be voided depending on the type of the misrepresentation.

Warranty

Warranties in insurance contracts are different from those of ordinary commercial contracts. They are imposed by the insurer to ensure that the risk remains the same throughout the policy and does not increase. For example, in auto insurance, if the applicant lends his or her car to a friend who doesn't hold a license and that friend is involved in an accident, the insurer may consider it a breach of warranty because the insurer was not informed about this alteration. As a result the claim could be rejected.

Action Taken by Insurer against a Breach

When an applicant supplies inaccurate information with the intention to deceive the insurance contract typically becomes void.

- If this deliberate breach is discovered at the time of a claim, the insurance company will probably not pay the claim.
- If the insurer considers the breach as innocent but significant to the risk, it may choose to collect additional premiums to cover their actual risk.
- In case of an innocent breach that is irrelevant to the risk, the insurer may decide to ignore the breach as if it had never occurred.

A breach is never worth a denied claim so it is in the best interests of everyone, certainly the agent, to disclose all information.

Principle of Waiver and Estoppel

A **waiver** is voluntary surrender of a known right. **Estoppel** prevents a person from asserting those rights because he or she has acted in such a way as to deny interest in preserving those rights.

For example, suppose an applicant fails to disclose some fact or information in the insurance proposal form. The insurer does not request that information and issues the insurance policy. This is waiver. In the future, when a claim arises, the insurer cannot question the contract on the basis of non-disclosure because they did not request the information. This is estoppel. For this reason, the insurer will have to pay the claim.

Insurance companies try very hard to request all necessary information but if they fail to do so the applicant cannot be punished for their error.

Guaranty Associations

Insurance companies must keep state-required reserves and other assets to satisfy their financial obligations, although the requirements may vary state by state. However, agents should never use their state reserve requirements as a marketing tool; rather agents should select financially secure annuity insurance companies to represent. The general public is not likely to understand how state-mandated reserves work and usually rely on their agents 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 agent will only consider financially top rated companies to represent.

How does the agent know which companies are financially strong? Although agents 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 agents 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.

The following are rating companies and their statements about themselves:

A.M. Best Company
Telephone: 908-439-2200, Extension 5742
www.ambest.com

"Founded in 1899, A.M. Best Company is a full-service credit rating organization dedicated to serving the financial services industries, including the banking and insurance sectors. Policyholders and depositors refer to Best's ratings and analysis as a means of assessing the financial strength and creditworthiness of risk-bearing entities and investment vehicles."

Demotech, Inc.
Telephone: 800-354-7207
www.demotech.com

"Demotech, Inc. is a financial analysis firm located in Columbus, Ohio.

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Telephone: 212-908-0500
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Fitch Ratings bases its ratings analysis and rating decisions, which are the agency's opinions, upon established criteria, methodologies and ratings definitions, and applies them in a consistent manner. These criteria, methodologies and ratings definitions identify the specific factors that Fitch Ratings considers during the rating and surveillance processes. Therefore, ratings are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating.

Fitch Ratings seeks to continuously improve its ratings criteria and methodologies, and periodically updates the descriptions on this web site of its criteria and methodologies for securities of a given type. The criteria and methodology used to determine a rating action are those in effect at the time the rating action is taken, which is the date of the related rating action commentary. Each rating action commentary provides information about the criteria and methodology used to arrive at the stated rating, which may differ from the general criteria and methodology for the applicable security type posted on this site at a given time. For this reason, you should always consult the applicable rating action commentary for the most accurate information on the basis of any given rating.

In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction.

The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors.

Users of Fitch's ratings should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only."

Moody's Investors Service
Telephone: 212-553-0377
www.moodys.com

"The system of rating securities was originated by John Moody in 1909. The purpose of Moody's ratings is to provide investors with a simple system of gradation by which relative creditworthiness of securities may be noted.

Rating Symbols
Gradations of creditworthiness are indicated by rating symbols, with each symbol representing a group in which the credit characteristics are broadly the same. There are nine symbols as shown below, from that used to designate least credit risk to that denoting greatest credit risk: Aaa, Aa, A, Baa, Ba, B, Caa, Ca, and C. Moody's appends numerical modifiers 1, 2, and 3 to each generic rating classification from Aa through Caa.

Where no rating has been assigned or where a rating has been withdrawn, it may be for reasons unrelated to the creditworthiness of the issue. No assigned rating may be for one of the following:

1. *An application was not received or accepted.*
2. *The issue or issuer belongs to a group of securities or entities that are not rated as a matter of policy.*
3. *There is a lack of essential data pertaining to the issue or issuer.*
4. *The issue was privately placed, in which case the rating is not published in Moody's publications.*

Withdrawal may occur if new and material circumstances arise, the effects of which preclude satisfactory analysis; if there is no longer available reasonable up-to-date data to permit a judgment to be formed; if a bond is called for redemption; or for other reasons.

<u>Changes in Rating</u>
The credit quality of most issuers and their obligations is not fixed and steady over a period of time, but tends to undergo change. For this reason changes in ratings occur so as to reflect variations in the intrinsic relative position of issuers and their obligations.

A change in rating may thus occur at any time in the case of an individual issue. Such rating change should serve notice that Moody's observes some alteration in credit-worthiness, or that the previous rating did not fully reflect the quality of the bond as now seen. While because of their very nature, changes are to be expected more frequently among bonds of lower ratings than among bonds of higher ratings. Nevertheless, the user of bond ratings should keep close and constant check on all ratings - both high and low - to be able to note promptly any signs of change in status that may occur.

<u>Limitations to Uses of Ratings</u>*
Obligations carrying the same rating are not claimed to be of absolutely equal credit quality. In a broad sense, they are alike in position, but since there are a limited number of rating classes used in grading thousands of bonds, the symbols cannot reflect the same shadings of risk which actually exist.

As ratings are designed exclusively for the purpose of grading obligations according to their credit quality, they should not be used alone as a basis for investment operations. For example, they have no value in forecasting the direction of future trends of market price. Market price movements in bonds are influenced not only by the credit quality of individual issues but also by changes in money rates and general economic trends, as well as by the length of maturity, etc. During its life even the highest rated bond may have wide price movements, while its high rating status remains unchanged.

The matter of market price has no bearing whatsoever on the determination of ratings, which are not to be construed as recommendations with respect to "attractiveness". The *attractiveness of a given bond may depend on its yield, its maturity date or other factors for which the investor may search, as well as on its credit quality, the only characteristic to which the rating refers.*

Since ratings involve judgments about the future, on the one hand, and since they are used by investors as a means of protection, on the other, the effort is made when assigning ratings to look at "worst" possibilities in the "visible" future, rather than solely at the past record and the status of the present. Therefore, investors using the rating should not expect to find in them a reflection of statistical factors alone, since they are an appraisal of long-term risks, including the recognition of many non-statistical factors.

Though ratings may be used by the banking authorities to classify bonds in their bank examination procedure, Moody's ratings are not made with these bank regulations in mind. Moody's Investors Service's own judgement as to the desirability or non-desirability of a bond for bank investment purposes is not indicated by Moody's ratings.

Moody's ratings represent the opinion of Moody's Investors Service as to the relative creditworthiness of securities. As such, they should be used in conjunction with the descriptions and statistics appearing in Moody's publications. Reference should be made to these statements for information regarding the issuer. Moody's ratings are not commercial credit ratings. In no case is default or receivership to be imputed unless expressly stated.

**As set forth more fully on the copyright, credit ratings are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, selling or holding."*

Standard and Poor's
Telephone: 212-208-1199
www.standardandpoors.com

"With offices in 23 countries and a history that dates back 150 years, Standard & Poor's is known to investors worldwide as a leader of financial- market intelligence.

Today Standard & Poor's strives to provide investors who want to make better informed investment decisions with market intelligence in the form of credit ratings, indices, investment research and risk evaluations and solutions.

Most notably, we are known as an independent provider of credit ratings. In 2009, we published more than 870,000 new and revised credits ratings. Currently, we rate more than US$32 trillion in outstanding debt.

Standard & Poor's is also widely known for maintaining one of the most widely followed indices of large-cap American stocks: the S&P 500. In 2007, the S&P 500 celebrated its 50th anniversary.

Additionally, the S&P Global 1200 covers approximately 30 markets constituting approximately 70% of global market capitalization. Approximately $1.1 trillion in investment assets is directly tied to S&P indexes, and more than $3.5 trillion is benchmarked to the S&P 500 – more than any other index in the world.

Moreover, Standard & Poor's independent equity research business is among the world's leading providers of independent investment information, offering fundamental coverage on approximately 2,000 stocks. We are also a leader in mutual fund information and analysis."

Weiss Ratings
Telephone: 877-934-7778
www.weissratings.com

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We encourage you to use our ratings and analyses to avoid the potential dangers of the *weakest investments and financial institutions — to find those that you can trust now and well into the future."*

Each rating company will have their own rating method so agents 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 agents consult more than one company. Each rating company will give their interpretation of the insurer's strength and weakness.

Equity indexed annuities will have some elements in their contracts that can be changed periodically as the insurer deems necessary to protect itself in adverse markets. This element may cause varying financial reports by the reporting companies. More importantly, a company that seems to regularly make changes in its favor to the detriment of their clients should be avoided. Although most EIAs have this ability to change various elements of the contract, by consulting the past history of the insurer it is possible to achieve some idea of what may happen in the future. There are no guarantees but past performance may give some idea of future performance.

Knowledge of the Product

Most agents intend to do a good job for their clients but unfortunately some agents have not completely understood how to determine whether or not the annuity product was suitable for his or her client. Each client is an individual; there is no product that suits every annuity buyer. By mandating suitability standards (and in some cases special suitability education) the state insurance departments hope to avoid errors that may cause financial harm to its citizens. Suitability standards provide guidelines for agents who may not otherwise understand how to determine product suitability.

In the absence of state mandated criteria insurance product suitability may be a matter of opinion. For example, those who favor equity indexed annuities may feel that there are no bad EIAs while critics may feel there are no good EIAs. There are no "good" or "bad" products, but there are certainly situations that are suitable and unsuitable, based on a particular person's circumstances. The goal of the agent is to determine if his or her particular client's situation would benefit from the annuity product he or she represents. If it would not, then the product may not be suitable.

There are several elements that determine whether the product should be placed, including the individual's risk tolerance, financial needs, cash reserves, and personal or financial goals. The Suitability chapter provides additional information on this subject.

It is not possible to predict how the markets will perform in the future. Producers representing annuity products, particularly variable and equity indexed products, should never make predictions of how well the annuity might perform in the future. Even looking at past performance seldom offers guidelines, as we have witnessed over the last few years. Unfortunately clients often blame their agents when investments perform poorly, so it is in the agent'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 agent in his or her client's file. Consider this signed statement future protection if the client or his or her family becomes dissatisfied with the investment's performance.

A Difficult Career Choice

Selling insurance is not for the weak-minded, but it can be very enjoyable with the right outlook. Hello, my name is Harry Bobs and I will be your "ethical" narrator for the remainder of this chapter. I have been in the insurance business longer than many of you have lived. I've seen it all: agents who lie, cheat, and steal. I have also seen agents who truly care about their clients, becoming lasting friends with many of them. The latter is certainly more enjoyable for both parties. I do not believe most agents are unethical; on the contrary, my experience tells me the opposite is true. Unfortunately, the ethical guys jump through many legal hoops due to the few unethical among us. It would be ideal if we could police our own industry but that is simply not possible. Most of us are too busy to try to "patrol" the industry and we don't have the tools for eliminating the unethical guys. It could too easily be considered a form of eliminating the competition. As a result, the states must do the patrolling.

Each state has an insurance department whose job is to look out for their state's citizens. This is not an easy task. The "he-said-she-said" scenario is often what they have to work with; not hard proof. As a result, their only avenue is often consumer legislation. Such legislation, while often necessary, means that ethical agents must jump through numerous hoops. Typically the unethical agent is only selling insurance for a short time, but he leaves behind financial damage that must be straightened out by the ethical agent that follows. If the damage is never straightened out the consumer may find themselves in a financially devastating position at some point, often at retirement age.

Insurance is necessary. It protects property, people and futures from financial ruin. In many areas, it would be impossible to open a new business if insurance were not available because the banks that loan the money wouldn't loan to them without insurance protection in place. Banks would not loan money for a new car if the buyer did not also purchase insurance to protect the bank's investment. Without insurance, home loans would not be possible in most cases. Without insurance, families would face years of poverty because the major breadwinner died prematurely. Those who sell insurance need to realize the important position they hold and be proud of the industry they represent. Realizing the importance of insurance is only the first step, of course. From there the field agent must gain the knowledge and communication skills necessary to perform not just an adequate job, but *a professional job*. The financial futures of their clients are often in the agent's hands.

It is a Matter of Perspective

If you tell a man that he has a one in five chance of entering the nursing home (and you are selling nursing home policies) he will tell you that means he has a greater chance of never needing to go there – and he'd be right.

Tell that same man that he has a one in five chance of winning his state's lottery and he will be in his car heading to the nearest store to buy lottery tickets before you can even finish your sentence.

It is all a matter of perspective: we rationalize our reasons to buy what we want and rationalize what we don't want. In this case, he has no desire to enter a nursing home but he wants to win the lottery. He will not spend his money on a nursing home premium but he will spend it on lottery tickets – even though our example gave the exact same odds in both cases.

Of course, we know that the odds of winning the lottery are more like a million to one than five to one, yet people buy lottery tickets every day. Insurance is a non-tangible. It cannot be driven down the road, washed proudly every Sunday, or shown off to the guy next door. Furthermore, your friends are not interested in looking at your policy but they will study the engine in your new car. Let's face it: buying something tangible is just more fun than buying insurance.

Most Americans are poor savers. The declining stock market has actually boosted the percentage of savings we make, but it still is not enough for the many years we will spend in retirement (often 25 to 35 years).

Behavioral economists (researchers who mix psychology and economics) have found three reasons why people seem to find it so difficult to save:

1. **Temptation:** No one is surprised at this. People are bombarded by television ads on everything from sneakers to automobiles. Even credit is dangled in front of us in the form of advertising through the mail – actually sending out the unsolicited credit cards in many cases. Even grocery stores offers temptations by placing candy at the checkout lanes, and snack cakes that are practically following us down the aisles.

2. **Lack of Understanding:** Many Americans simply do not understand the concept and rewards of saving money. Our grade school children no longer have class saving accounts. When I was young every student opened a savings account with a few dollars and saved change for a monthly deposit. We all marched to the local bank and made our deposits on a specific Friday each month. We were all very proud of our growing sums. Today the banks will not open such accounts because there is too little money involved and it affects their "bottom line." Additionally, schools do not want to put added stress on poor families that cannot spare even the

few dollars it would require. Somewhere along the line grade school classes entirely quit teaching the idea of saving.

3. Finally, **Optimism:** Americans are famously optimistic. Someone will support us as we age. Maybe we will inherit a million dollars from a long-lost uncle or win the lottery. Something will work out. Maybe it will be the government who gives us the solution (it's hard to believe anyone has that kind of government faith!), the Veteran's Association will house us and feed us (yeah, right!), or our children and grandchildren will lovingly take care of us in our retirement. Someone will support those of us who don't adequately save.

Someone may well be forced to support those who did not save for retirement – the taxpayers, which equates into our children and grandchildren and all the other people who work each day trying to raise their own children and pay their own mortgages. The support received through those taxpayers will not be adequate however. There won't be much traveling; there may not even be adequate money for medical needs, including prescription medications. The non-savers will merely survive, wondering why "someone" (meaning the taxpayers) is not helping them.

Researchers have found that merely visualizing a purchase brings the same "feel good" response as actually making the purchase. They also found that visualizing saving for a future reward brought about the same chemical "feel good" response in the human brain. So maybe having a secure retirement is more a matter of training people to focus on the goal with retirement activities like golfing or travel as the bait.

Just like saving for retirement, buying insurance policies is seldom considered fun. This means agents must be masters of the product and excellent communicators in the field. There is no room for sissies.

Establishing Ethical Goals

Everyone needs to have a goal, even insurance agents. In this case, we are referring to an ethical goal. We know from experience that ethical agents are just as successful as unethical agents – over time, more so. Ethical agents build a sound foundation for their business through moral standards. Just as a building needs a sound foundation to withstand the elements, agents need a sound foundation to withstand the ups and downs of the insurance markets. Those who built their business on a sound moral foundation will have clients that refer them to their friends so even the "down" times in the market do not adversely affect them.

At one time there was a billboard in Houston, Texas that asked: *"Whatever happened to personal responsibility?"*

The answer is simple: each of us still has responsibility – even those who refuse to acknowledge it. Refusing to accept personal responsibility does not mean it goes away. Parents are still responsible to raise their children with love, government is still responsible to those who hired them (our citizens and taxpayers), and insurance agents are still responsible to their clients and insurers. *Refusing to act responsibly does not remove the requirement.*

As an agent you are responsible to treat your clients fairly, to provide the services they deserve, and to fulfill other professional responsibilities. Isn't that why you are completing this course? Continuing education is required in most states, but true professionals would continue to learn even if it was not. These individuals seek knowledge and continual improvement. Even without education requirements career professionals still read product brochures, news articles, and industry magazines, striving to learn more about their chosen career. That's what personal responsibility is all about: accepting and doing what we are responsible for. Our mamas are not responsible for what we do or fail to do; our boss is not responsible; our spouse is not responsible. Each of us has a duty to complete what is necessary for our profession and our personal lives, whether it happens to be completing our continuing education in a timely manner or mowing the lawn before it gets knee high.

All of us know someone who, in their own mind, is never to blame for anything. It is his manager's fault that his leads aren't good; it is his accountant's fault that he failed to pay his taxes; it is his wife's fault that his bills aren't paid. We expect this attitude from our teenager who has not yet matured, but it is frustrating to see an adult refuse to accept personal responsibility. Whether it is failure to comply with state education requirements in a timely manner, failing to refund a premium within time requirements, or simply placing an inadequate policy, some people just never seem to accept their own responsibility for life's mistakes and shortcomings. The true professional accepts responsibility for their mistakes, corrects them, and then learns from the error so it is not repeated. Mistakes become learning tools.

The following example was relayed by an agent:

When I was a green agent I mistakenly told a new client that her policy would cover something it did not. When I realized my mistake, I returned in person (totally embarrassed) to tell her of my error. I expected her to cancel the application immediately. Being a lady of quality she accepted my apology but also kept the policy. As she explained it: *"I can probably get any policy I need from any agent, but it is not possible to get integrity with any agent."* She remained my client until her death some years ago.

Responsibility is really just another word for *accountability* – especially in our industry. It is easy to profess accountability when no mistake has been made. The truly ethical agent demonstrates accountability, however, when fault must be accepted. It is not just given lip service. Like this agent's experience, an error may even have unexpected (favorable) results.

Accountability is often a trickledown effect. If the company owner or manager is accountable, his or her employees are much more likely to be as well. Sit in any diner in America and you can quickly tell the mentality of the staff. Does the waitress take care of everyone, even when the table is not in her service area? Will the hostess help clear a table so their customers are seated quickly? Is the manager willing to pick up the pot of coffee and fill cups to help out his staff? Everyone has seen examples of outstanding service and attitude and everyone has also seen the complete opposite – employees waiting for someone else to take responsibility.

Whoever the leader is, his or her actions and accountability will be taken up by those who follow. Agents often work alone so they must be accountable on a personal basis, not to impress a manager, but to build a career for him or herself. The accountable agent returns telephone calls as soon as practical, they follow up problems to see if they were solved, and they demonstrate they are interested in their client's financial well-being.

It is partly attitude, of course. The person who likes his job will automatically want to do a good job but that doesn't mean it is always easy to stay accountable. After a long day it would be easier to ignore the telephone messages that wait for us, for example. It takes a mental discipline to stay focused on our accountability – tired or not.

We must also be accountable to our families, so where is the line drawn between work and home? Being professionally accountable does not mean clients must absorb every waking hour. Many agents have set times for returning messages, following up on claims, and the countless other tasks that take up our time as agents. Perhaps it is between four and five each afternoon; perhaps it is every Monday and Wednesday morning – whatever time frame is used, the agent must follow up so that his or her clients are taken care of. *As long as clients know the time table*, it goes smoothly. In short, the agent is accountable.

Regardless of the situation, our choices are our own. Yes, sometimes the right choice is the difficult choice; it could even cost us our job in some situations. However, for most of us making the right choice will not affect our job, except perhaps to make it better. Being accountable does not mean our life is more difficult; in fact, it usually makes it easier. For example, it is easier to mow the lawn before it grows knee high. It is easier to complete required education before the last week it is due. Being accountable makes our lives easier more often than not. Being accountable for the choices we make gives us the freedom to make better choices (like saving for retirement or returning that client's call which turns out to be a referral). Those who refuse to accept personal accountability often make their lives harder than it needs to be.

For example:

Andrew Agent failed to complete his continuing education earlier in the year. Now it is due in ten days. He has several choices:

1. He could blame his manager or office receptionist for not reminding him it was due soon. He might say to himself: "What is wrong with this company? They know when I am due. What would it have taken for someone to simply mention it a couple of months ago?"

2. He could blame his secretary if he works independently. He might say to her: "I pay you to take care of this office; that means reminding me of important matters like this."

3. He could call the education company he previously used and ask them why they didn't' send an email. He might say: "I listed my license renewal date. Why didn't you email me a reminder? You may have cost me state late fees."

4. He could call the education company he previously used and ask for recommendations. He might say to them: "I really goofed this year. Time got away from me and I am due in ten days. What do you recommend I do to speed this along?"

While it may well be a chore of office staff to follow agent license renewal dates, it is the agent's responsibility to know not only when his or her license renewal takes place, but also what is required to renew that license. This includes keeping a list of previously completed CE courses, with the course ID number listed. This prevents an agent from duplicating a course that might then be refused by the state when renewing his or her insurance license. In any profession that requires a state license of some type, it is the *individual's* responsibility to do what is expected to allow a smooth license renewal. Even when another person normally reminds the agent of a pending need for continuing education, professionals always track their own requirements. It is just too important to leave to another person.

Andrew Agent may work for a company that will take on all his responsibility, but ultimately he is an adult, with adult accountability. The continuing education company is not responsible to remind him of a coming license renewal or even the renewal requirements of his state. Most companies will make recommendations if asked. Accountability nearly always makes our lives easier because others are more likely to extend a helping hand.

Why Be Ethical?

In the long run, it pays financially as well as personally to be ethical. Those who plan to have a career as an insurance agent will do better financially if they are ethical. The unethical individual may do better financially for a short period of time, but for those who consider this their career it is vital to be viewed as ethical. When clients realize their agent cares about them and their financial welfare they will refer their agent to their friends. There is no better way to keep business and grow than through referrals.

Of course, another very important reason to be ethical is a no-brainer: *it is the law*. Agents must follow their state and federal guidelines. The majority of insurance law concerns consumer protection, not protection of field agents. You're on your own baby!

For many people, being ethical is just as important as showing their parents that they are successful in their career choice. It is a matter of pride. Actions are a reflection of who each person is as a son, father, and grandfather; people want to be proud of the choices they have made. They want their family to be proud of who they are. Each person will have their individual reasons for their own code of ethics. You cannot sit on the fence when it comes to ethical behavior; you either are or are not ethical – there's no in-between on this. Your actions will also define who you are to your friends (and whether they will recommend you to their friends), but they are seldom the important people in your life unless you have no family members. It is our family that truly counts in our lives. *We show off for our friends, but we live for our family*.

Our families know who we really are; our friends just think they know us. Your wife knows you lay around Sunday morning in your boxers; you want your friends to believe something else. Your children know when you are cranky (and they know when to avoid you); your friends only see the cheerful side you present. You can't fool your family; they see who you really are. Your spouse may support or oppose you on your ethical issues but she knows what you really think better than your friends or colleagues do. Your children may not say what they think but they do observe you. It is likely they will become the same type of adult they see in you. Whatever you tell your children will be totally overshadowed by what you demonstrate with your behavior. When you lay in your grave at the end of your life, your friends will all slap each other on the back and proclaim what a great guy you were. Your family will know the truth of your life; your family will remember the truth you demonstrated behind closed doors. It is this truth that actually lives on when your life ends, not what your friends thought they knew.

Does this seem a bit too dramatic when all we are talking about is selling insurance? I guess it really is a matter of perspective.

Following the Law

From a purely practical standpoint, each agent must know and follow their state's insurance law. If any federal laws exist, of course that must also be followed. The insurance companies an agent writes for will monitor such requirements: the forms will be correct for the issuing state, the manner in which new business is submitted will be molded to the appropriate laws, and the insurer will notify agents if they fail to follow the applicable requirements. Of course, the insurer cannot monitor an agent's every move. They don't know if you represented the products correctly; whether you obtained all the required signatures or how you treated the applicants. They must be able to trust their field force to some degree. They must assume their field force will represent their products fairly and comply with state and federal laws regarding the products they sell.

Many states are implementing specific educational requirements in an attempt to dispel the old "I didn't know" response when caught disobeying the law. Laws are also beginning to place more responsibility on the insurers, requiring them to monitor the agent's acquired education in specific fields, such as federal Partnership LTC policies and anti-money laundering. Specifically, the Deficit Reduction Act of 2005 opened up asset protection nursing home policies to all states; insurers marketing these products must be able to prove their agents acquired the proper education prior to selling them. Most states already have or will adopt the NAIC Partnership format, meaning as long as the acquired education was based on the NAIC guidelines it satisfies the federal requirements. Therefore, an agent taking the NAIC Partnership format *in any state* that has adopted that education format may use it to meet the requirements in any other NAIC Partnership state. The insurers have the responsibility of verifying the education was appropriately completed. This becomes increasingly easier as all the states eventually become uniform in the continuing education courses they approve. In a few states, the Partnership nursing home continuing education must be acquired only in classroom formats, so insurers may have an easier time of monitoring agent education in those states.

Ethics in the Workplace

Regardless of our occupation, each of us faces ethical issues every day. Professions earning a commission especially need a practical base from which to operate. Ethics could be talked to death and frankly, talk is not worth much. It is actions that really tell the true story. The basic question, however, is fairly simple when it concerns industry ethics: what is right and what is wrong?

Consider the definition of ethics:
eth'ics (eth'iks) *n. pl.* (1) the principles of honor and morality. (2) accepted rules of conduct. (3) the moral principles of an individual. - eth'ic, *adj.* pertinent to morals.
The New American Webster Dictionary

Ethics: the principles of honor and morality. That seems like a fairly simple statement, but what does it mean to an insurance agent? Who determines what is or is not ethical behavior? Must religious beliefs be a part of ethical behavior? Is it possible to make your living in commission sales and still be ethical? Perhaps more to the point, is it possible to make a *good* living in commission sales and still be ethical?

While the study of ethics is actually a complex matter with many shades of right and wrong, basically ethics is about the meaning of life. It is the abstract view of what is right and wrong. There are few absolutes and many varied definitions. Even those who make their lifework the study of ethical behavior often do not come up with the same conclusions.

The purpose of this chapter is to promote thinking. More to the point, we want to promote *ethical* thinking. A thinking individual is a powerful person. It is our desire to provide a few "tools" of logic. Accepting personal accountability is actually empowering because it recognizes our ability to improve on the decisions we make. Maybe we have not saved to this point for retirement, for instance, but we are able to change that through education and reasoning. This change may mean we stop foolish spending in order to begin saving; certainly an empowering move.

The Same by Any Name

Ethics may sometimes be referred to as **values**. It may also be referred to as **morality**. It really does not matter what label we give it because the term is merely a word. What matters is how we make our decisions, how we respond to others, and how we view ourselves and our lives. Regardless of whether our ethics are stated or implied, they are always present. The decisions that are made, with or without ethical considerations, have profound effects on our own lives and those of others.

Businesses do, of course, base many of their decisions on financial aspects: What will bring a profit? How can overhead be minimized? How can taxation be minimized? There are always many aspects to a business and we often assume that a business is neither moral nor immoral. After all, the goal is profits. However, companies do have a moral or ethical responsibility to the community, its employees, and even to itself. Many companies have demonstrated that it can make large profits while performing ethically.

A background of ethics or values form the foundation of the decisions made. A company trying to minimize taxation may not think they are considering ethical issues, but ethics will be part of the final conclusion. If the company faithfully follows all lawful procedures while minimizing taxes that is an ethical decision. If the company makes misrepresentations to minimize tax payments, that is also an ethical decision. It just isn't labeled as such by the company.

Because values become an integrated part of both personal lives and business conduct, individuals are often unaware that decisions are made with an ethical context. A person who has formed an ethical core in early life will continue to make the majority of their decisions based on that early training (even if they are unaware of it).

For example, a salesperson that formed his early sales presentation on the basis of honesty and ethical conduct will, over the following months and years, make a habit of saying his presentation in a certain manner. Court cases have been won and lost on this concept of "repeat actions." As time goes by, this sales presentation becomes a habit with little variation. Eventually, the salesperson may well forget how the original presentation was formed, but if ethics played a part in the original presentation, ethics will continue to play a part as time passes. The same may be said of driving a car, riding a bicycle, and other daily habits that were initially *"learned behavior"* but become *"reflex behavior."*

Ethics began as society's code of unwritten rules. From the time humans began living together, such codes of unwritten rules were necessary simply to survive. Survival could not continue if the strong (typically males) took everything, including food and shelter, from those who were weaker. The weaker individuals were likely to be women and children. If women and children did not survive, the species could not have survived either. These rules established the way in which others were to be treated for the benefit of all.

For centuries, societies have argued over what is ethical or moral. It was during the fifth century B.C. in Greece that the philosopher Socrates gave ethics its formal beginning. The word **ethics** comes from the Greek word *ethos,* which means **"character."**

Putting the Past into the Future

Every individual is a product of their past. In some way, each of us has been affected by the past. While the world around us may change rapidly, people do not necessary change at the same pace. Current attitudes are formed from past experiences and it can be very hard to change – even when change is necessary or prudent. We have seen many historical instances of people refusing to change, even when mandated by law and pressured by society in general. Perhaps it is impossible to understand current ethical considerations without having some understanding of the past and how it brought us to this point.

Our values, our thinking, and our actions are often directly related to the availability of education in America. Societies that wish to restrict the freedoms of others nearly always limit the people's access to education. The individual who does not have the ability to learn is less likely to understand human rights and resist oppression.

Higher levels of education naturally lend themselves to questioning. It is probably this questioning that has brought about much of the beneficial change in America. If certain groups had not questioned the use of child labor in factories, women's right to cast a political vote, or a minority's right to education in any school building, past change would not have occurred and continuing change would not be possible.

Ethics may not be what we think brought about wide social change, but it always plays a role. While education involves the questioning of *why* certain things are done or thought, that education often has a moral edge to it. Child labor was used because it was cheap. That meant that the products they produced were less expensive to buy. It was not just education that prompted many to view the cheap labor as wrong; it was the moral view that children should not be economically exploited. Ironically the factories countered with the suggestion that allowing children to work helped their families economically. They gave little value to the quality of the children's lives in those factories, but the economical advantage was certainly recognized.

Personal Values

As insurance representatives, we do not have all the social answers, but we are often a mirror of what is going on in our neighborhoods. If, as individuals, we are surrounded by people who are primarily concerned with themselves, it is likely that we will have that same attitude. Therefore, if the agency in which we were trained stresses SALES, SALES, SALES without any other input, we could lose sight of the role ethics should play. When ethical behavior is not deemed important by our management and immediate peers, it is not surprising that problems eventually materialize.

It could be said that ethics are a recipe for living. Our code of ethics gives each of us our personal rules and values, which determines the choices we make each day of our lives. These choices affect not only ourselves, but everyone around us. Some types of ethics tell us what *not* to do (it is wrong to steal). Others tell us what we *ought* to do (be kind to animals). In addition, there are those ethics or morals that actually take us beyond the basics of moral obligations. Mary Mahowald, a medical ethicist at the University of Chicago, calls this added ethical stand ***virtues***. Virtues might be referred to as *going beyond the call of duty*. It may also be referred to as *moral excellence*. Such moral excellence would include those who have no legal or moral duty to another, but go to extremes to help them anyway. It refers to the person who gives their life for a stranger or goes to other countries to work for people they do not know, even though there will be no financial rewards at all. Virtue is going beyond what we are obligated to do.

Ethics is never a separate part of our lives. It is part of everything we do and everything we say. Ethics determine how we treat those we know and how we treat strangers. Ethics determine our actions in financial and public matters. Ethics belong in every profession and are especially needed in some. Because ethics, as a subject, is so broad and complex, it may sometimes be divided into sections such as personal ethics, religious ethics, legal ethics, professional ethics, medical ethics, business ethics and so forth. Ethical neutrality is not possible. Rather, when ethical neutrality is stated by an individual, it seems to be a way of avoiding some particular issue.

In today's lawsuit prone society, the wise insurance agent or brokerage will make a point of following state regulations, but ethics actually goes beyond what is simply mandated by state or federal governments. Ethics define who we are. A man who tells constant lies is known to others as a "liar" (although studies show that 90 percent of us lie regularly). A man who steals is known to others as a "thief." An insurance agent who is unethical will also earn a reputation for such.

It has been said that legal authorities may be able to mandate *behavior*, but not *ethics*. Although this is likely correct, a person who would like to steal may not do so because of the consequences such behavior would bring about. Therefore, his *behavior* is controlled, but his *ethics* are not. Although he does not steal, he would still like to.

Controlling a person's behavior may, however, eventually lead them to an understanding of *ethical* behavior. It is not unusual for an individual to become the person they pretend to be. A person who acts ethically, even if they do not desire to be, may eventually soak in the ethical behavior and adopt some of that potential. In fact, since morality is about the way we live, we do learn it over our entire lifetime. To think that a person who is not ethical today will never be ethical is simply wrong. In fact, it could go the other way as well. The person who is behaving ethically today may not do so tomorrow. Even so, it seems to be true that most of our ethical behavior is learned during childhood and adolescence. Perhaps that is why ethical parenthood is so vitally important in the eventual outcome of our children's lives.

Children learn from what they see and hear. Children imitate the behavior they see, especially if it is coming from the adults that are close to them, such as parents. As a result, parents who set good moral or ethical examples are teaching their children to do the same. Unfortunately the reverse is also true. In homes where prejudice, racism, sexism and other immoral codes are practiced by the parents, children from those homes are very likely to act in the same manner. Children learn from what they see, good or bad. We have all heard adults say *"Do as I say, not as I do."* The chances are, however, that the children will <u>do as they do</u>.

It seems to be a popular notion that toughness is needed in the business world. Ethics may be perceived as a quality that does not belong with toughness. This is actually far from the truth. As many religions will be quick to confirm, toughness is often a vital part of ethical behavior. Children are the first to realize this. Peer pressure often demeans behavior that is ethical. Certainly the child that can withstand the stress of peer pressure is displaying toughness.

Toughness that is coupled with a code of high ethics may not always experience smooth sailing, but it is likely that the combination will produce an atmosphere that promotes business and that is always desirable. Toughness with ethics gives a passion for productivity and efficiency, along with the spirit of competition, all of which contributes to the traditional measures of economic success.

America was founded on the beliefs of many people who questioned the actions of the countries they came from. Those looking for freedom, religion, the right to work, the right to own possessions and land, and the right to make their own decisions all came together to form America. There is no doubt that those early settlers were tough.

Each of us probably believes our code of ethics is the correct one. Branding another as unethical is sometimes merely a disagreement as to what is right and wrong. Ethics are based on personal perceptions, not on scientific fact or the views of the majority.

Ethics are not always just a matter of how we think and act. Often it is also a matter of character. So many things come together to form our character that all must be taken into consideration. Values, principles, emotions, plus many other factors all contribute.

There is little doubt that each of us is influenced by others. Even so, for each path chosen, we alone must take responsibility (again, it comes to personal accountability). Each of us has the ability to build, change, or destroy our own character. Part of our character is, of course, our ethical guidelines.

There is no single act that defines our personal character. Each of us has likely participated in an act that was wrong. We may even have acknowledged to ourselves that it was wrong at the time of participation. That one action does not define our total character just as one kind act does not *build* our entire character. Character is more a matter of adding and subtracting our actions and thoughts. A good person can do something unkind, yet still remain a good person. A person who normally behaves badly can do something kind for another and yet remain basically an immoral person. We refer to these isolated deeds as being “out of character.” An action that is not consistent with one's normal behavior is not likely to form or change the character of a person (although that single action can affect another in either a positive or negative fashion).

Companies Set Guidelines

No business can exist without establishing guidelines. Every aspect of business does so. Guidelines include, of course, office procedures, sales procedures and simple conduct. They also include a code of ethics, whether that code is written or merely implied. Every business tells their employees what actions are right and wrong. It may be as simple as stating that overtime will not be paid unless properly authorized, or it may be as complex as a manager who turns his head when a forgotten signature is forged on an insurance form.

Ethical decisions are made everyday in the workplace. These decisions will affect the quality of work performed, employment opportunities, safety of workers and products, advertising, and simple day-to-day operations.

It is encouraging to note that businesses across our nation are responding to ethics and community values. Most large corporations in the United States now have a written code of ethics. This trend is growing. Additionally, speeches of chief executive officers and annual reports are containing talk of ethical needs and approaches in business. Whether this is window dressing for the public or a real move to business values may be debated, but certainly the knowledge of ethical actions exists.

Some of the open talk of ethics in business has to do with money: companies have been sued over negligent actions with increasing court awards. Companies can no longer afford financially to ignore ethical issues.

A business owner must be aware that without employees who are ethical, the only restraint is the law. Without ethics, any business transaction that was not witnessed and recorded could not be trusted. This would certainly cripple a business if employees could not be trusted. On the other hand, when employees cannot trust their employer to be fair, problems can also develop. Those who own and manage the business must demonstrate ethics, fair play, and community involvement to financially protect themselves and their company.

Sometimes, unfortunately, it is the business owners themselves that turn out to be untrustworthy. There have been some American businesses (although a significant minority) that have been involved not only in unethical activity, but illegal activity as well.

Today it seems Americans expect our government and other governments to be unethical or, at the very least, foolish. If we believe we have no power to change our government's policies, we will prove ourselves right. It might be hard to believe that the simple act of voting has any ability to change how our government performs but when all the votes are added together there is more power than an individual might recognize.

Too often government corruption has the potential of affecting public safety. For example, a former contract employee of the U.S. Army Corps of Engineers and a dirt, sand, and gavel subcontractor were both convicted of conspiracy and bribery in connection with a $16 million hurricane protection project for the reconstruction of the Lake Cataouatche Levee south of New Orleans. This levee is an eight-mile section that is the system's lowest and most vulnerable stretch protecting citizens of Jefferson and St. Charles Parishes. The convictions were the result of fraud investigations in the procurement of levee reconstruction contracts.

Of course we are all aware of the failings of the banking and mortgage industry. The subprime lending crisis and resulting credit crunch resulted in significant losses and many lawsuits involving the mortgage lending and securitization process. There were civil lawsuits, criminal and regulatory investigations, government efforts to correct the impact of the subprime crisis and credit crunch, and litigation and regulatory actions relating to the collapse of the auction rate securities market. Taxpayers will be covering the numerous bailouts for decades.

The inspection of Wachovia Securities caught many of us by surprise, perhaps even Wachovia Securities. Securities regulators from six states began an inspection on July 17, 2008 as part of a probe into the company's sales of auction rate debt. The inspection was triggered by their failure to comply fully with information requests from Missouri securities regulators.

Massachusetts sued Merrill Lynch over auction rate securities. The state alleged Merrill Lynch was committing fraud by pushing the sale of auction rate securities, knowing that the auction market was unstable.

Many of our clients lost their homes due to a collapsing housing market. Of course, some of the problems came not from fraud or shady practices but from over-eager buyers and mortgage lenders who turned a blind eye to their own accountability (there's that word again!). As we know, a mortgage is a loan made against real property with the intent being repayment as agreed by the borrower, under an amortization schedule until it reaches maturity. This would normally be interrupted only by significant life events such as moving, unemployment leading to bankruptcy, divorce, or serious medical events.

Mortgages were successfully handled by banks and lending institutions for many years using responsible repayment formulas. There were underwriting requirements to ensure that borrowers had the financial means to meet the repayment agreements. All the elements that could cause repayment failure, such as bankruptcy or serious life changing events were known by the actuaries that underwrote the loans, so risk factors were easily analyzed.

Consumers understood the concept that they were "sold" the house, but they did not consider the mortgage itself as being "sold" to them. Rather borrowers sought out the lending institutions and submitted loan applications. That changed. Advertisements came in full force on television, radio and in print. They promised that anyone could get a home mortgage regardless of many previously unlendable situations. Both banks and non-banks saw an opportunity and all seemed to want their chunk of the business.

Why did lending companies want to extend credit to those surely doomed to repayment failure? Because they were lending on the premise that the majority of these loans would be refinanced or the debt would be sold. Consumers often fail to realize that "debt" is a commodity that has value in the financial markets. Consequently, the following "concepts" were accepted by even normally sound lending institutions:

1. Down payments, signifying the ability to save and plan for the future, were no longer required. Many lending institutions would lend 100% of the home value.

2. Lending institutions made the assumption that few, if any, of the borrowers planned to keep the loan to maturity. In other words, they would either refinance or sell the home prior to the loan being fully paid off. If the borrower’s refinanced, it was likely to be with the same lending institutions. Borrowers were encouraged to utilize loans they might not otherwise have used, such as interest only loans. This allowed borrowers to buy more expensive homes than they would have ordinarily qualified for.
3. Borrowers were qualified based on the amount of the initial house payment – not the total loan amount. Therefore, banks and other lending institutions knew the borrower’s would be forced to refinance in many cases because they could not afford the increasing cost of their house payment. Initial “teaser rates” went up over time, causing often dramatic increases in monthly home mortgage payments.
4. Finally, many lending institutions did not qualify the borrowers to the extent that had always been done in the past. Some were jokingly saying that the borrower’s pulse was good enough. In effect, some loans simply took the borrower’s word that he or she could afford even the initial house payment. Many of them could not even afford that initial low rate, but the lending companies did not care. It was a matter of getting their initial commission and moving the debt along to the next company.

These loans were not based on the home’s equity because no down payment was required in many cases and loan amounts were therefore on the full value of the home. Of course, many expected the rising housing market values to continue to rise despite signs that it was getting ready to cap. In fact, people bought second and third homes on the premise that they would be sold within two years for profit based entirely on rising home values.

Many of us thought these were new ideas that just didn’t work, but that is not the case. In the 1920’s similar lending practices were used and had basically the same results in the 1930’s when the housing market dropped. While consumers may have thought these were new practices, responsible lending institutions were well aware of what happened in the 1930’s. Because it was common knowledge in lending circles, it was difficult to sell mortgage-backed securities based on ballooning rates without an extra yield premium, so some lenders simply lied.

Of course, not all lenders were unethical. Many lenders continued to work with sound lending practices, including some surprising lenders who were lending to those with even low credit scores. They continued to require down payments and verifiable incomes that were likely to continue into the future (meaning they had stable jobs).

One might ask how this could happen since it was already experienced in the 1930’s. Didn’t the government correct the possibility that it could happen again? Actually, yes they did but the law was ignored. Title 12, Sec. 1831o mandates banking regulators take prompt corrective action regarding any troubled bank. The law mandates specific actions well before the bank faces failure. It further states that a troubled bank must "restrain senior executive compensation" meaning no bonuses or raises. Obviously this law was successfully ignored not only by the banks, but the regulators as well.

Unethical practices are obviously continuing today; some years have not necessarily just been bad years for ethical conduct. Writer Robert Peston[1] wrote regarding Wall Street: *"The underlying cause of the current global financial crisis is a system in which there's little personal* ***responsibility*** *for lending decisions."* Responsibility: it does not seem to matter what industry we are discussing; responsibility and ethical actions are needed.

In the case of the home loan problems, much of the driving power came from commissions for issuing home loans. Many of those issuers did not work for the banking and lending institutions, but rather were paid on the volume of mortgages they arranged. The incentive became production rather than quality. Rather like the insurance broker who wants insurance applications, not necessarily qualified applicants.

Have you ever wondered where all these bad mortgage loans end up? The paperwork and administration duties are handled by specialist companies, such as New Century Financial, which has already gone into bankruptcy protection. The debt itself ends up on Wall Street with such banks as Goldman Sachs, Morgan Stanley, Merrill Lynch and others who take the debt and process it into asset-backed securities or bonds. The banks themselves may have no connection to the actual creation of the debt; they merely handle it once it is there. They do not know if the debt is secure or not (if it will be paid as required or default). Debt is a commodity that is bought and sold without regard to those owing the debt. The banks do have historic data but due to the types of loans that were being generated such historic data may be worthless.

The companies will assess the risk value of the bond or security based on the data on hand, so accurate verification of the risk may not be possible. For a fee, special credit rating agencies, such as Standard & Poor or Moody's will verify what they believe to be the correct risk rating, but unless they have better data such a rating is obviously flawed. As a result many of the bonds and securities have received inaccurate ratings so those who invest in them are receiving flawed investment advice from those who sell them. Data may eventually emerge allowing a more accurate prediction of the risk involved for investors, but by then it will be too late for many people.

Unfortunately for investors, not all involved have done their best to provide accurate risk assessment. Since many investors do not want any part of the mortgage industry, some have become creative when marketing these bonds. Sometimes they have been mixed with other bonds in collateralized debt obligations to hide the risk involved. As the mix becomes more muddled, additional investors (believing they are avoiding mortgage debt) will actually be purchasing in part the very thing they are trying to avoid. Some have branded

[1] Corporation Watch

mortgage debt "toxic waste." As a result of these "mix and measure" bonds, many large investors are simply avoiding bonds entirely. The mixed bonds have been sold worldwide so it is actually affecting global finances to some degree.

If we have given the impression that only American institutions have performed shamefully, that is not the case. This has been a global financial issue in one form or another. It is not something that the general investor is going to unravel.

A survey conducted some years ago by Business Week stated that 59 to 70 percent of managers feel pressured to compromise personal ethical views in order to achieve corporate goals. This perception of pressure seemed to be especially high among lower level managers. On the positive side, 90 percent of the managers said they would support a code of ethics in their business place and the teaching of ethics in business schools.

Even a normally ethical individual can be influenced by unethical pressure from others, especially upper management. In today's economic climate, individuals often feel they would be unable to survive financially if they lost their job. As a result, he or she may be willing to participate in an activity once hired that they would not have participated in prior to being hired.

It is interesting that the FBI shifted agents from terrorism activities to work on Wall Street investigations, including one into the fraud of Bernard Madoff. Apparently we have decided that the threat to our society is higher from the financial sector than it is from the more physical terrorists.[2]

Laboratory research has shown unethical behavior rises as the industry or climate becomes more competitive. Perhaps that is why some insurance agencies push competitive contests and look the other way when activities seem to compromise ethical behavior. These studies further indicated that when unethical behavior is rewarded (as with prizes or additional commissions) it further erodes ethical standards. On the other hand, the same studies noted that when unethical behavior was punished, unethical behavior was deterred.

Those who study the rise and fall of ethical behaviors have made some observations: it is necessary, if one wishes to preserve ethical behavior, to require:

1. A sensitive and informed *conscience*;
2. The ability to make ethical judgments *individually*; and
3. A corporate climate that *rewards ethical behavior* and punishes unethical behavior.

Most ethicists believe that the more complex our society becomes, the more we need to teach ethics to the general population. In the past, ethical behavior was primarily taught to children by their parents and churches. As families became more complex and spread out,

[2] Business Today

ethical teachings seemed to diminish. Some studies have suggested that the loss of grandparent interaction is partly responsible for the loss of ethical teachings.

There are probably multiple factors causing a perceived decline in ethical behavior. For example, when people interact face-to-face with others, there is less temptation to be dishonest. When we do not see or know the person we are dealing with, dishonest activity becomes easier. It is simply easier to cheat an individual we do not personally know.

Example:
Scenario #1: Betsy finds a large sum of money on the bus. There is no obvious person who left it behind. The honest thing, of course, is to turn the money in so the owner can be found, but statistically Betsy is likely to keep it.

Scenario #2: Betsy finds a large sum of money on the bus on the seat an elderly woman had been occupying. Betsy had briefly chatted with her and learned she was on the way to see her new great grandchild. Having had a personal connection with the possible owner of the cash, statistically Betsy is more likely to turn the money in to authorities.

Promoting Ethical Behavior

Ethics is not entirely about oneself; it is also about others. It is not so much what one *knows* that makes an individual ethical, but rather what he or she *understands*. We all *know* it is wrong to steal, but *understanding* how stealing harms others is more likely to promote ethical activity.

Making ethical decisions addresses four basic issues:

1. Is it possible to teach others ethical behavior?
2. What is the scope of ethics?
3. What does it take to be a moral person?
4. What are a person's responsibilities to *other* moral persons?

There is no doubt that each of us, regardless of our occupation, faces ethical issues on a daily basis. Those in an occupation with a "public interest" are especially faced with ethical issues and probably legal consequences.

Ethics are standards to which an insurance agent or broker must aspire to; it is accepting the ethical commitment owed to each client. Every type of profession has an informal code of ethics, which may sometimes be more understood than written. Ethics are a means of creating standards within any given profession to upgrade it and give it honor. It is a means of measuring performance and acknowledging outstanding individuals. Ethics are often a means of providing priorities and building traditions based on integrity.

It would be hard to imagine doing business with anyone that we **knew** to be unethical. Can you imagine turning over control of your financial affairs to an attorney convicted of stealing from his other clients? Would you buy a car from a person who had knowingly lied to others about the cars he represented? Would you deal with an insurance agent who had repeatedly misrepresented the products he or she sold? Ethics are the only element, other than legal mandates, that add an element of trust to many industries. It is very difficult to mandate ethics. Only behavior, as we previously stated, may actually be mandated. If a person is ethical, that is something within themselves that simply adds to their trustworthiness.

No matter what our profession may be, as individuals, each of us faces ethical issues each day. Some are very simplistic in nature while others are complex and may have many sides (and many correct answers) to them. We face moral issues every day. Such questions as: *How much should I give to the poor? Is it wrong for me to take drugs? Should I report someone who is cheating* are daily concerns.

Some types of ethical or moral questions can be directed to our religious institutions for support in determining the right answer. Sometimes the answers can be found in our legal system. If our state or federal government says commingling funds is illegal, for example, then we could also state that it must be unethical as well. Sometimes, determining what is ethical is simply a matter of what feels right emotionally. We have all said or heard someone else say "It just doesn't *feel* right." That feeling of right and wrong is probably the result of our childhood upbringing. Even if we do not distinctly remember being taught that a particular action is either right or wrong, somewhere in our upbringing or past experiences, we have received such teachings.

While this course cannot instill ethics into anyone who has none, it may provide the tools for determining the more complex issues. By using basic concepts and theories and by having an appreciation of what constitutes an ethical solution, decisions may be made on the basis of reason.

It should be noted that different conclusions may be reached to the same ethical question. It does not mean that one solution is right and another wrong. Ethical questions often have multiple answers, all of which may be correct. Many ethical questions involve multiple hues; some decisions may be based solely on facts, while others may be based less on facts and more on emotional factors (or what simply *feels* right).

Business leaders often question whether ethics may be taught in the workplace. This, of course, depends upon multiple factors. First of all, does the employee **desire** to be ethical? As with all things, the person must want to achieve the goal at hand. If other goals are more important to the individual, then it will perhaps not be possible to teach ethical behavior. If however, ethical behavior **is** important to the individual, even if other goals are also sought, ethics may be taught. Unfortunately, those who are faced with the responsibility of hiring personnel can seldom determine the individual's ethical desires.

Sharing is one of the first lessons a child learns. Sharing is a form of ethics; it is the opposite of greed. As adults, we learn to share in numerous ways, but sharing begins in childhood. The shift from securing our own interests to sacrificing on behalf of others is an essential part of what is meant by "ethical decision making." This may especially come into play for insurance agents. The choice to make a sale and earn a commission *in any way necessary* rather than sacrificing the sale on behalf of honesty is an ethical decision. The selfish person cannot routinely make such moral decisions, or perhaps more correctly **will not,** make such decisions.

It is necessary to understand that one of the general features of taking an ethical point of view is a willingness to take into account the interests, desires and needs of others. A person may argue that it is necessary to look out for one's own interests, desires and needs. While this is certainly true to a point (we must clothe, feed and house ourselves and our families), taking our own interests into account need not mean making unethical or immoral decisions regarding others. Even commission salespeople are able to make a very good living while still maintaining ethical behavior. In fact, the best salespeople do not need to behave unethically because they have mastered their trade through the development of communication skills and professional training.

When a child asks his or her parent *"Why do I have to share my toys?"* the reply may be *"Because if you don't share your toys with your sister, she will not share her toys with you."* This simple logical answer teaches the child a valuable lesson. Our interests are tied to the interests of others. Just as our ancestors had to protect one another to survive, we must treat each other ethically so society and all that involves can survive. For example, if only those who wanted to pay taxes did so we would not have free schools, decent roads and bridges, emergency services, libraries, and many other luxuries that exist solely due to the taxes we pay.

Every aspect of our society is built on the premise that it must be ethically run for the good of those who cannot adequately protect themselves. Our laws protect the weak, the less educated, and the unusual from others. We know the system is not perfect; there will always be those who cheat, lie, and steal. There will always be those who kill others, those who harm themselves (through drugs or alcohol), and those who cannot look beyond their own self interests. Even so, our society runs pretty well as long as we are constantly vigilant about enforcing ethical behavior. When we fail to act ethically there are unfortunate consequences, as seen in the housing and loan markets.

Just as the man who is known as a liar or a thief will find others unwilling to trust him, the insurance agent who is not ethical will, at some point, find making a living impossible because no client will wish to deal with him. We are better able to achieve our goals when we recognize the goals and interests of others. Plato argued that immorality (unethical behavior) is ultimately self-defeating. While the con artist may not believe this and some unethical people do seem to prove the point, most people believe that, at some point in time, each person receives what they have given. The Bible says we will reap what we sow. Even if we do not get back what we give others (whether that be good or bad), most people would agree that it is easier to be happy with ourselves when we feel we have done the right thing.

Is it possible to teach ethical behavior to others?

Many feel it is possible to teach ethics, though perhaps not in every situation. An agent who has never considered ethical behavior might suddenly begin to do so if the agency begins a strong ethics campaign. On the other hand, an agent might continue to act unethically even if threats are made to recall his or her license to sell insurance. One thing is certain: the effort must be made to emphasize ethical behavior because there will always be those agents who will respond favorably to such efforts.

What is the scope of ethics?

This is an expansive question that could be carried to great depths. In many industries, including the insurance industry, the professionals have knowledge that the general population does not have. As a result, those individuals who seek out the professionals must rely upon their honesty and integrity. Therefore, a feeling of ethical standards must exist. It was the potential for abuse of power that provided a set of rules for what is commonly called "ethical behavior." Sometimes, ethics are written standards, which may be mandated by law on either a local or federal level. The premise, upon which practical ethics must be based, is that power must be exercised in the interest of the clients who seek the professionals out and may not be exercised solely in the best interest of the professionals themselves.

Parts of the insurance industry have been labeled (often unfairly) as lacking ethical standards. Usually what we find is not an industry as a whole without ethics, but rather some individuals who have received much publicity. The insurance industry, which deals with senior products, is one section that has received bad publicity off and on. Part of this has to do with the age of the consumer. If a 25-year old person is taken advantage of, many would think he was simply stupid or uneducated to have allowed it. If a 75 year old is taken advantage of, however, publicity is sure to follow. This is not surprising since a 25-year-old is more likely to have the ability to make sound judgments in comparison to a 75-year-old person. Also, our older population controls most of the nation's wealth. If a salesperson (in whatever industry) is greedy and unethical, he or she is most likely to hit those with money. That would typically be older people.

We should also ask ourselves why society seems to consider it less offensive to take advantage of a 25-year-old person. If unfair advantage exists, why does it matter how old or young the victim is? Perhaps that is an ethical question in itself.

When we look at what the scope of ethics is or could be one might be surprised at the extent to which it could be taken. Even our financial investing may be an ethical issue. For example, if an agent were an animal activist, would it be ethical for them to invest in companies that use animals in the laboratory or for testing? If a client is an environmentalist, should he or she invest in any type of investment that is detrimental to the environment?

People and cultures do not always agree on what is ethical. What one culture or society may consider ethical another may not. Even within the same culture or society, people may disagree on what is and is not ethical. America fought a civil war over a strong ethical disagreement.

Every person probably has some degree of greed or selfishness within them. The ethical person realizes this possibility. Since ethics is a code of values to guide man's choices and actions, the ethical person will bypass their own greed and do what is perceived as best for the majority of people or best for the person they are dealing with. In choosing his or her actions and goals, constant alternatives are faced. It is not always easy to decide which choice is best and ethical. Without a standard of values, ethical choices would be very hard to make. At some level, our religious background may set the standard of values by which we make our choices. However we arrive at it, understanding how others feel determines many of our ethical decisions.

What does it take to be a moral person?

Most people know right from wrong. While what is right may not always be agreed upon, as long as a person acts on what they *perceive* to be right, then they are acting ethically. For most people, there will be little disagreement since most of us are not involved in the global ethical questions. Most of us deal with the simple things in life – earning an honest living, paying taxes, supporting our families, giving to our churches, helping our elderly parents, and all the other aspects of daily life. Our quest for ethical guidelines is mostly black and white. We don't have to address the issues on Wall Street or help the President solve world peace.

The ethical person believes in doing what is right. He or she doesn't have to think about it; they know the path to take. The ethical insurance agent does not believe it is necessary to trample their potential clients in order to get the sale, they do not believe it is necessary to tell half-truths or leave out needed information. Of course, it is also necessary to be well prepared and use good communication techniques. All types of professions benefit from these skills.

It is not possible to be one person at home and another person at work. Who we are is defined everywhere we go and in everything we do. Three questions must be addressed:

1. What kind of person am I?
2. What quality of work do I want to perform?
3. What do I want my legacy to be?

Just as a man is defined by the lies he tells, and a thief by his actions, all of us are defined by our daily activities. We do not necessarily have to be a liar or a thief to define ourselves as less than honest. Many of our political figures are not wholly dishonest and yet they are not perceived to be honest either. How do we want ourselves defined? Answering such questions cannot be avoided. Even when we try to ignore them, we are still answering the questions by our actions. It must be realized that the questions are asked in the minds of every person we come in contact with. They look at us and they form opinions to these questions. Coming to terms with the basic philosophical questions about what we are doing with our lives may be the most practical of all possible ventures.

If we have children, we know they are very good at defining those around them, including their parents. Children may not voice the image they see, but little is missed. How do you wish your children to view you? What you do in your every day lives will form their opinions. It will also demonstrate to your children what path in life they might take.

Perhaps the worst image some children receive from their parents is that of violence, whether against them or each other. It is difficult to understand how an adult would allow that type of personal action to exist, whether it involves striking a spouse or child. Verbal abuse is just as damaging. While it may not show as prominently as physical abuse, the effects last for a lifetime.

What quality of work do you want to perform?

Quality of work includes how we treat our clients, perform the necessary insurance duties, including required continuing education, and the effects of the policies we place. It is *quality*, not quantity of work that counts. Forging signatures, misstating health conditions, omitting information for the sake of a sale, and so forth, determines the *quality* of one's work. True professionals simply feel their integrity is worth more to them than a quick commission. We all occasionally make mistakes and that is not a reflection of quality unless we do nothing to learn from the error. If an error occurs and no effort is made to correct it, then that would reflects on the type of work performed.

What do I want my legacy to be?

Most of us must surely want to be remembered in a favorable light. It is doubtful that we go through life worrying about it, but we also don't want people standing around our grave saying "I sure am glad he's gone!" I remember a friend saying about an especially mean family member: "I showed up at the funeral just to make sure she was really dead!"

Those who proclaim the loudest that they don't care what anyone thinks probably care the most. Most of us want to be remembered in a favorable light. We want our children to keep our picture on display; we want our grandchildren to talk fondly of the time we spent with them; we want our friends to remember the good times.

While the legacy that matters most is the personal one we leave our family and friends, we will also leave a business legacy. Hopefully it will be one of competency. Of course, most people would not view themselves as incompetent even if they were which is why the industry is supposed to remove those that are incompetent. Sometimes, competency is merely a matter of obtaining required or necessary education within any given industry. It is always interesting to note the amount of sincere education acquired by the leaders in an industry. The leaders are nearly always more concerned with educating themselves to a greater degree than are those at the bottom. Education and ethics go together. It should be noted that *success* and education also go hand-in-hand.

The Leaders of the Pack

It is unlikely that most agents would consider *who* they work for to be a matter of ethics. However, as many industries have shown us, it can be. When ethical behavior is not deemed important by the company individuals find themselves following the pack. When an individual feels their day-in, day-out role is primarily connected to making money without any regard as to *how* the money is made, ethics may easily take a back seat.

How does an agent know, except in the extreme cases, if their agency lacks ethics? It may not always be a black-and-white situation. Sometimes the decision can only be a personal one if the agency is not noticeably to one extreme or the other. One would not expect an agency or brokerage to be outright unethical. Each state has mandated certain procedures that a company must follow which usually prevents outright unethical behavior. It is more likely that questionable companies would ignore unethical actions of their agents, which would equate to condoning such actions.

Some examples of this might include:

<u>Example #1</u>

Joan, an insurance agent, is sitting in the agent's room of the agency where she works. As she is completing her paperwork on the business she has written that week, she notices that she forgot to have one form signed. Another agent in the room, Matt, suggests: "Don't worry about it. Just put one of his signatures against the window pane and copy over it onto the one you need."

Joan: “Isn't that illegal?”

Matt: “Maybe, but everyone does it. If you're not, then you're the only one who isn't.”

As Joan asks around, she discovers that Matt is correct. Virtually everyone she spoke to about it confirmed that they too copied signatures where one was forgotten. Joan found that nearly every agent *intended* to get all required signatures, so it was not a matter of purposely omitting them. Rather, it was an easy way to perform below necessary levels of competence. Several agents even mentioned that the management had sometimes been present when signatures were copied. They simply left the room and acted as though they had not seen it.

Of course, it is unethical to copy any signature in any situation. It is also nearly always illegal to do so. In this case there are additional ethical questions involved. Is Matt unethical for advocating that another person forge a signature? Is the agency unethical by ignoring the behavior going on? By ignoring the behavior, is the agency condoning it? If Joan had decided against forging the signature would she then be free of any other agent's unethical behavior? Or, having knowledge of unethical (and even illegal) activity, would she be ethically obligated to report it to the insurance department? Should she go elsewhere to work and leave it at that or, in the interest of ethical behavior and responsibility, should she report the behavior to the State Insurance Department and perhaps to the insurance companies as well? Since Joan had developed several good friendships among the agents, how would loyalty to her friends and her responsibility to ethical conduct intertwine?

As you can see, ethical behavior is not a simple matter. Do your standards of what is ethical apply only to yourself or to others as well? When personal views do not correspond to the views of others, which view is right?

Example #2

John works for a large investment company. John is a strong believer in environmental issues. Because of his beliefs, he will not refer any client to any stock or company that John feels harms the environment. John seldom allows his clients to see any investment that he does not agree with. John's company knows that John will not present any company that he does not agree with. The company says nothing as long as John brings in a good quantity of business. If his business is down, however, they do bring up the matter.

Is it ethical of John to only show those companies that he agrees with? Secondly, is it ethical of the company he works for to only be concerned about it if his sales are down? Could John ethically represent companies that he opposes? Which set of ethics should come first: his own or his responsibility to his clients to allow them to make their own choices?

If the company that employs John should require that he show all options to their clients, is John ethically bound to follow his employer's requirements? Whose ethics come first: John's, the client's, or the employer's? Different people or groups often do not agree on what is or is not ethical. Who should decide which ethics come first? This question might come under the heading of "What are a person's responsibilities to *other* moral persons?"

Basically, all of these concepts or questions bring us back to the original point. A person must know ***why*** they are doing a particular thing. In the case of selling insurance, if the agent does not understand the reasons *why* insurance policies are important to own, it would be very easy to lose track of important ethical elements. The lack of this understanding might eventually force the agent to deal with the basic inquiries that come about when ethics are pushed to the background.

What are our responsibilities to *other* moral persons?

Most people realize that they are responsible for their actions. In sales, we often hear the statement *"For every action, there is a reaction."* This is generally true in life as well. It goes beyond the obvious situations (if you smack someone, they may smack you back). If you are rude to a person, you may not realize the "reaction" at that moment, but one will surely follow. The reactions may not always be noticeable to others. This is especially true when it involves emotions, such as hurt feelings. Since each of us is responsible for our actions, the question then is "are we responsible for the *reactions* that follow?"

Some reactions are directly tied to our actions and are predictable. If we lie in order to obtain money, our actions are then directly tied to the reactions that follow. What we did was deliberate and the results should be no surprise. In such situations, we are responsible for the reactions to our actions.

In other situations, we cannot be responsible for the reactions. If we act in a responsible manner and a reaction occurs that hurts or offends others, we may not necessarily have any responsibility. What a person does in everyday life is the result of multiple decisions made over their lifetime. Those decisions include our perception of whom and what we are. Our character (or lack of it) is made up of our day-in, day-out decisions. The irresponsible person will not care what his or her responsibility to other moral people may be. Therefore, we will look only at what an ethical person's responsibility is towards other ethical persons.

Let's look at the example of John, the investment counselor. He would not present any investment to his clients that he did not personally agree with. Let us assume that most of John's clients are themselves ethical people. Since his clients are themselves ethical, is John wrong in making such investment choices for them without giving them a chance to bring out their own sets of ethics? *What is John's responsibility to other moral or ethical persons?*

Moral or ethical responsibility is not a single choice. Such choices are made daily in many things that we do. If we assume that our children are basically moral people, then what are our responsibilities towards them? This may also be said of our peers at work. If the majority of the agents at the firm we work for are ethical people, do we then owe it to them to also be ethical?

Agency XYZ prides itself on being ethical. The owners and managers stress such behavior at all company meetings. While sales are certainly promoted, it is made clear that the sales must be honestly come by. XYZ Company seeks out the very best products available so that their agents can present a superb policy to their potential clients. Training and education is given a top priority by the company as well.

It would probably be safe to say that XYZ Company has invested not only time but money into their company and their sales force. Since they have stressed ethical behavior, it is also probably safe to say that they do not feel such behavior will hurt them financially. In fact, they probably feel it will benefit them financially. Given this scenario, XYZ Company has probably attracted those insurance agents who also give a high priority to ethical behavior. If an unethical agent came to work there and misrepresented the products (theirs or others), XYZ Company, or any other aspect involved in the sale, how would this affect the ethical agents?

An agent once relayed this true story: she had been building a client base for about two years when the agency she worked for became the subject of an investigation by the state's insurance department. Since she had always prided herself on giving her best efforts to her job and her clients, it was distressing to see the agency she worked for on the evening news. It did not matter whether the agency had actually done anything wrong. It did not matter whether *she* had done anything wrong; she worked for the company and that was enough in the eyes of many.

In this same context, the agents at XYZ Company would be affected by an unethical agent even though the other agents were very ethical in their behavior. People believe in the old saying *"It only takes one bad apple to spoil the whole barrel."* Therefore, one unethical agent will affect how others in the same agency are viewed. In this context, *every* agent has a moral or ethical responsibility to all the other agents. In the case of the agency being investigated, that agency had a moral or ethical responsibility to all of its agents. Of course, it is the job of the state's insurance department to investigate any complaint. That certainly does not mean that anyone is actually guilty of doing something wrong. Chances are, however, if it hits the evening news or the newspapers, it will not matter whether there is any guilt or not. Opinions will be formed. Therefore, each insurance agent and each insurance agency has an ethical responsibility to act in a way that will not cast doubt on themselves or others.

Sociologists have contended that determining our own identity is not an easy thing. Many people never realize that we are able to *choose* who we are by the choices that we make. Certainly, we are influenced by many things, some of which are beyond our control. Even so, most of whom and what we are, we determine ourselves.

Objectivist Ethics

Since reason is man's basic means of survival, it is not surprising that we have the ability to form who and what we are. This is called *Objectivist Ethics.* Since everything man needs has to be discovered by his own mind and produced by his own efforts, there are two basic elements involved in becoming the person we choose to be: *thinking and actions.* We decide who we will be and our actions carry out those thoughts. To be an ethical person, we must, through our thinking, choose to be so, and then productively work towards it.

If some people do not choose to make any conscience choice, they will develop by imitating and repeating the actions of those around them. This is why it is so important that agencies and management staff make ethical behavior a priority in the workplace. Those who simply repeat the actions of those around them seldom make an effort to understand their own work. Unfortunately, *who* is imitated is seldom a concern to these individuals. As a result, one bad apple can, in effect, spoil the barrel.

Those who do choose to think out their actions and work productively towards a goal still do, however, remain the main force. They are the people who are most likely to be copied by others. Even those who survive by using brute force, or by making others their victims in some capacity, survive only because someone else was thinking and working productively. In other words, con men survive off the thinking efforts and hard work of others. Those who use brute force to steal or loot, survive off the thinking efforts and the hard work of others. It all comes back to those who do use logic and conscience choice.

As a theory of ethics, objectivist ethics holds man's life as the *standard* of value and his own life as the ethical *purpose* of every individual man. The difference between "standard" and "purpose," as used in this context can be important. "Standard" is an abstract principle that serves as a measurement or gauge to guide a person's choices in his or her achievements or specific goals. The goal itself or the achievements obtained become the "purpose." Probably every person has some "purpose" or goal in life, but not every one would have a "standard" of life.

Pete was born very poor. This poverty made such an impact on him in his childhood that he now strives to become wealthy. He obtains his accumulating wealth by whatever means necessary. Although Pete definitely has a goal or *purpose* in life of becoming rich, he does not have any *standards*. There is little doubt among those who know Pete that he will become very rich. Along the way, however, Pete is not finding much happiness. He has not thought out the goals he has established. Pete knows *what* he is doing, but he does not understand *why* he is doing it. Pete would be surprised (and perhaps even laugh) if someone told him that ethics are a part of finding happiness.

Holding on to our Ethical Code

Our history is full of wise men that wrote about the philosophies of life. While many of them did not agree on many points, most did agree on one: lack of ethics promotes disorganization, financial turmoil and, sometimes, even the demise of governments.

As individuals, we may often feel that we have little control over others. This is true to a certain extent, but we do actually have more control than we might realize. The control we have is the ability to choose our own way of life. There is little doubt that what we do on a day-in, day-out basis affects everyone we come in contact with. We are also impacted by others in the same manner.

The activities and policies of a business tell the employees what the firm's underlying values actually are. It will not matter what is written in the employee manuals. What the firm actually *does* will be the loudest indicator. Actions reveal more about a business than does executive speeches or advertising campaigns. The employees will judge the company by the way they are treated individually.

Is the way we treat others an extension of our code of ethics? Often we forget that ethical behavior is not only connected to such things as paying our taxes fairly, following the laws or telling the truth. Ethical behavior can also be connected to how we treat others. Ethics is a code of values to guide man's choices and actions. In choosing one's own actions and even goals, we must face constant alternatives. Even such things as the manner in which we speak to others are a part of our daily alternatives.

Selfishness is something that we expect from children, but not from adults. To be selfish is to be motivated by one's own self-interests. This concept can be applied to individuals or companies. Insurance agents are often accused of self-interest, but companies are probably the most common target of such claims. For an individual or company to center on their own self-interests, they must have considered what constitutes their own self-interests and how to achieve it. Because a selfish person or company chooses their goals through reasoning, selfishness is part of a goal to achieve self-gratification, wealth, or power by whatever means necessary.

Being ethical can be very difficult when being unethical appears more rewarding from a financial or public standpoint. The public standpoint is often overlooked. If we feel strongly about something that no one else seems to, it is very easy to keep quiet. In fact, that is precisely what gets "followers" into trouble. When a person knows something is not right, but no one else is saying anything, it is easy for the individual to simply go along with the group.

For example:

Greg works for a very large insurance agency. Greg has always had very strong religious convictions and, as a young man, took much teasing because of his views. Over the years Greg simply found that keeping quiet was easier. After all, he reasoned, as long as he personally held his moral ground, what others did was their own business.

Mike was also an agent with the same agency as Greg. As time went by Greg found mounting evidence that Mike was "clean sheeting"[3] his applications. One day in the field Greg ran across one of Mike's clients. She was an elderly woman who obviously had some mental disorder. She could not remember simple things and was under a doctor's care.

Back at the office, Greg asked Mike how he ever got her on that policy, which was issued only 6 months previously. "I would not have even attempted it, given her medical situation," stated Greg.

Mike replied "I simply stated what she told me. If she didn't say it, I didn't write it."

On two other occasions, Greg found similar circumstances in Mike's business. Greg voiced his concern to Mike. "You know those people won't be covered if something comes up. The company will simply rescind their policy."

Mike: "You can't say that for sure. Anyway, you worry too much."

It became obvious to Greg that Mike did not intend to change his practices.

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[3] Clean Sheeting: presenting a "clean" medical application, omitting health conditions or references that would require additional underwriting or perhaps even prevent the policy from being issued.

Since Greg is not involved and performs his job ethically, does he have any moral obligation to Mike's clients? Since Greg considers Mike to be a friend, does he have an obligation towards Mike?

Greg was so concerned that he went to his manager. The company's manager told Greg that it was not his concern as did several other coworkers. In fact, most people that he talked to within the company seemed to be viewing Greg as a potential troublemaker. Greg had heard about "whistle-blowers" and he knew he could be putting himself in a precarious position with the company if he became too vocal.

On the surface it would be easy to say that *right is right* no matter what. It is likely that most people would, however, suggest a different course for others than they would suggest for themselves. Studies have shown that people are more likely to *voice* ethical behavior than follow it.

The truth is, our identity is established by our actions (a liar is known for his lies; a thief is known for his stealing, etc.). A common pitfall to proclaiming ethics, but not following them, is that an identity is established. When we allow ourselves to be defined by whatever we happen to fall into, that in itself is a choice. Who we are is established by what we do and even by what we fail to do.

Who we become is a gradual thing. Seldom are we formed by one single experience although one single experience, if great enough, can change our direction or focus in life. Change, for either good or bad, can be a gradual process. So gradual that people may fail to notice what is happening. Therefore, a code of ethics must be a daily goal that we deliberately choose to follow.

We often hear that Americans are the largest consumers of goods and services in the world. We have become a nation of buyers where we were once a nation of savers. Pleasure today is promoted over financial safety tomorrow. This attitude is natural; most people would rather have something now than later. Without a system of values, individuals may come to feel that society owes them a comfortable living in retirement. This rationalization allows them to spend today without worrying about tomorrow. Self-discipline and self-control have given way to self-fulfillment and material consumption. Businesses have also fallen prey to material consumption. Material consumption can often be translated into one general word: greed. It is the desire for more today.

Some might say being ethical is hard work, but others would disagree. Having a specific ethical code could make life easier since such individuals instinctively know who they are and how they wish to respond to any given situation. It removes the stress that might otherwise exist when decisions are necessary regarding personal or business actions. The beauty of freedom of choice is the ability to improve on past decisions; we are not permanently tied to what we have done in the past.

It is possible to discontinue acting in an unethical manner, or "mend our ways" as it is often referred to. It is never too late to begin to act in an ethical manner. In fact, John Newton, the man who wrote one of our most famous songs, was the captain of a slave ship. As he came to realize that slavery was wrong, he used his experiences to bring this same understanding to many others. The song written by John Newton was *Amazing Grace*. Knowing this, the words of the song gain a greater meaning:

Amazing grace, how sweet the sound
that saved a wretch like me
I once was lost
but now I'm found
was blind, but now I see.

While there are many reasons to perform ethically in business, the one that should matter most is our image to others. We are a reflection of our lives, our work, our families, our community and ourselves. Our children will copy us (that's hard to believe during their teen-age years, but it does happen), our families and our communities will be affected by our actions and we must live with ourselves. In fact, those around us, including our coworkers, are affected by our values (ethics). Just as a follower may follow the cheater, he may also follow ethical behavior. When an agent defines their character as an ethical human being, it will show in his or her daily behavior, which includes his or her work. This will bring self-assurance, which will ultimately benefit him or her in many ways, including financially. Personal integrity radiates confidence and everyone prefers to deal with people who seem confident.

In an effort to become the super-salespeople our company, agency or management staff may promote, people tend to embrace a variety of roles. That might include optimum time usage, aggressive sales techniques, becoming a superb team player, or motivational skills. Certainly all of these avenues can have advantages in one way or another. Each method does have its place in the business and sales world. Usually, each method that is promoted contains a certain amount of useful advice because they contain certain truths. That is precisely why these books tend to sell well. Even so, these methods, whatever they may be, also have their limitations.

Agents have complained that there seems to be something "missing" even when they have followed the methods precisely; perhaps the why of our *profession* is missing. **Why** are you selling insurance - only to make a living? Do you understand where a product fits? Does the product do an outstanding job of meeting another's goal? If not, you have likely missed the *why* of your job. It is in the *why* that ethics or values often play an important role. When an agent understands the role they are playing in another's quality of life, the satisfaction gained goes hand-in-hand with ethical behavior. Clearly defined goals and purposes are essential if people are to understand what their lives in general and their work in particular are really all about.

It seems that psychology is the current rage in selling. While it may give an air of being scientific, often the "psychology" listed is more apt to resemble manipulation. When such techniques are encouraged by their employer, individual employees may feel inadequate to challenge the validity of them. This may especially be true if the concerned salesperson is not the "star" of the agency. Often, an individual may feel their job is not secure enough to question the techniques being pushed on them by their employer. Or, if the salesperson is not the super producer of that agency, they may simply feel that they have not earned to right to speak out. In actuality, ethics belong to everyone, not just the superstars of sales.

Totally fulfilling work probably does not exist. For many people, commissioned sales are something to be feared. It is probably safe to say that some amount of high self-esteem likely exists for those who enter the commissioned sales field. A person **must** feel they can succeed even to enter into such work. This brings us to another area of ethics. In this case, it involves those who recruit commissioned sales staffs.

Nearly every insurance agent has, at some time or another, had a company or person promise the world. The majority of workers do not enter commissioned sales. There must be a reason. If financial success were so easy, everyone would be doing it.

Can ethics be a part of promotional selling? At what point does reality need to be interjected? Should the fail rate be stated?

It might be easy to state that the "dark side" should also be stated, but would you expect that in other industries? Can you imagine a new car salesman saying: *"Oh, sure, the car looks great now, but it won't in a few years. There will be wear and tear and the paint job will become dull. Five years from now you'll be glad to just get rid of the car."*

It is common for agents to say that they would never have gotten into the business if they had known *everything*. Even so, now that they are in the insurance business, they do enjoy their work. There are many aspects of commissioned sales that can scare a person out of ever entering it. Should these aspects be discussed with new recruits? There are no easy answers to these questions. It is safe to say, however, that overstating the benefits in commissioned sales is commonplace. Promoters often feel it is necessary to promise the old "chandelier in the barn" routine in order to bring in new salespeople.

There is no such thing as a *totally* satisfying job. Certainly it is desirable to find fulfilling work, but most things are a mixture of enjoyable and mundane. In other words, there are times that the job seems extremely fulfilling and there are other times when the job seems absolutely terrible. Even fields of work that seem to be glamorous to others generally carry with them a certain amount of negatives. Even jobs that promise excitement carry stretches of boring routine tasks.

Promotional advertising is all around us. As viewers of this, we must be aware that glamour and excitement also carries simple hard work and frustration. Look at the ads for joining the armed forces. These ads show handsome men flying planes or jets, standing on the decks of mighty ships, or visiting exotic foreign places. They do not show kitchen duty, strenuous marches, or dangerous duties.

There are so many temptations in life that ethics must remain a primary focus, especially in financial industries and commissioned sales. Even though it may seem to come effortlessly to a few, the majority must make a conscience effort to be ethical. Ethical people typically have a moral reason for being such. People who consider ethical standards to be a high priority also value such personality traits as patience and kindness towards others. In fact, whatever the career line, the most successful salespeople state that patience and kindness is necessary in their line of work. Some state this quality as enjoying people. Top-notch salespeople do, of course, develop the necessary skills for their jobs, but their love of people motivates them to do a better job than the average person. They tend to "go the extra mile" for their clients, even when that extra mile does not overtly bring them any financial rewards.

An individual who is naturally kind towards others tends to have a sensitive awareness of them. Kindness generally takes into account how another person might feel as a consequence of what we do. That is not to say that a kind person always sympathizes with others in every situation. Sometimes being kind means withholding sympathy. It does mean that empathy must be involved. Let's look at the difference:

Sympathy (noun): (1) fellow-feeling; compassion. (2) condolence. (3) agreement; approval; accord.

Empathy (noun): (1) the complete *understanding* of another's feelings, motives, etc.

Not all will agree on the need for sympathy or empathy. Sympathy may not necessarily help a person and may, in some cases, increase the existing problem. Empathy tends to be aimed at correcting a given situation, and may be described as "tough love."

When a person is discharged from their job, personnel managers report that they often try to soften the blow by being less than honest about the person's shortcomings. In addition, they often do not tell the next potential employer the true reasons they were discharged.

Such evasions of the truth may do more harm than good. Unless the person knows and understands the deficiencies and mistakes that led to the loss of his or her job, those deficiencies and mistakes cannot be corrected and are likely to be repeated. Certainly, kindness needs to be used when relaying the information, but honesty is still the best option.

An individual that does not know what changes need to be made will never make any changes at all. As a result, the same mistakes will be repeated over and over again. The truth, in such a situation, may leave you disliked by the person, but it may also lead that person into the possibility of success. Sometimes being liked is simply not as important as being kindly honest. It is not always kind to deny the truth to a person who truly needs to hear it. Of course, there must be kindness when telling someone the truth rather than some type of power or pleasure in pointing out their failure.

Looking the Part

In the business world and in sales especially, assertiveness is valued. It is hard to imagine a meek insurance sales person. It is generally that take-charge type of personality that is prized. We read books on how to dress for success. Red *power* ties must be worn; business suits in specific colors are sought.

In fact, few of us desire to have a salesperson, of any type, who has an inflated ego sitting at our dining room table trying to sell us something. While we may not be looking for meekness, we do appreciate humility. Do ethics also concern such personality traits as humility? If you were new to an agency and were unsure of what was proper, whom would you copy?

Personality types do not signify ethical conduct, of course. Any person can be very ethical just as any specific personality type is not always honest. In fact, con men are often very charming, which is how they become successful in stealing from others.

Courtesy

Respect is an ethical behavior element. Some people seem to be instinctively courteous, but chances are it is a habit they have purposely formed or carefully been taught in childhood. Courtesy is not linked to income, background, or schooling. Courtesy is a trait that is purposely developed. Those who practice courtesy simply wish to make others feel comfortable.

I can't say that courteous people are also ethical people, but they are certainly more pleasant to be around. Of course, con artists may also be very courteous, but for different reasons. We are drawn to those who treat us well. We are more likely to treat them favorably in return. Considering this, it is surprising that more people do not practice simple courtesy.

We have all heard the saying, *"It was the straw that broke the camel's back."*

That means that there was a string of burdens, one of which finally made the entire situation unacceptable. Even in marriages, it is often the tiny problems that erupt into divorce proceedings while the larger differences are seldom addressed. The final "straw" is the sum total of the indignities that were endured day-in and day-out.

Simple words, such as "please" and "thank you," make mundane tasks seem more enjoyable. Many managers seem never to have learned how to say these simple common words. They somehow feel that their personal power will be diminished if they *ask* an employee to perform a task. These managers prefer to *order* their employees to do the work. In the end, those managers do not get the performance they could have by using simple courtesy.

Mores

Mores are those customs, which are enforced by social pressure. Mores are relative to culture. They are established by patterns of action to which the individual is expected to conform and from which deviation may bring disapproval and perhaps even punishment. While these standards are considered to be a matter of ethics, they may vary from society to society.

The Thorndike Barnhart Comprehensive dictionary defines mores as:
mo.res (noun): traditional rules; customs; manners.

We stated previously that only *behavior* may be dictated, not ethics. The term mores works directly into this context. Mores are ethical standards that are enforced by social pressure. Groups of professional people create ethical standards to give their profession honor. These groups desire society's approval and they realize that there will always be those among us who will not voluntarily follow ethical procedures. As a result, *mores* are developed.

Many types of professions deal with knowledge that the average person simply would not have. Insurance is one of those professions. As a result, those individuals who seek out the professionals must rely upon their honesty and integrity. A feeling of ethical standards (which are enforced by social pressure) must exist. It was the potential for abuse of power and knowledge that provided sets of rules or what is often called ethical standards. Sometimes ethics are written standards; sometimes they are merely understood. Often ethics, which have previously been “understood,” become written laws when individuals do not follow preferred practices. At that point, pressure from society makes these “rules” into written laws or mandates.

Terrance is new to the insurance industry. Therefore, he eagerly accepted when Ralph offered to take him into the field so that Terrance could see how to generate a sale. At their first appointment, Terrance noticed that Ralph did not fully disclose a limited benefit that the client had directly asked about. When they were back in Ralph's car after the appointment, Terrance asked about it.

Terrance: “It was probably just an oversight, but you didn't tell Mr. Macky about the limitation on that benefit he asked about.”

Ralph: "Look, do you want to make a living or not? No, it wasn't an oversight. By law, that is not something that I specifically must state. It's in the material I left him. It's his responsibility to read it all. If he doesn't, that's his problem. I'm not a baby-sitter, you know."

Even with the limited training Terrance had received, he knew that company policy mandated clients receive complete information by agents. Even when not legally obligated there is an ethical responsibility to provide full disclosure. Ethically, Terrance knew Ralph should have openly answered Mr. Macky's question. Of course, if it ever came up, it was likely that Ralph would claim he had done so.

If such a scenario repeated itself often enough and involved enough agents and consumers, it is likely that the state would then **mandate** specific legislation addressing the situation. Ethics, or mores, already mandate it. Every consumer wants complete honesty from those they deal with, including complete disclosure from their agents. Therefore, complete information is a custom, which is enforced by social pressure.

Mores are established patterns of action to which an individual is expected to conform.

Mores vary from culture to culture because how people live and what is important to them vary from culture to culture. For example, an insurance agent probably would not have many rules (resulting from society's pressure) in cultures that have no past experience with insurance. Since it has not been a part of their culture, the need for specific rules may not be known. As the need and desire for insurance increase, however, such codes of conduct would arise. We have seen this in our own country. When Medicare was first introduced, there were relatively few rules or regulations on the design of Medicare supplemental insurance policies. As abuses mounted, standards were implemented because the *need* for them brought about pressure from our society.

Mores relate to **customs**, not always laws, although those customs often develop into laws. Mores are customs that are enforced by social pressure. In this context, "right" simply means according to the mores and "wrong" means in violation of the mores.

We must point out that mores do not automatically make an action right or wrong. Mores make no attempt to determine what is right or wrong morally. They simply define what is right or wrong according to the given culture.

A good example of this has to do with the slavery that existed in the United States. It was the *custom* in some areas to own slaves. Those who lived with those customs generally tended to support slavery. That belief (which is a mores) did not necessarily make it *morally correct.* There is the tendency in any group of people to consider their best interests to be right. That which is contrary to their best interests may often be considered wrong. In some areas of society it could be argued that mores may be negative to one group of people and positive to another.

As a whole, however, mores tend to be the general rule of conduct for the society in its totality. Generally speaking, it is right for the members of the culture to follow the mores because they developed from the group *in its entirety*. Without mores, any society would lapse into a state of anarchy that would be intolerable for its members. While this basic concept is correct, one should not lose sight of the fact, however, that not all mores are morally acceptable. There is certainly some obligation to conformity in our society for the good of all. If one is deviating from the generally accepted code of behavior, that individual might wish to consider the possibility that his or her deviation has to do with personal gain. If this is the case, that deviation cannot be rationalized away.

When Helen Keller was asked if there were anything worse than being blind, she answered: *"Yes. Being able to see and having no vision."*

It is a natural and correct human condition to want to be somebody! All of us need to receive recognition for who we are and what we do. Unfortunately, so often we do not have any idea what our calling in life is. We spend years in school, often years in a job which simply pays our bills. We may spend virtually no time at all determining what is important to us and what will give our life meaning. Again, it all comes back to the "*why*" in our lives and careers.

There is no denying that our workplace has a great influence over who we are. We are constantly exposed to the theories of sales techniques (some good, some bad), the promotions of numerous companies (sell our product and go to Spain!), of our agencies (Your production is down. What are you going to do about it?) and of our coworkers (I sold 10 applications last week. How did you do?). There is also an added pressure: since we work on commission with few companies offering any guaranteed salary, we know we must produce or our creditors may not get paid. The financial pressure itself can cause the most honest salesperson to be tempted to get a sale in any manner possible.

A work atmosphere that is kind and considerate, education oriented, and cooperative can go far in securing ethical behavior practices, but let's be realistic. When an agency is investing heavily in its sales force, it is likely that production is a major criterion for remaining employed there. Certainly there are agencies (many of them) that do promote both sales **and** ethics. If you are lucky enough to find yourself in such a work situation, it is likely that new comers become **more** ethical (just as others will become **less** ethical in the opposite type of atmosphere) just by being exposed to those who work there.

How does one know if an agency is a good place to work? We cannot give you any sure guidelines. It may be necessary to simply try the agency out for a month before it is possible to know. You can, however, ask yourself a few questions:

1. Is the agency anxious to equip you to succeed? In other words, do they have an ongoing educational program? This is not referring to the required education that your state demands, but rather to a program that connects you soundly with your products.

2. Does the interaction at the agency seem to be relaxed and positive?

3. Do you get a "gut" feeling that you will be happy there? We are often reluctant to consider whether or not a workplace will make us happy. Somehow that suggests that we might be a bit wimpy, but if you are not content with where you are employed, the chances are you will not perform well in the sales field or you will be tempted to act unethically in order to maintain your pride.

If you *really* want to be somebody, become the "somebody" that you really want to be. When your life is nearing its end, chances are you will not be considering how you could have made *one more sale* if only you had tried harder, or listened better. No, you will likely do what most people do: regret the things you did not take the time to do with your family, for your religion, or for personal enjoyment.

It has been said that, while we clamor for the recognition and respect of others, what we are really trying to achieve is the recognition and respect that we give to ourselves. We are not attempting to weigh the correctness of this, but it does seem to make sense. Perhaps each of us, when considering our ethical conduct, should imagine our own deaths, reflecting upon what would be important to us then. What acts would we be most proud of in our lives? What will stand out? It is doubtful that, when death comes, we will remember how many sales we made. It is more likely we will think of the people we know and love and how they will consider us when we have died. For those *who really want to be somebody*, they will have been successful if those they love and respect feel the same way about them.

We occasionally hear a motivational technique that seems to mask the real aim of the motivator. For example:

"It is important that you make lots of sales so that you can help others. If you do not have any money, you cannot give as you would like to your church, your family, or your friends. If you make lots of money, then you can donate to organizations that are important, maybe even get a plaque put up in your name. Don't feel guilty because you are financially successful! The only way that you can help others is to help yourself."

We would not have a problem with this motivational technique if *ethical behavior* were given some importance. Each time we have heard this approach there was a clear rationalization of getting sales any way necessary because down the road you would be helping someone else. We thought it seemed like a new twist to the *"Rob the rich to give to the poor"* theory. The professional will not fall for this.

Certainly, we are not advocating that an agent pass up a sale. We are advocating that ethics must be a part of each and every sale. There simply is no reason not to act ethically. It is not a matter of either/or (either get the sale **or** be ethical). Ethics and selling simply go together, as many salespeople from all types of vocations can confirm.

As we have stated over and over, our actions speak louder than our words. Being an ethical person is our statement about ourselves. It is our statement to our children, spouses and our coworkers. Behaving in an ethical fashion, not just in our work but in our daily lives, is our declaration that we value *who* we are and *what* we do.

An ethical insurance agent that goes bankrupt because he or she could not bring in the earnings necessary to pay their bills is not likely to do the consumer much good. Therefore, for the good of the consumer, it is not enough to merely be ethical. The agent must be both ethical and skilled in his or her trade. In fact, it seems probable that the financially *successful* agent is more likely to be ethical since there will be less stress involved, less desperation to make the sale.

Education

Certainly, education must play a role in ethical selling. Why is education important? It is common to hear agents and agencies alike complain about the educational requirements of their state. The agent may look for the shortest or easiest educational course to simply get the requirements out of the way.

Consider this:

You are not feeling well so you go see your general practitioner. Your doctor states that you must go to a specialist because he or she suspects that you have a heart problem. The specialist that is recommended has a booming practice and obviously does very well financially. The office is plush and he or she drives into the complex parking lot in a fancy foreign sports car. There is lots of office staff and everyone seems intent on pleasing the waiting patients. Even so, you ask the medical specialist some questions that are important to you about their schooling.

The specialist replies, *“Oh, don't worry yourself about that. I finished school twenty years ago, and I haven't had the time to attend any of the seminars or other educational programs. But don't let that worry you. I've had lots of practice and I make a point to read all the brochures sent to me by my suppliers.”*

Of course, we realize that a heart specialist is not an insurance agent. Even so, the point is the same. How much confidence would you have in such a doctor? Why should a consumer have confidence in an agent that does not consider education important? In some ways, the medical analogy is fitting because much of the insurance we sell deals with our client's "financial" health.

Probably every agent alive has attended a seminar where educational laziness was obvious. Of course, it is the responsibility of the speaker to be interesting and cover a topic in an organized and practical fashion. Having stated that, it is also the responsibility of the agent to attend the seminar in a prepared manner. He or she should have a notebook, ink pen or pencil or a recorder. Notes may be optional, but if the seminar is truly educational it does seem that notes would be appropriate.

It is not appropriate for the attending agent to talk to those around him (which is likely to interfere with the enjoyment and learning of others), read the paper or a magazine, write personal letters, or work on personal business during the seminar. It is not unusual to observe an agent or two sleeping through the seminar waking up only long enough to sign the roster that is passed around for attendance. Certainly, the agent who signs in and then leaves for an hour or two is not learning anything. Although most states have specific rules about such actions, they still occur. The agent who must be policed into being responsible about his or her educational actions cannot be considered ethical or even professional.

As an educational company, we have heard complaints from agents who feel they have been in the business too long to learn anything new. Again, we refer back to the medical doctor who feels education is not necessary for their continued medical practice. Just as you would not feel comfortable with such a doctor, would your clients feel comfortable with that attitude from you?

Getting Education in a Timely Manner

It is impossible to truly be a professional unless education is made a priority. Every educator's dream is to no longer hear *"How easy are your courses?"* It certainly does separate the serious career agent from the average agent. Since the boss won't let us say "I don't know; how stupid are you?" we will continue acting as though that is a normal question. However, no professional would ever ask it.

While there was initially great variation among the states, they are gradually becoming uniform due to the adoption of the Midwest Zone Agreement. States want uniformity in education and procedures to better monitor the industry. At all times, however, it is the responsibility of each agent to know and understand their state's education requirements. Each agency is responsible for promoting education as an important feature necessary for the welfare of both the agent and the consumer. An agency should never resent the time an agent takes out of the selling field to acquire education. In the end, the agency also benefits.

The words, *"in a timely manner,"* seem to be the key phrase. It is very difficult to get all that is available out of a course if an individual must rush through it in order to meet a deadline.

Product Knowledge

There is another side to education besides formal, credited courses. Agents must know the products they represent of course, but they also need to be able to read a policy with understanding. Agents will see products from other companies besides those they personally sell. The ability to read a policy with understanding is part of being an insurance professional.

For example:

Angie is a fairly new agent having only been in the sales field for about six months. She works for a large agency with a very large field staff. While the agency does hold product meetings, it is not unusual for new items to be added before they have been formally introduced in the product meetings. As a result, Angie is often given brochures and applications for products she is not familiar with.

Angie's field manager, Reggie: "Here are some brochures for a new cancer policy we just got in. It's fairly simple, but if you have any questions give me a call. Just read the brochure. That should do it."

Angie reads the brochure and understands the basics of the product. What Angie is not sure about is where such a policy fits in and who might benefit from buying it. She knows that major medical policies are supposed to cover such things as cancer. Since Angie sells mostly life insurance, however, her understanding of medical policies is not great. Angie makes the determination that many plans must not cover cancer. Otherwise, why would insurers issue cancer policies? Angie sells two cancer policies in the first week and is highly praised by Reggie. Being so new, Angie does not often get praise, so now she begins to make a special point of suggesting her clients buy the cancer policy.

We are not trying to suggest that cancer policies are either good or bad. The question here does not necessarily concern the value of the policy itself, but rather how Angie handled a situation concerning education. Since Angie was not sure where this new product best fit in and misjudged major medical coverage benefits, what should she have done? It was obvious that Reggie felt the brochure should answer her questions, but he did offer his assistance if she wanted it.

What were Angie's options?

1. She could have called Reggie or cornered him at the office to ask questions.
2. She could have asked other agents more experienced than she.

3. Angie could have waited for the product meeting and asked questions.
4. Angie could have called the insurance company marketing the product. Most companies have product support departments.

Did Angie need to do any of these things? Since she was able to sell the product even though she was not fully educated in medical policies, did any questions even need to be asked? Remember that Angie did not have a great understanding of medical policies and made the assumption that some plans must not cover cancer. Is it possible that she misrepresented existing medical policies due to her misunderstanding? We know that Angie would not have purposely misrepresented other policies, but does this lessen her liability? If Angie did misrepresent other plans, what will this do to her credibility if her clients discover her error? If Angie did not bother to explore this product completely, is it possible that this is a work pattern that repeats itself with other products also?

Does the agency bear any responsibility here? Although they do have product meetings occasionally, is it their responsibility to have such meetings before releasing a new product to their agents? Since the agents are basically self-employed, does this mean that education is solely the agent's responsibility and that anything the agency does is more of a courtesy than a responsibility?

We are not attempting to answer these questions. Often the answers vary so much depending upon such things as contracts, etc. that each agent must determine their own answers. However, it is certainly true that each agent must take on a degree of responsibility when it comes to education in general. To rely upon another person or agency to fulfill educational needs is foolish, both personally and financially.

Laying Out Policy Benefits and Limitations

Once the consumer has agreed to hear the agent's presentation the agent enters into many possible pitfalls. Policies can be very difficult to understand. Most presentations involve a few set items, which include premium rates, benefits, agent services and company stability. Of these, the premium amount should be the least important, although our clients do not always allow this to be so. As a result, rates often take up the majority of the presentation, yet an Errors and Omissions claim has never occurred due to the premium quoted. Probably 98 percent of the E&O claims filed relate to the benefits of the program and how those benefits were discussed (or not discussed, as the case may be). Obviously, more time needs to be devoted to that aspect. Then, as an agent, you must hope that the client remembers what was said and understands the concepts discussed.

The insurance contract can be very intimidating. Technical in nature, complex in its subject matter and seldom read in full by either the insurance agent or the policy-owner, it is bound to be misunderstood at some point by somebody. It has been said that insurance contracts are the *number one unread best seller*. More insurance contracts are probably sold than nearly any other type of contract, yet they are seldom read by the consumer. Unfortunately, policies are seldom read in their entirety by the selling agent either.

To our clients, the most important part of the policy is the part that begins, *"We promise to pay . . ."* In reality, all other parts are, of course, limitations and/or conditions on the policy.

In some ways, life insurance policies are more easily understood than other types. After all, a person is either dead or alive. If the insured dies while the policy is in force, the promise of a payment is kept. In a medical policy, there may be numerous limitations or conditions of payment that the consumer (policyholder) has difficulty understanding. Medical policies contain such things as co-payments, stop-loss provisions, elimination periods, plus a variety of other confusing and easily misunderstood clauses. All of the provisions can create dissatisfaction, which can cause questions regarding an agent's diligence in presenting the policy and providing services. This is not to say that a life policy should not also be clearly explained to a client. Any contract can be confusing to the consumer. Any contract can cause a misunderstanding.

There are steps that an agent can follow to minimize possible misunderstandings:

1. **Full disclosure** is always necessary in any type of policy being suggested to a client. Where different interpretations are possible between a brochure and the actual policy, the policy is always the final authority. A brochure is simply a selling tool; never the final answer. The statement the agent receives over the telephone from the agency or home office also takes second place to the actual contract. The policy is the final word every time. *An agent who has not read the contracts he or she is selling, is an agent waiting for a lawsuit to happen.*

2. An agent should always be **slow to replace** an existing contract of any type. This is not to say that an existing contract should never be replaced. However, to do so without fully examining what is currently in place would be foolish. The agent should first be fully informed of any new or preexisting health conditions, take-over provisions and limitations that may exist in the new plan. Health problems of any dependents that may apply should also be reviewed.

3. Sometimes owners/employers may not be enrolled in and paying premiums for **worker's compensation coverage.** While this does not necessarily apply to the senior clients you will encounter, increasing numbers of older-age people are now working past the typical retirement ages and might need this consideration.

4. Whether you are dealing with a health program, a disability program, or a life insurance program, make sure that **health questions** are clearly understood and correctly answered. A term that has come into wide usage lately is *clean sheeting.* It means that an agent knowingly fails to correctly list existing or past health conditions of the applicant. The agent is presenting a "clean" application so that

the company will accept it and issue a policy. This is obviously illegal and will not be tolerated by any insurance company!

5. Sometimes an agent simply is not aware of **existing health conditions.** If the applicant does not fully understand a health question, it may be incorrectly answered through no direct fault of the agent. We say *direct* fault because it is ultimately the responsibility of the agent to present the questionnaire in a way that is understandable. Even if the agent thought the health portion of the application was correctly completed, it will not alter the insurance company's view of it. A policy may be rescinded (taken back) by the insurance company for incorrect or undisclosed information. This may occur, for example, on a question, which asks if the applicant has high blood pressure. Since the person is taking a medication that keeps his or her blood pressure under control, they may answer the question "no" when, in fact, it should have been answered "yes." Since these types of misunderstandings can easily happen, an alert agent will want to closely monitor the questions and answers on applications.

6. Eligibility of applicants is always a concern when replacing an existing coverage. Do not overlook the **eligibility of dependents** also. An employee's spouse or disabled child may be especially vulnerable.

7. Any time an existing coverage is being replaced with a new policy, **continuity** must be considered. The old plan should never be dropped until the new plan is firmly in place. The policy should actually be in hand and **reviewed for accuracy** before the old policy is dropped.

The actual way in which a plan is presented can be very important since so many of the consumers will not understand industry terminology. The weight falls on the agent to present the policy in such a way that understanding is possible. Again, this often comes down to good communication skills. We also suggest that you pay close attention to the "body language" of your clients. It is often possible to tell that your client is lost merely by the expression on their face. Many people feel awkward saying that they are lost. This might especially be true if they feel their agent is in a hurry to get on to another appointment.

There are also those agents who cannot seem to resist being overly technical. The agent may feel that such technical explanations are necessary or he or she may simply be trying to impress the client. These agents may be extremely knowledgeable, but they are unable to present their knowledge in a way that is understandable to the layperson. While this relates more to skills than it does to ethics, an ethical person will put a priority on client understanding. If the agent is trying to impress the client, then we must ask the question, does ethical conduct allow for such self-serving purposes?

Policy Replacement

Most agents are geared to replace other policies, if necessary, to bring in business. Even the most ethical of agents realize that this will often be part of their sales day. In some areas of insurance, replacement became such a problem that state and federal legislation was enacted to protect the consumer.

Most states require that comparisons (for the purpose of replacement) be precise and done in a manner that fairly compares the two policies. Often there are specific forms, which must be utilized if replacement of an existing policy takes place.

Agents often complain that it is very difficult to compare policies if the types do not have much in common. It ends up comparing apples to oranges rather than apples to apples. Whatever the situation, an ethical agent will fairly compare the two products, not only because he or she is ethical, but also because it is simply smart to do so. We live in a lawsuit prone society and it is not surprising that many consumers are all too willing to sue.

Most consumers are aware that competing agents will be attempting to replace each other's business. Realizing this, consumers do tend to use judgment before replacing their policies. Replacement practices may not be as obvious to the consumer when it involves an agent replacing their own policy. Consumers seldom question a replacement when it is the same agent (versus a competitor) doing the replacement.

Why would an agent replace their own business?

An agent may replace their own policy for several reasons; some make sense while others are questionable.

One reason some policies are replaced by the writing agent is to gain another **commission** or a higher commission, depending upon the type of product. Obviously, this is not a valid reason to replace one's own business.

Another reason an agent might replace his or her own business has to do with the **mobility** of the industry. It is not unusual for agents to work for a period of time for one agency and then, for one reason or another, move on to a different agency. If an agent is not meeting production standards, the first agency might terminate the agent or terminate benefits, such as providing leads. When the agent moves on to another agency, he or she often feels that his or her clients belong to them. Legally, this may not be true, depending upon the agent's contract provisions with the agency. Regardless of the legal aspect, the agent may desire to bring his clients with him to the new agency. Since the agency is benefiting from the additional business, few agencies worry about the ethics of such replacement business. In fact, it is not unusual for agencies to actually encourage the practice.

A third reason for policy replacement deals with **company stability**. The industry has seen some ups and downs in the financial stability of some insurance companies. If an agent feels that he has clients in a company that may be suffering some financial problems, the agent may change their client's policy in an effort to protect the consumer. Certainly it is best to use strong companies initially to prevent this situation, but even the most careful agents may, at some point, find their clients with an unsound company.

Replacement of business is sometimes proposed by the agencies that have legal rights to the business but, due to contracts with vested agents, are paying part of the commissionable earnings to those **terminated agents**. The agencies may be able to move the business within their agencies and therefore, discontinue the commissions paid to those agents who have been terminated. As we have stated, not only individual agents, but agencies as well have a duty to behave in an ethical manner. Most insurance laws protect the consumers, not the agents.

When the Agent Allows Misconceptions

It would probably be surprising how many policies are sold on the basis of assumed facts or misconceptions. We are not saying agents purposely misled consumers, but they may have allowed misconceptions.

An agent relayed this story:

I was sitting in the home of an older client who was interested in investing in an annuity product. I was showing him several plans available. One was paying a higher interest rate than the other two, and the consumer liked the higher rate. I made a point of telling him the ratings of the companies, carefully pointing out the one company's "B" rating.

After a moment's pause, he replied: "Hell, I would have been happy with B's when I was in school."

It is obvious that the consumer did not understand the importance of financial ratings. It would have been easy to simply fill out the application and never address the obvious misconception on the part of the client.

Any agent who has spent time in the field can probably tell their own stories of people who made incorrect assumptions placing a sale directly into the lap of the agent. Some misconceptions may simply be amusing, while others may cause serious legal problems. Sometimes it can be so difficult to clear up a false assumption that the agent simply lets it slide by. This is seldom wise. It is always better for the client to correctly understand what they are buying. The next agent in their home may clear up the matter, making the first agent appear either inept or unethical. As one agent relayed, he hates coming into a home where he must spend most of his time correcting the false information left by the agent before him. While this does tend to cement the sale, it is also a waste of time and energy for the second agent on the scene.

One other point should be made at this time. Insurance agents tend to have a reputation only slightly higher than that of a politician. Why does this happen? It is probably safe to say that the majority of this reputation comes from consumers who feel that they were “taken” by an insurance salesman. Either the consumer did not get what they thought they were buying or they felt pressured into buying something they did not really want or intend to buy. We often hear people say that the *“big print giveth and the small print taketh away.”* In reality, print size is generally mandated by each state. There is no "big" or "small" print. What the consumer really means is that claims were not paid due to policy limitations or gatekeepers. When the policyholder knows which claims will *not* be paid, he or she is not likely to be upset, but when policyholders believe a specific claim will be paid he or she is sure to be angry by a denial. The denied policyholder will probably feel the salesperson misled him or her or, at the very least, failed to fully disclose the conditions and limitations of the policy. Angry clients are never good for the career agent.

When the Client Thinks the Premiums are Too High

Another area of ethical behavior that should never happen still needs to be addressed. It needs to be addressed because it does happen. There was the client who thought he was paying the premium for a full year only to discover that it was a 6-month premium. There was the woman who was told her bank would be drafted one amount only to learn that the draft was for a much higher figure.

Sometimes when an agent fears he or she is losing a sale due to the amount of the premium, figures may be incorrectly stated for the benefit of the sale. We would like to think that such situations are merely misunderstandings, and certainly misunderstandings may happen. There is never any excuse for purposely misstating premium amounts.

Premium amounts may be misstated simply because the agent is inexperienced in using premium tables. So many types of policies have formulas for figuring rates. For example, many long-term nursing home policies have premium rates that vary according to multiple factors, each of which must be considered. Major medical plans are based upon ages, the plan selected, and sometimes health conditions.

Obtaining Proper Application Signatures

The practice of forging client signatures is not only unethical, but illegal as well. Despite this fact, it is much more common than many people might realize.

There are many reasons why signatures may not be obtained from the client. Often, it is merely an oversight by the agent. Such oversights clearly suggest disorganization on the part of the agent. New agents might benefit from highlighting signature lines on all their forms before entering the field. Doing so could prevent the omission of needed signatures.

In some cases, signatures might be purposely overlooked as a way of avoiding the explanation of certain forms. This commonly occurs when replacement forms are required and the agent feels inadequate explaining the information contained in them. Again this is not only unethical, but generally illegal as well since all forms need to be disclosed to the client. In addition, the well-trained, well-organized agent simply does not need to omit signatures, whether by oversight or by intention. Anytime an agent feels uncomfortable about a particular form, he or she should seek council from an experienced ethical agent.

Keeping in Touch after the Sale

The hardest policies to replace are those belonging to the agent that keeps in touch with his or her clients. What are an agent's ethical duties regarding service following the sale?

This often depends partly upon the arrangements made between the agent and his or her agency or insurance company. Some companies have a separate servicing staff so that the selling agent is not expected to do any further service work. Most agents, however, are probably expected to do any necessary service work personally. Even if the selling agent is not expected to do so, most professionals do feel that referrals and additional sales result from close client contact. In addition to that aspect, everyone likes to feel that they were more than a commission to a salesperson. Even a simple birthday card at the appropriate time is appreciated by the consumer.

Many agents want to provide service to their clients. Not all agents or agencies feel this desire. Many simply do not wish to take on the burden of service after the sale. Certainly, servicing one's clients is prudent, but is it required from an ethical standpoint? Some states mandate that each client must have an assigned agent. This means that the insurance company must assign an agent to every account if the writing agent is no longer with them. Those states then expect those assigned agents to handle any claim requests that might occur. Many of the states report that the lack of claim service is the number one complaint from consumers.

Earlier in this text we pointed out that it is only possible to mandate *behavior,* but not necessarily ethics. Is it possible to force an agent to properly service their clients? Probably not. If the agent is not smart enough to understand that service promotes sales and helps business retention, it is unlikely that he or she will be smart enough to understand service requirements imposed by his or her state. In fact, an agent who is unwilling to service his or her accounts, probably will not even be educated enough to know *how* to service the accounts. When this happens, one can only hope that the insurance company or agency will step in and handle the matter. If no one handles it, eventually the client will simply change agents and insurance companies.

Selling the *“Fast Buck”* Items

Some might consider “fast-buck” an unfair label. However, we feel the evidence is compelling that many people, not just insurance agents, will quickly step forward if there appears to be a “fast buck” available by selling a particular item. There may be differing opinions on what constitutes a "fast buck" item. *In fact, it is often true that the fast buck lies not in the item sold, but in the manner in which it is sold.*

In some states, selling Revocable Living Trusts has become big business. While there is no doubt that a living trust can be very beneficial in the proper circumstances, many of these trusts have been sold for inflated prices to people who did not benefit in any way. Sometimes the consumers did not benefit because the trust was not properly executed; sometimes the consumer simply did not need the trust, so their purchase was unnecessary.

Perhaps the most perplexing aspect of the sale of these revocable trusts has to do with the way in which they are sold. An item is definitely a “fast buck” item when the seller says anything necessary to get the sale. Consumers have been told so many incorrect things about trusts that it has become clear to many state regulators that the aim of many trust companies is simply to bring in cash. If this were not the case, there would be more control exercised over the sales force. Unfortunately for those who are honest in their promotion of revocable living trusts, many states have passed specific legislation in an attempt to curb the abuses.

The “fast buck” label does not intend to imply that particular *items* are in this category. Actually, it has to do with *how* the items are sold. Any product paying a commission or finder's fee can become a fast buck item. Fast buck has to do with the attitude of the salesperson. Is the salesperson thinking almost entirely about making some fast money or are they considering where the item fits and whom it best serves?

As we saw with the living trust sales, a valuable estate planning tool was misused by salespeople for the sake of making a fast buck. There was often little concern for the consumer or the consumer's needs. Therefore, this item is both a useful vehicle in the right circumstances and a fast buck item in the wrong circumstances.

Commingling Funds

Any professional should always be shocked when they hear an agent express ignorance regarding the hazards of commingling funds. This is something that every agent should be aware of. While state laws do vary, the basic concept remains the same: insurance funds and personal funds should never be mixed. By this, we mean that two separate accounts must be kept. It might even be wise to go a step further and use two separate banks, one for your personal account and one for your insurance account. Many professionals have an operating account and a trust account. The trust account is used for funds that generally belong to the insurance company or the client – not to the insurance producer. The operating account is used for commissions that are due and payable to either the agent or the agency. The operating account is used to pay the routine bills that come with running a business. The trust account holds funds "in trust" for either the insurance company or the policyholder.

Any agent that is not clear on this should contact their state's insurance department for that state's specific requirements.

The Professional

There are many people wanting to be thought of as a professional investment advisor. Simply desiring the title does not make one a professional, however. In many states, a person can give themselves nearly any title they desire. The title may have nothing at all to do with either experience or training. From a business standpoint, it means selecting insurance companies, products, and other support systems that are both professional and knowledgeable.

The first step for any ethical investor or advisor is to be sure that the insurance companies and professionals giving advice are themselves ethical. That does not necessarily mean that they must share the same views on the environment, government or community. It does mean that they must be honest in every capacity. Certainly, this means following all laws, but also honest in how they deal with the consumers, agents and brokerages.

Consumers often ask others for recommendations. Professionals in other fields that are themselves ethical often make referrals as well. These professionals would include accountants, bankers, or attorneys. It may even include fellow insurance agents that do not themselves handle particular types of investments. If you belong to a specific type of organization and your investing goals are in line with that organization's views or activities, other members might also be an excellent referral source. For example, if you were part of a group that worked with homeless people, fellow volunteers are likely to have your same goals. As a result, they might be able to steer friends to you for professional investment advice. Ethical investors do generally feel more comfortable when their investment advisor is like-minded.

Another area often overlooked is fellow church members. If you have members of your particular religious organization who work in the investment field, they may be an excellent source of information. Consumers do not always feel comfortable working with someone they feel TOO close to, but they may still consider you for their ethical investments in some areas. In addition, it may not be wise to take on clients that are close friends or relatives. There can be many pitfalls when clients are more than business associates.

Preparing for Tomorrow

We hear it so often, but our lack of preparing financially for retirement is a huge problem in America. It is actually an ethical duty to financially prepare; otherwise we are expecting others to support us financially in retirement. Those "others" may be our children and grandchildren or the taxpayers, but whoever it ends up being it is the duty of each person to do what is necessary to be self-supporting. It is not ethical to spend every dime today without consideration of financial needs in the future.

Financial Management

Each of us must manage our day-to-day lives in the best way we can. This includes the management of our finances. This is just as true for the insurance agent as it is for any other person in any other line of work. In some ways, it is especially necessary for those in commissioned sales.

Those in commissioned sales often tend to overlook necessary financial discipline regarding taxes, Social Security payments, and other types of business requirements. As every agent has heard, there is a very high failure rate in commissioned sales. Some of those failures result not from a lack of sales ability, but rather from a lack of business sense. Most experienced businessmen and women state that their most important asset is their CPA or bookkeeper. Those who have an accountant who is experienced in small business or commissioned sales state they are especially happy with the relationship.

Sometimes it is difficult to locate those people and institutions one wishes to do business with. Generally, it is worth the time it takes to find them, however.

Most of us tend to bank with the institution located nearest us. Few people take any time at all in selecting their bank past the location. This is unfortunate since banks do vary in many areas. For the small business owner or independent agent, it is particularly necessary to understand the opportunities, or lack of them, offered by their bank.

Business ethics involves many things. Certainly one ethical concept is paying bills on time. This is true even in our private lives, of course, but it is especially necessary for your business. Not only may the person you owe money to be a potential policyholder, but they may also personally know other clients you currently have. An insurance agent with a bad financial reputation is not going to generate great trust.

Small business owners often overlook one other vital factor in their business: the people they hire. This includes not only insurance agents but also the office personnel. It goes without saying that anyone who answers the phone needs to be courteous. Beyond that, personnel also need to be knowledgeable and display a willing attitude. Probably everyone has, at one time or another, been in a public setting where the person waiting on them obviously was not interested in the duties at hand. Perhaps it was a rude clerk in a grocery store or a clerk who seemed resentful when you requested a larger size in a piece of clothing. Whatever the incident, such actions always hurt the business they work for. For example, if a clerk in ABC store is rude, the customer does not say: *"A clerk named Sue was rude."* Rather she states *"ABC store is rude."*

Nowhere is this truer than in a commissioned business. A commissioned business typically has a great deal of competition. The consumer has many choices of companies and products from which to buy. An insurance agent who seems impatient for the signature or appears rude when a consumer does not wish to purchase a product damages the agency they work for. Chances are the consumer will not remember the individual's name, but they will remember the company that was represented. It only takes one unprofessional agent in your company to turn numerous sales over to your competition. Any agency who tolerates such behavior, no matter how much that particular agent sells, will experience reduced business overall.

Due Diligence

What does the term, due diligence, actually mean? For the agent, due diligence is the analysis of a particular company's products, performance and financial standing. Where life insurance is concerned, this is often done to determine whether there is a reasonable expectation that the illustrated values presented can actually be achieved. Life insurance is, in some measure, the business of making long-term promises to clients. It is vital to those clients that the company is able to keep the promises they are making. Due diligence is the agent's analysis of whether or not the company can, in fact, keep their promises. The term, due diligence, is primarily derived from the securities industry.

For the insurance company, due diligence is an ongoing process which insures that pricing objectives are being realized, and that integrity and consistency of internal procedures are being maintained. It is working with the agents and agencies, as well as their policyholders, to preserve fairness in all parts of the operation. An insurance company that is concerned with due diligence will treat its sales force and back-up members as well as they treat their policyholders. Company due diligence also means making investments that are sound and prudent. For life insurance companies, due diligence is not a new concept, even though it may be for many agents.

The life insurance industry has moved their product design away from fully guaranteed values and benefits towards a dependency on current, sometimes more favorable parameters. This means more risk has been transferred to the consumers. The factors more often used these days also tend to be more volatile. In many cases, only the strength and the integrity of the company involved can ensure that projected, non-guaranteed elements of the policy are actually realistic.

As agents and the general public have become more educated on the variety of options available, insurance has seen a change in how it is perceived. While price has always been considered, additional elements are now commonly looked at as well. Consumers want to know if the company they are considering can manage its overhead expenses, mortality expenses and investment returns in a way that allows the company to make good on its promises in the contract.

In addition, the role of the agent has changed. Whereas the agent was typically thought of as only the salesperson, consumers now consider the agent to be someone who must give reliable information for the good of the policyholder. We no longer accept the view that the agent represents only the company. This change in the general perception of an insurance agent places greater responsibility, both legal and ethical, on the insurance producer.

In the public's view, the level of service and the quality of the advice given are linked directly to the insurance company and that company's performance. It must be noted that practicing due diligence makes sense from many standpoints, one of which is financial protection for the agent, as well as the consumer. When an agent takes the time to investigate his companies *(and document that investigation)*, he or she is also protecting their own financial future. Lawsuits are common and it is reasonable to believe that even a good agent can experience one. Due diligence is, of course, an ongoing process since companies can and do change how they operate. Due diligence might be considered as a method of self-protection through knowledge.

Many agents groan when due diligence is brought up. They picture hours of work put into a schedule that is already difficult. It should brighten their day to know that there are more answers than one might imagine at their local library. A morning spent looking up the companies they are representing, or are considering, is a morning well spent. There are three reasons to do so:

- To prevent lawsuits from angry consumers who feel they have been taken,
- To protect the trust they have spent hours building up with their clientele, and
- To determine if the people associated with the companies they sell have the level of integrity desired.

If an agent bases his or her company affiliations on commission levels, leads provided, or where the next convention will be held, he or she is in for a few surprises down the road. An agent should request a copy of the insurer's annual statement and pay particular attention to the interrogatories, because they are brief and speak to short-term changes from the previous report.

Agents must begin their due diligence process by gathering information on the major components of the company from as many sources as possible. This would include seeking information directly from the company. In fact, this is probably the first place to seek information. Generally, such information is readily available. The agent should not overlook another simple way to gather information: ask questions. Management, fellow agents, insurance company staff, anyone who seems knowledgeable may be able to supply information. Anytime an insurance company seems reluctant to provide information to their own agents, a red flag should go up.

Insurance producers can learn much from simply asking other agents who have been with the insurance company for a relatively long period of time. Ask about the speed of the company's claim service since this is often an indicator of company solvency. Find out if commission checks seem to be consistent, correct and on time. If a financial error is made, how long does the company take to correct it?

The agent should collect the three most recent sets of financial statements and study them. Does the company seem to be making excessive profits? Does the company seem to be making minimal profits or perhaps too little profit to ensure continuance? Compare the surplus in relation to the amount of business being produced. Ask the state Insurance Department to see if there are any watches or cautions outstanding. How many complaints from consumers has the company experienced in the past year? You may also wish to look at complaints over a three-year period to see if any pattern seems apparent. The agent may also want to watch for any shifts in management of the company since this can change the philosophy of the company.

Once a measure of information is gathered, the agent must assimilate it in a manner that is easily understood and assessed. There are several ways to assess this information, but often the agent simply looks at it from the standpoint of "Does it *feel* right?" With so many carriers to choose from, there is no need to represent any carrier that does not *feel* comfortable.

At the very least, agents should consult rating agencies. They are not infallible but they will supply basic information. Only top rated insurers should be used.

There is both a technical way of locating sound financial companies and a common-sense approach to it. Understandably, it is difficult for an agent to research each individual company, although that must be done to a certain degree. Sometimes, a common-sense approach actually works better because much of the information that an agent may find on any given company could be outdated or unconfirmed.

A certain amount of technical analysis of historical data is important, especially as a point of reference to start with. To spot a potential problem before it happens, however, a common-sense approach is often more effective. Once a potential problem is identified, technical analysis is then appropriate again. The technical analysis will either confirm or deny the suspicion of a financial problem within the company.

Financial due diligence could also be called solvency appraisal. Traditionally, such an appraisal is done from a technical standpoint. It is true that if you told another agent that you simply had a "gut feeling" that a company is having financial trouble you are not likely to be taken seriously. As a result, even if it is simply a gut feeling, you must be prepared to then proceed to the technical detective work that is necessary to validate your feelings. Many "gut feelings" originate from sensing that something has changed or is amiss. This might be something as simple as delayed claim payments. There are some problems or limitations to the technical approach:

1. Agents rarely conduct their own technical analysis. Instead, they refer to what others have compiled. It would simply be too time consuming to personally research each company we deal with and most agents are not willing to spend the amount of time it would require. In addition, few agents would even know where to begin such an analysis.

2. Most professionals feel that a true technical analysis requires historical data on the company in question. In the past such data was considered important, but with so many rapid changes occurring, the validity of such data may now be questioned.

3. Even though we do recommend that agents stay with "A" rated companies, there is evidence that the rating services are generally unreliable when it comes to predicting insolvencies. This appears to be true of both corporate bond rating services and insurance rating services. Many professionals find it best to review multiple rating companies so that several perspectives can be seen.

4. One problem with technical analysis lies in the oversimplification of only a few indicators. Agents and consumers alike tend to lock in on only one element in the analysis. The public, for example, knows only about the rating systems and seldom understands precisely what those ratings really indicate.

5. Generally speaking, the management of a company determines its business practices. If the company is not a mutual company, who owns it becomes an important indicator. If the owners of the company are not the managers, then who is managing the company is also very important. Corporate values and culture can often be shaped by a single powerful person. Along this line, if the management of a company changes, the strength and weakness of that company can also change.

6. Product design is something that agents often do spot immediately, especially if the agent is experienced. Product design tends to be a mirror of those who are running the company. It is a fundamental extension of the leader's vision, desires, and

values. Are there gimmicks or sound benefits within the product? Some products seem to utilize a "bait and switch" sort of theory. Common sense should also tell us that a product that puts out more than it takes in will not benefit the companies or its policy-owners.

7. As we have discussed, replacement selling is more common than ever before. As a result, the risk of adverse news or competitive interest rates can cause disloyal policyholders. This makes *distribution* a point of common sense. A debt loaded volatile national and world economy does nothing to reduce the risk that could pull a company into insolvency. Distribution of products must, therefore, be considered. Stockbrokers are notorious for rolling their money quickly. If a company does a lot of single premium or asset intense products (such as annuities) distribution can become critical. Insolvency risk is much higher when insurance products are distributed through a limited number of non-insurance distributors.

To recap, the technical approach has some limitations:

1. Technical analysis is difficult and few agents know how to do it.
2. Historical data is not always reliable.
3. Rating services are useful, but not necessarily an indicator of insolvencies.
4. Technical data is often oversimplified or simply misunderstood by both the agent and the consumer.
5. The ownership and management of companies that are not mutual companies is an indicator of company practices. Few agents or consumers personally know who is in charge of the companies they deal with.
6. Product design is a fundamental extension of the company's management, but technical analysis seldom takes this into consideration.
7. Distribution is critical for the solvency of a company, but it is very difficult to know how products are distributed in many technical analyses.

Despite these limitations, technical analysis is still useful as long as it is combined with the agent's common sense. There are many ways that an insurance company can get into trouble. Usually it is a combination of problems; seldom one problem alone. Instead of making little mistakes, the company might make one or more large mistakes, which of course can have severe consequences. Perhaps losses greatly exceed gains and capital and surplus are consumed. When money goes out faster than it comes in, no business or individual can run efficiently. This is called a **negative cash flow**. A **positive cash flow** means more money is coming in than is going out. In addition, if one or more of these problems is made public, policyholders may begin to withdraw their money, which only intensifies the existing problems.

Like so many things, the old saying, *if something looks too good to be true, it probably is*, is an excellent common sense approach to insurance products. The easiest product to sell may well be the very product you should avoid. It will save you future embarrassment and liability to avoid some products.

A common sense approach to due diligence is a practical way for many agents to spot potential trouble for themselves and their policyholders. The object is not necessarily to find those companies that are sound, but rather to avoid those companies that are not. Such things as ratings and historical data certainly do have their value, but they should not be the only indicators used.

The insurance industry has suffered many image problems, a few of them deserved. In public opinion polls, insurance agents routinely end up at the bottom of the list between attorneys and politicians. Consumers simply do not feel that insurance companies and their representatives consider ethics to be a high priority. In fact, many consumers feel that ethical behavior of any kind in the insurance industry exists only because the states mandate it.

For many questions of ethical behavior, there must be consideration of all facts involved since the deciding factor can vary from situation to situation. An agent must ethically give the insurance company all facts considering the insured that are pertinent to the issuance of the policy, but on the other hand, the agent also owes it to his or her client to give them all the pertinent facts regarding the insurance company. In other words, the agent has an ethical duty to *both* the insurance company and the policyholder.

In the past, most agents felt that giving the financial rating assigned to a company by a rating firm was sufficient, but in recent years that has not proven effective. In one case, it may be sufficient, but in another it may not be enough. How is an agent to know when he has given enough information or too little? Must the consumer take more responsibility for looking up facts and figures on a specific company or is that the role of the insurance agent and his or her agency?

Some people feel commission structures have been a primary cause for ethical problems within the insurance industry. These individuals feel a commissioned basis fosters an "anything goes" attitude. That does not completely explain the problem, however, since many other industries also function on a commission basis without the negative image that has plagued the insurance industry. Most experts feel that commissioned sales, of any type, is ethically neutral although it is possible to have unintended results if it is not structured properly. It is not the commission pay system itself that causes problems. Rather, it is how people prioritize their work and their lives that bring out negative results. When making sales becomes the priority, without any other aspects considered, integrity can certainly suffer.

All companies want to make a profit. In fact, companies have a duty to their stockholders to run a profitable business. Being profitable, however, should not alter other ethical concepts within the business.

Property and casualty lines may have little incentive to use one company over another on the basis of commissions, since they tend to pay about the same. It is more likely to be an issue in the life and health field. Some advocacy groups are calling for the discontinuance of all commissioned sales people. Interestingly, few of the consumers themselves seem to view commissions as the root of the problem. Consumers are more likely to target the insurance company itself as the major source of dissatisfaction. Groups that are calling for the discontinuance of the commissioned agent force may not be taking into consideration the matter of customer service. While there are certainly a measure of agents and agencies that do not provide service, there are many that do. Without commissions, it is unlikely that service will get better. We have seen many industries that do not utilize commissions demonstrating very poor customer service practices. Many feel commissions may encourage good customer service since agents want to retain their client base.

A basic question asked not only by the consumer, but by the agents themselves, is whether or not the insurance companies and management staffs actually value ethical behavior in their field force. While most people do feel that practicing good ethics is also practicing good business, many agents feel that there is little, if any, recognition for ethical behavior or practices. Insurance agencies seem uncertain how to reward, or even recognize, ethical sales practices in their field agents. Certainly, underwriters value ethical behavior because it is necessary in order for them to underwrite the policies effectively. When an agent has a reputation for giving solid information, the underwriters are likely to do a better job for that agent in terms of time and judgments. On the other hand, when underwriters know an agent consistently omits needed information or is vague in the routine information given, then underwriters are much more likely to question every aspect of that agent's submitted applications. Certainly, in this area, ethical behavior is rewarded.

Clearly, the issuance of insurance policies is based upon ethical behavior. There is the general agreement that the insurance industry is founded on ethics. It would be impossible for the industry to operate without it. The risk-sharing mechanism is closely dependent upon the ethics of trust. The insurance industry depends upon the consumer to act ethically when disclosing personal information, it depends upon the agent to relay that information correctly to the underwriters and it depends upon the insurer to keep their promises that appear in the contracts. Even the claims that are submitted to the insurance companies depend to a certain degree on ethical behavior. Of course, we all know that many fraudulent claims are submitted each year, which drives up our costs for insurance protection. Such fraudulent claims are certainly unethical. Ironically, many consumers feel insurance companies have lots of money, which makes filing false claims, in their minds, acceptable.

There was agreement from those participating in the ethical review for *Insurance Review* magazine that encouraging ethical behavior, within any company, must begin with top management. A strong, understandable code of ethics must not only be a written doctrine, but also practiced by those at the top. The more massive a company is, the more a written code of ethics is needed since many of the employees may never have access to top management. When ethical codes are clearly stated and demonstrated by a company, the lower management and staff are more likely to behave ethically themselves *because they know it is expected.*

A written code of ethics that is buried in a company manual, but seldom discussed, is not likely to be taken seriously by the employees of the company. This is especially true when management does not appear ethical themselves. Employees certainly want to be recognized, so it simply makes sense for management to recognize ethical behavior. Such recognition will promote ethical behavior among the employees, which will benefit the company itself. On the other hand, if top management seems only to recognize sales without any concern as to how they are achieved, the message will be clear to the sales staff.

Some companies conduct ethics training sessions. Questions that arise in the sales field every day are looked at for possible solutions, which are both ethical and sensible. Ethical competency often is simply a matter of education. It is also a matter of peer pressure. When coworkers expect ethical competency, others are more likely to act ethically competent. Ethics must be made a part of the decision making both by the company management and individually by the personnel. If employees are to act ethically, however, they must feel confident that their superiors will stand behind them.

It seems like the quantity of rules and regulations grows daily. With their abundance, it may seem asking "is it legal?" should be enough. Simply following the laws may be the minimum acceptable level of ethical conduct however. It is up to the business organization to develop company standards for employees and sales staff. Ideally, that will be higher than is actually mandated by law. Of course, each individual must also set their own personal standards of conduct. We all know of individuals who do simply use what is legal as their standard of ethical behavior. For these individuals, as long as they are not breaking the law, any behavior is deemed acceptable, regardless of how many other people are taken advantage of.

Doing the proper thing ethically is simple when the choices are clearly between an action that is right or wrong. Stealing or not stealing is basically a clear-cut choice, for example. Making ethical choices is not so easy when the decision is between two sets of action, either of which might be right and/or wrong. This generally has to do with two sets of ethics, either one of which could be valid. For example, we have all probably lied to someone in order to spare feelings. This may not necessarily make the action right, but the choice was made between truthfulness and another person's feelings. Both of those choices may be ethical (it is not right to lie nor is it right to hurt another person).

Ethical behavior tends to have long-range (versus short range) benefits. In the short term, it is often advantageous financially to make the sale no matter what tactics are used. In the long term it is more advantageous to behave ethically even if that means forgoing the sale. When an individual is financially stressed, it is more likely that he or she will ignore the ethical requirements making the financial gain the top priority. This applies to both individuals and businesses. When an agency or other type of business is struggling, their first concern may be profits rather than ethics. That is why salespeople must use some thought regarding whom they choose to work for.

Society as a whole has become much more demanding when it comes to ethical behavior. At the same time, we are living in an age when financial success is more likely to be admired. Often, we feel that others wish to be treated ethically, but others are not necessarily willing to do the same in return. Nearly everyone has, at one time or another, gone out of their way to do something for another only to be treated badly in return. Such situations do not change what is ethical but it may change our future behavior.

Sometimes ethical behavior is aided by our advancing technology. People may act more ethically simply because they realize that their chances of being caught in unethical actions are greater today than in the past. In the past, our technology often did not allow vital information to be brought out quickly. Today, with the aid of computers, information is much more available to a greater number of people. This brings up another question: when an individual acts ethically, not out of desire, but because they know they must, is that person actually ethical? As we previously pointed out, sometimes we are only able to dictate a person's behavior, not their ethical standards.

Each of us has a public image, which is either good or bad. We sometimes make the mistake of believing only large companies must be concerned with public relations. It is doubtful that any other area is more important than how the public (consumers) see us. Having a good public image means more referrals will be generated, more business will stay on the books and people will be more trusting of our advice. In fact, when businesses sell, it is often the public image of the company's name that raises the price. When a business has a reputation for excellent service or products, the business is simply worth more money.

We sometimes think of public images as having to do with advertising budgets and promotion. Actually, our public image is simply how others perceive us. The definition of oneself is seldom set down by us, but rather by others we come in contact with. We establish the traits others judge us by. This is true of both individuals and business.

Individual ethics and business ethics are sometimes thought to be different things, but that is not necessarily true. Every business has a responsibility to develop a business ethic. Certainly, an insurance entity must worry about becoming the concern of a government regulator if legal ethics are not followed, but it really goes beyond that. Without clear principles within the business outlining what is acceptable and what is not, problems may easily develop, with both the public image and the legal continuance.

Accounting firms and attorneys point out the need for a clearly written, legally sound employee manual for every business. With the number of employee-related lawsuits being filed, employers simply cannot afford to ignore the need for a well thought out employee manual.

Experts note that a significant percentage of these employee-based lawsuits would never have stood up in court if the situation had been properly addressed in the manual and then emphasized at company meetings. Businesses that have not put together such a manual are definitely at legal risk. Besides lessening the likelihood of being sued, a well-written (and followed) company manual can also improve employee morale as well since it establishes what is expected of the employees.

Such things as churning policies, misrepresentations of products or services, and outright fraud taint the public's image of our industry, which ends up hurting every person within it. All of these issues need to be addressed in the company manual. Often, salespeople are hired as independent contractors. In other words, each salesperson is self-employed. An agency may do this for a number of reasons, but even if this is the situation, the agency would still be wise to formalize a manual on ethics in selling. It is simply prudent to do so.

If It's Legal . . .

Another philosophy often heard expressed is: *If it's legal, it must be moral.* Again, we only have to look at our country's past history to know that this is not necessarily true. The fact that slavery was, in some places, legal did not make it right. The fact that children could legally work in factories did not make it right. The fact that it was illegal for women to vote and sometimes even illegal to own property independently of her husband did not make it morally right. While laws are intended to have a strong connection to morality, we know that this is not always the case. In all major historical situations it required people of strong and dedicated conviction to bring about radical change. In some cases, people gave their lives for those changes.

It is certainly necessary to teach our children to respect the law. It is necessary to not only respect the law, but in most cases, follow it as well. Otherwise, our country could not prosper. However, not every law reflects what is moral. As Martin Luther King, Jr. said, *"Any law that uplifts human personality is just. Any law that degrades human personality is unjust."*

Moral inconsistency appears to be a part of our human nature. Even good people will be tempted in some situations. Morals are often about dealing with the temptations of life. It is easy to be ethical when temptations never arise; the real test is resisting the temptations.

Ethics often require tough choices but ultimately our lives are usually easier. Choices between right and wrong are not always easy to identify. Individuals must make what they perceive to be the best choice. It is not necessary to always be right but it is necessary to stay with the morals we believe in.

A moral ***dilemma*** is the struggle to determine what is right, while a ***conflict*** occurs when you know what is right, but you do not particularly wish to do the right thing. For example, among friends, relatives or colleagues it can be difficult to take an unpopular stand even if you feel strongly on the issue. Interestingly, studies have shown that individuals are more likely to take a stand on political issues than on morality issues. Perhaps it is socially acceptable to disagree on politics but not on moral conflicts.

Some people can react morally even in crowds, while others find it difficult to step forward. People who step forward in difficult situations possess **moral certainty**. They strongly believe in doing what is perceived to be right, even when others fail to act. It does not necessarily make their view right or wrong but these individuals are certain of their moral path. Such people are more likely to help a stranger in distress, even facing personal danger to do so.

Two separate studies have shown that a strict religious upbringing substantially contributes to a person's moral certainty. This may be because there is no ambiguity about what is right or wrong. There are straightforward definitions of right and wrong; good and bad. Another study revealed that when a person is presented with multiple choices or ideas of what is right or wrong, the more likely that person is to be indecisive. Apparently, it is more difficult to narrow down multiple choices of what is right or wrong and easier to make the choice when only a couple of alternatives are presented.

From a common-sense approach, it seems logical that a child who has been taught right from wrong will have less ambiguity as an adult since he or she has a background in moral issues. It is those who have never considered the right path that will have the most difficulty making such decisions. When moral education has been provided (and accepted as truth) decisions are simply easier to make.

We could continue to study the issues of morality, which is simply acting ethically, indefinitely. We could cloud issues with multiple views and supporting facts. The topic of ethics is a complicated and complex issue. Basically, however, ethics is simply a matter of doing what we perceive to be right. Acting ethically is not a difficult thing, but it can be a struggle. People and businesses do not act ethically for multiple reasons ranging from simple laziness to indifference to ignorance. All too often greed is also an element.

Certainly, ethical behavior is practical from the legal standpoint. To behave unethically means that you may find yourself in a legal dilemma. Unethical behavior may also mean legal action against an insurance producer, the agency, and the insurance company.

A twelve-year-old from Ohio wrote: *"If everyone did their share, no one would have to save the entire world."* Although simplistic, this statement makes an amazing amount of sense. If each of us acts responsibly, everyone benefits. This is especially true in the insurance world.

There are no clear or easy answers to many of the moral dilemmas in our lives. Most of the ethical choices we have are not complicated, however. We, as insurance agents, know what is legal and what is not. We, as insurance agents, know if we have concealed necessary information from the consumers (our clients). We, as insurance agents, know if we have lied or been truthful. Each of us has personal shortcomings of some type, but ethical behavior is something that we clearly have control over. With free choice comes responsibility. No ethics course will change the reader. As in all things, each individual must make personal choices regarding their own integrity and accountability.

Being ethical simply means doing what the individual perceives to be right even when it means forgoing a commission. Each day brings multiple opportunities for going either way, but we know what we should do. Temptations will always exist; the moral person handles them without giving up their morality. This means overcoming greed, laziness, indifference, temptation and perhaps even fear. The truly committed ethical or moral person will have personal convictions by which they live. These convictions didn't happen by accident. They were convictions that were fully adopted and continually followed.

It is easy to be moral and ethical when it makes us look good or noble. It is easy to behave ethically when others will be observing us. The difficult part comes when there will be no recognition for our convictions, when we may even be unpopular or have to face another who is acting illegally or unethically. Doctor Martin Luther King, Jr. said a person's worth is *"not where he stands in moments of comfort and convenience, but where he stands at times of challenge and controversy."*

Maya Angelou said: *"My mother said that I must always be tolerant of ignorance but understanding of illiteracy. That some people, unable to go to school, were more educated and more intelligent than college professors."* Moral convictions seldom rely solely on education. While education is likely to bring about thought, convictions are something the individual personally adopts, regardless of their educational status.

In the end, *what* you and your business represent will be established by your convictions, your principles, your actions and your words. It will not matter how many material things you have, what you look like or who you know. You will be defined by what you do and what you say. *Who* you are is the only thing that no one can take away from you. It is your final statement about yourself, your business and your life.

Irene Peter said: *"Ignorance is no excuse – it's the real thing."* There is no excuse for ignorance when it comes to ethical conduct. Insurance producers are exposed to ethical education (in most states) each license renewal period. Increasingly more states are now mandating training in insurance ethics.

We had hoped to end this chapter on some grand statement that insurance producers could carry with them throughout their lifetime. In the process of researching this material, however, it became evident that each person must arrive at their own grand conclusion. For in the end, we each make our own choices and choose our own life paths. We choose our own mishaps, our own miseries, our own troubles. We also choose our own principles, our own victories, our own happiness, and our own ending statement about ourselves.

Perhaps the greatest challenge is not philosophical knowledge, but rather *moral understanding.* The challenge is not your financial goal, but rather your moral living. The financial goal will come on its own.

NAIC Suitability

2010 Suitability in Annuity Transactions Model Regulations

The National Association of Insurance Commissioners (NAIC) adopted the 2010 Suitability in Annuity Transactions Model Regulations to set standards and procedures for suitable annuity recommendations by producers and to require insurance companies to establish a system of supervision.

Specifically, the Model Regulation was adopted by the NAIC to do three things:

1. Establish a regulatory framework holding insurers responsible for ensuring the annuity transactions they underwrote were suitable based on specified criteria.
2. Require producers to be trained on the annuity provisions in general and specifically on the products he or she was selling or recommending.
3. Where feasible and rational, make the suitability standards consistent with those established by the Financial Industry Regulatory Authority known as FINRA.

Insurance companies, under these Model Regulations, acquired duties regarding product compliance. In general, prior to recommending a particular annuity to a consumer, the insurer or producer must make reasonable efforts to obtain consumer information that allows the insurer or producer to establish product suitability for that person's personal circumstances. Based on the information given by the consumer, the producer (or insurer if no producer is involved) must have reasonable grounds to believe the transaction is suitable for the situation.

The producer may not dissuade or attempt to dissuade any applicant from providing accurate and truthful information on his or her application. Why would a producer want to do that? If some of the applicant's information would show the product was not suitable the agent may not want to disclose it.

If the consumer refuses to provide necessary information at the time of product application both the insurance producer and the insurer are released from suitability obligations. Obviously, if the buyer gives wrong information, partial information, or no information at all, the producer and insurer cannot be expected to make an accurate determination of suitability. Even in these circumstances, however, the producer or insurer must make the best recommendation possible with the information they have available.

Some suitability requirements may apply under FINRA, which would apply to variable annuities. The so-called "safe harbor" is intended to prevent duplicative suitability standards.

Suitability Information

What, exactly, does **"suitability information"** mean? It means gathering and using information that is reasonably appropriate to determine the suitability of the product being recommended. This information would include such things as age, income, financial objectives, time horizons, and other pertinent facts.

Some Repeated Information

You will find that this chapter repeats some information found in previous chapters. Since we wanted to make this a complete chapter on suitability, there was no way to avoid this. Where states have initiated annuity suitability standards based on the NAIC outline, we wanted to put required information together in one complete chapter.

Selecting Appropriate Products

There is no "perfect" investment vehicle and each vehicle carries some type of investment risk. This is true of everything from stocks to saving accounts at our local banks. In some cases the risk has to do with the type of investing, but in other cases it is inflation that robs us of our 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 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 professionals feel it is the emerging popularity of equity indexed products that has caused the states to begin requiring annuity training and suitability requirements. Just like other annuities, equity indexed product are issued by insurers, but they have aspects that are not like the traditional fixed rate annuities most consumers are familiar with. Equity indexed annuities are *not* variable annuities; they are fixed rate annuities, but very complicated fixed rate annuities.

What is an Annuity?

What exactly is an annuity? It is generally described as a contract issued through an insurance company that allows money accumulation and distribution for life or some specified time period. Unlike life insurance products where policy issue and pricing are based largely on mortality risk, annuities are primarily investment products. 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."

The NAIC Buyer's Guide to Fixed Deferred Annuities states an annuity is a contract in which an insurance company makes a series of income payments at regular intervals in return for a premium paid in a lump sum or over a period of time. They further state that only an annuity can pay an income that can be guaranteed to last for the lifetime of the annuitant (under a lifetime income annuitization income option). The amount of life time income will, of course, depend upon the amount of money deposited into the annuity.

Making Decisions

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. Yes, there is some information provided (some very good information in fact) but it is seldom complete. There is a logical explanation for this incomplete financial picture: it would take a book to completely explain any financial investment vehicle. It simply is not possible to give a total look at a complicated financial vehicle in a few paragraphs or even a few pages of text. Generally speaking, most websites will be promoting their particular products, so the information provided may be slanted to their products.

Unfortunately, every author, every agent, and every well-meaning next-door-neighbor claims to be an expert. Who should the average consumer believe? If you are the selling agent, you hope your clients believe you, but it will only take one mistake to convince your clients otherwise.

The wise agent will 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 client may claim otherwise. When it is the agent's word against his or her client's the outcome is uncertain. This is also a strong argument for agent documentation. Especially if an equity indexed annuity product is presented there can be consumer confusion and poor choices can have adverse consequences. Even when principal is preserved a client who receives zero growth may become unhappy.

The first step is always to realize that although fixed rate annuities are an excellent and relatively safe investment 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 of great importance. Annuities are designed to be long-term investments so they are seldom a wise choice for short-term goals. The Internal Revenue Service considers annuities a retirement vehicle so they will impose a 10 percent penalty on withdrawals made prior to age 59½ (it is an early withdrawal penalty).

There are important differences between 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 agent to market variable annuities. They 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 Have Many Uses

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

Safety of Investment

There are many reasons fixed annuities offer safety of investment, but one of the reasons has to do with capital reserve issues. Our government gave money to maintain many of the banks following their poor lending practices and resulting money problems. Most experts felt 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.

Funding Retirement

Although annuity funds may be used for any reason, retirement is a primary use. Annuities are tax deferred vehicles, so 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 will penalize 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. Agents 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 a presiding judge.

A structured settlement is a settlement amount that is structured to pay a specified sum over a specified time period or 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; it 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. Agents 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.

Agents 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.

Beneficiary Designated Money

Surprisingly a large number of annuities are never annuitized or used by the contract owners so beneficiaries eventually end up with the money deposited into the contracts. It is possible that the goal was always to provide funds for the policy's listed beneficiaries or it is possible that the contract owners simply did not require the funds during their lifetimes.

Avoiding Probate

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 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 very 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 versus New Money Rates of Interest

There is often a difference between annuity 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 owner and the annuitant are often the same person. The **owner** is the individual who owns the "rights" to the annuity income. The **annuitant** is the person whose life is measured by 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 we continue to live longer, we are justified in fearing we might run out of money before we run out of life. In other words, Americans are at risk of having too little money set aside for the last years of their life. As we continue to have smaller families, we may not be able to count on our children to care for us both physically and financially in our last years. A major cost to our 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.

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 contracts allow the interest earnings or 10 percent of values to be withdrawn without incurring penalties. Some annuities reward investors with bonus interest points if they do not withdraw funds within specified guidelines.

Categorizing Annuities

Annuities may be categorized in various ways, depending upon the source used and the context intended. However, they are typically categorized in one of three ways:

- Fixed or Variable;
- Immediate or Deferred; and
- Flexible or Single premium.

The first, fixed or variable, will affect the security of the investment since fixed products are always more secure from a risk standpoint than variable.

The second, immediate or deferred, describes when income is desired. Immediate products immediately produce income while the second choice defers income.

The third, flexible or single premium refers to the ability to deposit additional money later on (after the investment was first purchased).

Benefit Payment

Immediate Annuities

Individuals who receive a lump sum settlement or who have other sources of accumulated savings often chose 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 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 CD and buys an immediate annuity from her local insurance agent. 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.

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 later 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 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 rates rise, but recently that has not been the case.

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 at all.

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, semi annually or annually throughout the life of the policy holder, or for 2 or more people. Contracts can also be for a predetermined time period. In all cases, it is important for the investor 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

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. Having said that, there are other more identifiable risks in many investments.

Each investor has what is commonly referred to as ***"risk tolerance."*** This means the ability of the investor 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. A young investor has time on their side; if they lose big, they have time to make up their losses. An older person does not have time on their side. Older investors should always seek safety rather than excessive risk.

Some types of annuities have more risk than other types. The riskiest annuity is the variable annuity; 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. Generally speaking, the risk in these annuities is 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 as long as 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 funds 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 provider 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).

Indexed Fixed Annuities

An equity indexed annuity is first and foremost an annuity product. Unfortunately, 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**. They may be one of the best retirement tools developed in recent years, especially considering how the stock market has recently performed. EIAs 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 very complex. Equity indexed annuities (called 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 as 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 investors, 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.

Clients should make sure that these types of annuities are suitable for their situation. These annuities are not suitable of everyone and agents 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. Investors may believe they are receiving a competitive rate of interest when, in fact, they are not due to charges in the contract.

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 very 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 specific 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 or not other aspects of the economy go up or down. Actual rates will vary from company to company and even among annuity products with 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:

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

When an investor decides to annuitize, the amount of each check on a fixed rate annuity will depend on the current interest rates. 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 20 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.

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 3 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 with past experience in the stock market.

While annuity contracts are not all the same, generally EIAs do not have internal expenses, meaning there are no fees, or front-end or back-end loads that could retard 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% Internal Revenue Service early withdrawal penalty.

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 a traditional fixed rate annuity would.

All EIAs 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. EIAs 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 investors.

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 well 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.

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% 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.

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 any portion of the money within the first years of his or her variable annuity, he or she must pay surrender charges based on a declining scale.

Agents should never assume that the percentages or costs we have listed 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. Always read and understand the product being sold.

Funding Variable Annuities

Investors should first maximize their retirement options as far as their individual retirement accounts (IRA) or employer-sponsored programs are concerned. If the investor has the ability to invest additional funds 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.

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 the wise agent will certainly shop around for the 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.

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 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.

Traditional fixed rate annuities are typically suitable for the investor who is risk adverse and wants 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 owner for early withdrawals. It may be possible to take 10% withdrawals without penalty; refer to the annuity contract for details. Certainly if the 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 on. Whatever payout option was chosen determined length and amounts of systematic income.

Annuity critics seem to concentrate on commissions earned by the selling agents, an odd concern to say the least. This is odd because the rate of commission has no direct effect on the contract terms. As long as the investor is aware of the guaranteed rate of interest and is content with the guaranteed rate stated, whether or not the agent 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.

Sometimes annuity critics argue the annuity product would pay a higher rate of return if the agent 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 agent will receive. The first and primary concern is simple: does the investment suit the investor's goals and requirements, including risk tolerance?

The commissions paid to agents may affect the bottom line since the more the insurer pays their agents (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 investor will not get a better contract by bargaining for lower commission rates. The investor would be wise to shop the marketplace for the best product but that is wise regardless of commissions paid. Many critics feel agents only present products that pay higher commissions and there may be some truth to this. That does not prevent consumers from shopping around since many available products are offered through varieties of online websites and through local agents. 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 agents earn that the important issues are overshadowed: safety of principal, insurer financial stability and satisfaction of investment goals.

Many professionals advise consumers to simply find a product that fits their needs and leave commissions between the insurers and their agents. Many elements of how insurance companies determine commissions have nothing to do with the actual product so price shopping, while always advisable, may have no bearing on what the agent receives in compensation. Some insurers pay a higher commission for the same reason a department store pays higher salaries: they want the best people representing them. As it applies to equity-indexed annuities, higher commissions may be paid to compete with management fees financial planners would lose if they recommended EIA products. Financial planners stand to lose a substantial sum over the life of the EIA since he or she would have made multiple fees if they were managing a mutual fund, for example.

Agents do have an ethical responsibility to represent and recommend suitable annuity products. It would certainly be unethical to recommend a poor product simply because it paid a higher commission. Many states already have or are in the process of implementing suitability requirements for annuities because there has been fear that agents might place unsuitable products, especially with older investors who do not have time on their side if a mistake is made. Investors are always best protected by finding a career agent with product knowledge and a desire to be in business long-term. Agents who plan to be a career agent are probably more likely to select product quality over commissions paid. They must if they want to remain in business.

Annuity suitability must always be considered. Since they are long-term investments any type of annuity product must suit the needs and circumstances of the investor. For example, most professionals would feel it was unwise to place all of an investor's funds into an annuity (no matter how good the product is). If he or she had an emergency need for cash there would be none available unless the investor paid an early surrender penalty on the withdrawn funds. Therefore, agents must understand the circumstances of each investor prior to making recommendations. Only if the investor refuses to provide full information is the agent released from his or her ethical obligation to determine product suitability.

Guaranteed Rates of Return

Fixed rate annuities, such as 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 if market conditions were good. At each anniversary the minimum rate is re-set, but that would 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.

Investors must always pay attention to the guaranteed or floor rate since it is the only 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 rate but the principal is still guaranteed. In other words, in the worst index situation the investor would not lose their principal but he or she might not gain any interest earnings. Generally fixed rate annuities (that are not equity-indexed vehicles) would guarantee at least a couple percentage points in interest 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. 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.

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. Agents should never deposit money the investor may need prior to the term of the annuity contract. Annuities, including fixed equity-indexed annuities, are not suitable for anyone who may need to make large withdrawals prior to the end of the policy surrender periods.

Most annuity owners and annuitants do not consider how rates are determined or credited; they largely prefer to have their agents select and present an appropriate and advantageous product for them. Crediting of participation rates can be complicated even for agents who work daily with the products. It might prove very difficult to fully explain the process to consumers. Despite the fact that 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 company will credit all their fixed annuity products the same but that is not always true. Even within each company, different products might credit earnings differently.

Some 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 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 agent be fully and completely aware of the products he or she is marketing. It doesn't matter how sincere the selling agent was; if a major error is made it is the agent's fault since he or she had an ethical duty to know the products he or she represented.

Important EIA Fact:

While most fixed annuity products guarantee against loss of premiums paid in, that is not always the case. Some equity indexed annuities do not make this guarantee of the full amount, guaranteeing only a percentage, such as 90% 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 EIA was surrendered during the penalty period, that could also result in a loss.

In order to know how interest earnings will be credited, it is necessary to understand how the company credits premiums for the purpose of calculating interest payments. You must also know if the issuing company has contract limitations preventing them from changing crediting methods. So, first look to see how the insurer credits premiums and secondly, look to see if crediting methods may be changed. This will be found in the policy.

Every agent 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. Investors should 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 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, such as a higher index participation rate.

Some non-equity indexed annuities will offer bonus rates for one year, maybe even several years. Of course, if the investor surrenders his policy during the surrender period bonus rates would not apply. Alternately, some EIA products will offer a bonus to an older non-EIA annuity in order to draw in the business to an equity-indexed annuity product. 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. It suggests 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 this statement, 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 customers. The cost of offering such bonus points is figured in to overhead; insurers are typically very 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 equity-indexed annuity. Of course, withdrawals made prior to age 59½ will incur an early distribution charge from the IRS as well.

Index 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 was 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.

The National Association of Insurance Commissioners (NAIC) has published a buyer's guide for equity-indexed annuities. Although there are more elements to these products than just the potential maximum return, since consumers will be looking for products that produce greater returns, it is likely that this element is often the characteristic focused on.

The NAIC does not endorse any company or contract; their publication is intended to help the general consumer understand equity indexed annuities so that they may make the most prudent choice for their particular circumstances. Their publication states:

> "What are equity-indexed annuities? An equity-indexed annuity is a fixed annuity, either immediate or deferred, that earns interest or provides benefits that are linked to an external equity reference or an equity index. The value of the index might be tied to a stock or other equity index. One of the most commonly used indexes is Standard & Poor's 500 Composite Stock Price Index, which is an equity index. The value of any index varies from day to day and is not predictable."

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 very important aspects to equity indexed annuities: the indexing method and the participation rate.

Equity indexed annuities are fixed 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.

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 company may set their participation rate at various amounts (depending upon the product); for example, it may state a participation rate at 80%, which means the annuity would only credit the owner with 80% 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% the index-linked interest rate would be 6.3%. This is figured by multiplying 9% times 70%, equaling 6.3%.

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%) 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% to 90% perhaps) in order 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.

The NAIC states participation rates vary greatly from product to product and even from time to time within the same product. It is certainly important for agents to fully understand how they work but consumers also need a basic understanding of them. A high participation rate may be offset by other features, including simple interest, averaging, or point-to-point indexing methods. Conversely, an annuity company may offset a lower participation rate while offering a valued feature such as an annual reset indexing method.

An important note: some EIA contracts allow the insurer to change participation rates, cap rates, or spread/asset/margin fees either annually or at the start of the next contract term. If an insurer subsequently lowers the participation rate or cap rate or increases the spread/asset/margin fees, returns could be adversely affected.

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 companies average daily, while others average monthly. The National Association of Securities Dealers (NASD) mentions in their brochure titled *Equity-Indexed Annuities – A Complex Choice* that averaging could reduce earnings. They also state in the brochure that a major challenge when buying an equity-indexed annuity is understanding the complicated methods used to calculate gains in the index the annuity is linked to. Returns vary more than a traditional fixed rate annuity but not as much as a variable annuity (equity indexed annuities are not variable annuities; they are fixed annuities). Because of the minimum guaranteed interest rates EIAs have less market risk than variable annuities.

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 9% but the cap was set at 6%, then 6% would be the most the investor could earn. Not all equity indexed annuities will have a cap, but it is something that agents and investors must be aware of.

Caps absolutely do affect how these products perform but that doesn't 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 agent 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 caps and monthly caps but products vary so agents 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.

Spreads, Margins and Administrative Fees

Some 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. For example, an EIA might charge a 2% per year spread from the index-linked return. Figuring the cost over time can be difficult or at least complicated, but over ten years, with the index performing at an average of 12% per year, there would be a 2% loss, so earnings would be 10% rather than 12%. This is a simplification, but it does give the reader an idea of how it works.

Returns

Equity Indexed annuities will be linked to such things as the stock market, but that does not mean returns will directly reflect a stock market purchase. EIAs are linked to the performance of the index – not to the actual stocks that the index is based upon. As a result, the annuity does not give credit for dividends that could have been reinvested if the actual stocks had been purchased. The NASD states that most equity index annuities only count equity index gains from market price changes, excluding gains from dividends. An investor that is not earning dividends will not, therefore, have the same gains he or she would have if he or she had directly invested in the stock market. On the other hand, the investor also will not experience some of the losses that would have occurred with directly investing in the stock market. Those who oppose investing in EIAs will point to this potential loss of growth, while those who support EIAs will point to the protection from principal risk. The investor is trading the dividends that might have occurred for their safety of principal. There is no investment that will be ideal. High risk means potential high loss; low risk means less earnings.

Most equity indexed annuities use something simple, such as the S&P 500, and do not take into account reinvested dividends. While the loss in value of reinvestment of dividends can be significant, especially over a number of years, those who invest in these types of annuities are typically more concerned with the safety of their principal and are, therefore, willing to earn less. Even without reinvested dividends, indexes still perform pretty well. EIAs usually do better than certificates of deposit or bond rates, although that is certainly not guaranteed.

It should never be assumed that every client will appreciate the benefits of equity indexed annuities, especially if higher earnings are important to them. It is always a question of suitability and risk. Those who want higher earnings will probably not be happy with EIAs; such investors will probably want to benefit from dividends for example. Some advocates argue that the loss of reinvested dividends is offset by the annual reset (ratchet) annuities that credit the index return with only a zero in negative years. However, many feel it is unwise to push any investor into any vehicle that they seem unsure of.

There are variables in equity indexed annuities; all products are not identical. For example, an EIA that is back-tested does not ensure financial performance. **Back-testing** means that the annuity was tested against historical returns, perhaps as far back as twenty years. Future performance will not always mimic past performance. We have seen our markets change dramatically and they are likely to remain unpredictable. Additionally, there is no guarantee that the back-testing is reliable since reliability is often determined by those doing the testing.

Back-testing can help to illustrate the annuity, so it is not without merit. However, agents and investors must remain aware that past performance does not guarantee future performance. Professionals generally prefer the use of *Monte Carlo analysis*, which uses multiple samplings of random hypothetical market returns. This may present a more accurate visualization of the product and will not leave a false impression of how the annuity is likely to perform.

Indexing Formulas

Equity-indexed annuities credit earnings differently than other fixed rate annuities. Where traditional annuities state a rate of interest and then apply those interest earnings at specified intervals, an EIA calculates its return against the index to which it is linked. This is called the **indexing method**. Equity-indexed annuities credit interest using a formula based on changes in the index to which the annuity is linked. The formula decides how the additional interest, if any is earned, is calculated and credited. With traditional fixed annuities, interest gains are always earned, although how they are credited may vary. EIAs do not necessarily have interest gains, since they are based on the indexing method. The indexing method, or formula, decides how the additional interest, if any, is calculated and credited. The amounts earned, and when they are paid, depend on the contract features.

There are multiple formulas for indexing, with new methods appearing regularly. As a result, we will not attempt to describe indexing formulas. New methods often are developed with the hope of attracting consumers, but in the end the amount earned is going to depend upon the performance of the index that is used. Even professional analysts cannot accurately speculate on market performance over several years and annuities are long-term investments.

Many investors find having multiple equity-indexed annuities, with each using a different indexing method, advantageous. By purchasing EIAs that use different indexing methods, the investor is likely to end up with good average performance between the various annuities. Additionally, many investors consider having multiple EIAs as a means of diversifying their annuity portfolio. Some indexing methods work better under some conditions, and worse under others. Diversification prevents being affected adversely with no other annuity investment to offset the adverse conditions.

Some of the new equity-indexed annuities allow several indexing methods. The designated indexing method on these annuities can be changed at certain times, usually on anniversary dates. These allow consumers to select their indexing method at the time of purchase. Some of the newer EIAs allow consumers to use several indexing methods simultaneously, allowing investors to do with one contract what usually requires several to achieve.

Some equity-indexed annuities will allow the investor to see their progress (or lack of it) at specific times, usually annually. These annuities have "reset" features that lock in gains on some specific basis, such as once per year so that the investor knows whether he or she gained during the year. Generally EIAs held to maturity do not lose principal, but that does not mean it is guaranteed to have gains. Other equity-indexed annuities do not have the ability to see what returns are until the EIA has run its entire term, which may be many years after purchase. Investors who want to be able to view their returns should choose a reset product.

Annual Reset Indexing Method

For investors wishing to see their returns annually the annual reset indexing method is typically the best choice. Annual reset EIAs usually looks at the index at the end of each contract anniversary date and locks in gains made as of that date. This is called the **annual reset method** or may be referred to as the **ratchet method**. Under this method the gains posted at the end of the year (or at whatever point is in the contract) will remain even if the index goes down later. The ratchet method compares the changes in the index from the beginning to the end of the year, with declines being ignored. The advantage is a gain that is locked in each year. The disadvantage is the possibility of lower cap rates and participation rates that might limit the amount of available gains.

Under annual reset methods it is possible that there will be no gains. If the index declined from the previous year, the contract simply credits zero for that period. In the next contract anniversary year there is then no place to go except up. The previous period's end value for the index (not the annuity value) is used as the starting point for the new period, meaning that each period is looked at individually. It does not matter whether there were gains in previous contract years and will not matter in coming years what gains, if any, were given in the current year. Although there may be lower contract cap rates and participation rates, investors choose this method for the locked-in gains, meaning current profits will not be lost to bad years that may come in the future. Even if the stock market were to crash, any past gains are retained in the annuity values.

Investors often do not mind the lower cap and participation rates because they feel they will be offset by the fact that negative years result in zeros rather than value losses. While we would all like to see our investments increase in value, we also do not want to lose values. A zero gain is better than an investment loss.

High Water Mark Indexing Method

Another indexing method is the high water mark method. It compares the index at various periods during the contract to the index level at the beginning of the term. Although the time periods can vary, typically the contract's anniversary date is the time measure used. The high water mark indexing method takes the highest of these values and compares it to the index level at the start of the term. While the investor may be credited with more interest under this method than other indexing methods and receive protection against declines in the index, the disadvantage is that the investor may not receive any index-link gain at all if he or she surrenders their EIA early. That is because interest is not credited until the end of the contract term; if the contract is surrendered early, the contract term was not reached. Some of these contracts will still give the investor interest based on the highest anniversary value to date under a vesting schedule. Some high water mark indexing contracts might impose lower cap rates and participation rates. As always, it is important for investors to know and understand all policy terms. Certainly agents must know this as well.

If it were not for participation rates and caps, the high water mark indexing method would give investors the highest risk-adjusted returns of any indexing method, but of course there are caps. It is also important to realize that only the highs reached at the comparison periods count (usually policy anniversary dates). If a high is reached midway they will not apply. For example:

- A contract is issued on June 1, 2000.
- On June 1, 2001, the index had increased by 12 percent.
- On December 15, 2001 the increase rose to 42 percent.
- By June 1, 2002 it was down to 10 percent.

Because only the anniversary dates apply, the 42% index rate will not apply. Over the next ten years the percent at the anniversary date will be calculated. At the end of the ten year term, the investor will receive the highest point recorded on an anniversary date during the term of the contract, up to any applicable participation or rate caps. It is not unusual to have a participation rate that is less than 100%.

Point-to-Point Indexing Method

The point-to-point indexing method compares the change in the index at two distinct points in time, such as the beginning of the contract and the end of the term. Although the investor may enjoy a higher cap and participation rate, which credits more interest, the disadvantage is that it relies on a single point in time to calculate interest. As a result, even if the index that the annuity is linked to is going up steadily during the contract's term, if it happens to decline dramatically on the last day of the term, then part or all of the earlier gain can be lost. Since gain is not credited until the end of the term, the investor may not receive any index-link gain if the policy is surrendered prior to the end of its term.

To recap, the point-to-point index-linked interest, if any, is based on the difference between the index value at the end of the term and index value at the start of the term. Interest is added at the end of the annuity's term.

Even though point-to-point contracts offer the potential for the best long-term returns the disadvantage is the inability to gauge the contract's performance until the end of the contract's term, which could be anywhere from five to ten years. Until that time, the growth will appear to be zero even if the market is significantly up. If the annuitant dies during the term, for purposes of measuring contract performance, the date of death will be used as the end of the term.

The point-to-point method may be best for the longest-term EIAs since we can expect the best gains over the longest period of time. However, since the ending value is based upon that specific point in time, a sudden or unexpected downturn could prove detrimental to the contract's final value.

Some point-to-point indexing contracts charge a spread, stated as a percentage, per year. Others may limit participation to less than 100% or impose caps. The contract may limit or alter the way the means of crediting based on point-to-point. They may use the end point to average the index over the term of the contract and credit interest on a compounded basis based on the average rate, less some stated percentage defined in the contract. As always, all contracts should be fully understood by the selling agent and the investor.

Multiple EIAs with Diversified Indexing Methods

Diversification is not a new idea; agents and professional planners have been advocating that for years. Annuities may also be subject to diversification, which is something many investors may not have previously considered. Obviously, we cannot know in advance which annuity indexing method will perform best over the coming years but investors who purchase several types of annuities are bound to average out their earnings. This is especially true of equity-indexed annuity types. Some indexing methods will do better in volatile markets and others will do best in steady markets.

Many professionals feel the indexing methods of the EIAs are not nearly as important as other issues and features, such as selecting highly rated insurance companies. While this is true, it is still important to understand the indexing feature chosen. Also important is choosing a product with competitive interest rates, participation rates, caps and other features. By purchasing several different EIAs with several different features the investor may minimize lower earnings due to market trends. Even professional investors realize that it is not possible to guess which indexing feature will perform best in the coming years, since it will depend upon how the markets perform. Therefore, buying different annuity products with different indexing methods is a good way to diversity within the annuity market.

Whatever annuity products are selected, they should be purchased from different insurers so that there is diversification of insurance companies. Of course, all companies should carry no less than an A rating from A. M. Best company.

Withdrawing Annuity Funds

Most insurance agents are probably familiar with the "income for life" ability 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 may be very small (too little to actually support their income needs). 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 amount they are setting aside is inadequate that does not mean he or she should abandon saving altogether.

Ideally each citizen should begin setting aside money from the time they first receive a paycheck, regardless of how young he or she may be. Parents are wise to encourage the act of saving a percentage of income from the very first check a child receives for his or her birthday or other occasions from Grandma and Grandpa. Establishing this financial trait is one of the most important gifts a parent can bestow upon their child since it sets up a habit that will benefit their children for the remainder of the child's life.

Payout Options

Annuities are designed for pay-out after age 59½ since the Internal Revenue Service considers them to be retirement designated vehicles. They may still be used for other goals, but primarily they are considered retirement vehicles. Although annuities were designed for payout, they are overwhelmingly used for accumulation. In other words, the majority of annuities are not annuitized (turned into an income stream). Instead most investors accumulate funds in their annuity, and then simply withdraw the entire value or exchange it tax-free for another annuity, with the accumulation process starting over again. Often annuities are simply left intact year after year, eventually going to heirs.

Even though most annuities are not annuitized for systematic payout, it is always important for agents 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).
>
> 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.
>
> Annie also begins receiving $1,000 per month on January 1 just as Alvin did. However Annie Annuitant lives to a very 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's 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 very 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 agents must be certain their clients understand the advantages and disadvantages of each payout option.

It is very 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 policy. As discussed, annuities were designed to provide a systematic income at some point in time. When a policy owner annuitizes his or her contract, 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 a 10% 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 very important that annuitants and annuity contract owners realize that the lifetime income option does not consider beneficiaries. 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 depends upon what is selected at the time of annuitization. Many insurers 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 will receive remaining funds. Once the guaranteed period (period certain) expires beneficiaries 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 will 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 agents 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 was 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 whether the annuitant or contract owner will owe taxes on the earnings or not. 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 considered to be growth, with the last money withdrawn being principal. In a non-qualified annuity, the principal was taxed prior to deposit.

Annuity gains are taxed at ordinary income tax rates, which can be high. 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 do keep their annuities for 15 to 20 years or even longer. 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.

Qualified and Non-Qualified 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 plan.

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 they are distributed, these 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 January 1, 2006, a qualified plan or a Section 403(b) plan (not a governmental 457(b) plan) may allow 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 the 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.

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 usually preempts all state laws that relate to ERISA plans; however, ERISA does not preempt state insurance, banking or securities laws, even if they do relate to an ERISA plan. As a result state laws will 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:

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 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 agent 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 of 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 of 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 investor 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 agent, 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 insurer to become insolvent that even critics of annuities seldom mention the possibility. Even so, it is important to utilize only financially secure insurers because even a very small chance of failure is important.

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*. EIA 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 company (not just specific assets or specified pools of assets), which explains why it is very important that only financially secure companies be selected. EIAs 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*.[1]

Insurance companies must keep state-required reserves and other assets to satisfy their financial obligations, although the requirements may vary state by state. However, agents should never use their state reserve requirements as a marketing tool; rather agents should select financially secure annuity insurance companies to represent. The general public is not likely to understand how state-mandated reserves work and usually rely on their agents 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 agent will only consider financially top rated companies to represent.

How does the agent know which companies are financially strong? Although agents 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 agents 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 agents 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 agents consult more than

[1] iUniverse, Inc. New York Lincoln Shanghai, Copyright 2006

one company. Each rating company will give their interpretation of the insurer's strength and weakness.

State Guaranty Associations

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. The goal is to provide a promise that policyholders will continue to be protected even if their issuing insurer is no longer solvent. *It is always best to use highly rated companies and insurance producers may never use state guaranty associations as a sales tool or as an inducement to purchase insurance from an insurance company that is not highly rated or financially stable.* Only very foolish agents would recommend any company that is not currently stable.

Insurance companies are monitored by the various state regulators; the goal is to recognize a company in financial trouble and protect their state's policyholders from a failing company. If the state finds a company is in financial distress, within the laws of the state, every attempt will be made to correct the situation. This time period is usually referred to as "rehabilitation." If the company cannot be rehabilitated it will be declared insolvent. At that point the laws of the particular state will allow the commissioner to ask the state court to order liquidation of the insurer.

Suitability Standards

Many states have mandated suitability standards for annuities because there have been errors made in the past. Most agents intend to do a good job for their clients but unfortunately some agents did not understand whether the annuity was suitable for their client's financial situation or not. By mandating suitability standards (and in some cases special suitability education) the state insurance departments hope to avoid errors that may cause financial harm to its citizens. Suitability standards provide guidelines for agents who may not otherwise understand how to determine product suitability.

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

Determining Suitability

There are several elements that determine whether a product is suitable, including the individual's risk tolerance, financial needs, cash reserves, and personal or financial goals. In some cases, it is obvious that an annuity is not suitable or perhaps that *some types of annuities* are not suitable. 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.

Agents 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 we have witnessed over the last few years. Unfortunately, clients often blame their agents when investments perform poorly, so it is in the agent'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 agent in the client's file. Consider this signed statement future protection if the client or his or her family becomes dissatisfied with the investment's performance.

Agents must ask their clients to consider several questions when considering the appropriateness or suitability of an annuity product, especially if that product is an indexed or variable contract. 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 59 ½.
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 agents ask these and similar questions of their clients their focus should be on the most *adverse* possibilities. For example, if the investor 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 agents 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 suitability requirements. Any investor 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 investors 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.

Equity indexed annuities are complex; if the selling agent feels the concepts are not well understood by the investor it could prove foolish to still initiate an application for the product. Perhaps a traditional fixed annuity would be better understood than an equity indexed annuity. If so, that might be a better product to place with the investor. Agents should never place a product that is not adequately understood *and accepted* by the investor.

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.

Sales Practices

Agents know they are required by every state to be honest in the course of practicing their profession, but appropriate sales practices go beyond that. Agents 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, the buyer is often unaware that he or she has been adversely affected until years later when they reach retirement or some other pre-planned goal.

Product Replacement

There are situations that call for replacing one existing product with a newer insurance product, but this is not true in every case. Agents should never replace an existing product with another unless there are specific reasons for doing so – and those reasons are sensible. 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 was past the surrender period. Putting the buyer into a new annuity with a new surrender period should not be done without serious thought.

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

Deceptive Sales Practices Forbidden

Some agent 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 agents must correctly and honestly present their own products, they must also correctly and honestly present other products, such as the policy the agent is attempting to replace.

Full Disclosure

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

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

Product Knowledge

Agents must know the products they represent and be able to adequately communicate the product's characteristics to potential buyers. For example, even advocates of equity indexed annuities admit that they are more complex than most other types of annuities. Since EIAs are not all the same, an understanding of one EIA product does not guarantee understanding of *all* EIA products. Although the basic concept may be understandable, that does not automatically mean the agent or investor understands the individual products being marketed. Even experienced financial planners often have to read the actual equity indexed annuity policy to gain an understanding of how the individual product performs.

Certainly, agents must read and fully understand any product they plan to present to consumers.

Identifying Suitability Issues

Suitability issues seem to arise for some basic reasons, including (though not limited to):

1. The agent 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 agent 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 agent mistakenly believes he or she understands the product they are selling. Even though it may result in an unintentional agent error, the end 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 agents know their clients have misunderstood the proposed investment under no circumstances should the product be placed until the investor's error is corrected.

Just because an investment product, such as equity indexed annuities, are complex does not necessarily mean they should not be sold. If agents understand the mechanics well enough to relay a full understanding to their clients that will likely be sufficient. The point is to understand the ups and downs well enough so clients do not get nasty surprises later on. Many agents will gain a full understanding of just one or two equity indexed annuities and sell only those particular EIA products. This prevents any harm done to their clients as long as suitability standards are observed.

The states have a very difficult job. They must attempt to eliminate use of the *"trust me"* technique used by agents to place annuity products regardless of client suitability. It is doubtful that the states will ever be able to completely eliminate unethical agents but with required suitability 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 investors.

There is no question that annuities are long-term investments and, as such, lack liquidity. Large early withdrawals – prior to the end of the surrender penalties – could result in loss of principal due to penalties. Therefore, large withdrawals are not suggested during the surrender penalty years. Many products allow smaller withdrawals during the surrender penalty years without any insurer fees so this may be an avenue for those who sometimes need to withdraw cash. All annuity investors must be aware of the Internal Revenue Service penalty of 10% on withdrawals prior to age 59½, called early withdrawal penalties.

It is due to these early withdrawal fees, both from the IRS and the insurer, that make it theoretically possible for *equity indexed* annuities to lose money; this is not true of traditional fixed rate annuities where the principal is guaranteed. According to NASD, the guaranteed minimum return for an EIA is typically 90% of the premium paid at a 3% annual interest rate. If, however, the investor surrendered his or her EIA early, he or she could end up paying a significant surrender charge and a 10% tax penalty that would reduce or even eliminate any returns and might even reduce principal.

Since many EIA products only guarantee a return of 90% it is possible to lose money on equity indexed annuities, whereas traditional fixed rate annuities guarantee 100 percent of the amount deposited into the annuity product. Obviously one way to avoid this is to look for equity indexed annuities that guarantee 100% of the premiums paid.

Some equity indexed annuities do not pay earnings until maturity, which is usually the point at which the surrender penalties end. In other words, some contracts will not credit the annuity with the index-linked interest if it is surrendered early.

Long-Term – Not Short-Term Use

Annuities of all kinds are typically long-term investments so the issue is never about liquidity (there is none) but rather about suitability. When the topic seems to snag on liquidity it is usually a sure sign that the agent 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. Even small withdrawals should not be an issue when addressing product suitability. Withdrawals prior to the annuity term should never be a goal – period.

Although some annuities may have provisions for withdrawals under specified conditions, such as medical need, if the investor has set aside sufficient liquid reserves (outside of any annuities purchased) even that should not be a topic. Agents and financial planners should assess liquid reserves prior to determining annuity suitability – prior to suggesting buyers consider an annuity of any kind.

Some investors tend to be spenders and will spend funds if they are available, even if set aside for other purposes. Such people have difficulty maintaining emergency cash funds because they are constantly removing the funds for other purposes. For such individuals an annuity might seem attractive because they are long-term, illiquid financial vehicles. The lack of liquidity may seem beneficial as a result. When consumers look for financial vehicles that prevent them from removing funds this is known as **lock-boxing**, but many are skeptical of using annuities in this way. If the investor cannot maintain an emergency fund he or she may access their annuity anyway so the illiquidity is not ultimately a successful deterrent. In fact it may make the situation worse as insurer penalties for early withdrawal are levied.

There are circumstances where lack of liquidity is an advantage. This might be true for an individual that needs money kept out of reach, and will not access the annuity on a whim. For example, an inheritance that is not needed for daily living costs or emergencies might do well in an annuity. This might especially be true for investors who are behind on saving for their retirement.

Generally speaking, creditors cannot access funds in an annuity so, for some people who are having credit issues, the inaccessibility of annuities might prove to be an advantage. Creditors can usually access such things as bonds, stocks or mutual fund shares, which would have to be sold at current market value even if that means a loss. Not all states offer creditor protection for annuities so investors should seek legal council. It might even be prudent to establish residency in a state that does offer protection for funds placed in annuities. In such states creditors would never be able to get access to annuity funds (sometimes even annuity payments may receive protection from creditors). Seldom would an annuity be protected from Internal Revenue Service claims however.

A Comprehensive Financial Plan

It is unlikely that any one type of financial vehicle would be sufficient to comprise a fully adequate financial plan. Annuities must be part of a portfolio that considers all types of investment vehicles so that the investor's goals and aspirations are fully satisfied. Assets must be logically divided among several types of financial vehicles so that the investor's full needs are met. An agent or financial planner that merely divides the client's assets among an array of annuities, even if diversified among several indexes and annuity types, is probably not doing an adequate job of protecting his or her clients. Generally, it takes several types of investments to appropriately address possible future returns and investment risks.

Most annuities (with the exception of variable annuities) are considered safe financial investment vehicles. Equity indexed annuities could be classified with cash and equivalents such as Certificates of Deposit and money market accounts because they are made up of fixed annuities, which are traditionally safe. The risk is small that the investor will not receive at least the minimum returns. While we would all like to see huge growth, safety of principal is typically the primary concern. The biggest risk is not loss of premium (principal) but rather that the growth will be too small to match or exceed the rate of inflation. It is possible that loss of buying power could occur with annuities. In other words, while the principal is maintained the interest earned is too small to maintain the same level of buying power ($100 may only buy 80% or $80 of what it once could buy).

This is the same risk that all conservative financial vehicles face. Lower financial risk also means lower rates of interest earnings, so lower rates of growth.

Fixed annuities guarantee that a certain amount will be available at some point in time (depending on contract terms) but they do not promise that the returns will keep up with rates of inflation. Even though annuities are not liquid financial vehicles, they do promise that at least the principal will be available at some specified date.

Many investors like to "ladder" their investments, with some coming to maturity each year during retirement or at least during the early years of retirement. Many investors stagger their investments to reach maturity in five-year increments. The goal is to provide continual income during retirement; as one investment is used to fund retirement costs, the next investment matures and takes up where the last investment ended. Laddering is often used to keep current interest rates, since once an annuity is annuitized payments are set and not subject to changing interest rate environments.

For example:

Rachel Retiree has given lots of attention to her retirement planning. She has Social Security income, which is too small to live on, but no pension from her working years. Knowing that she would not receive a pension she saved regularly throughout her working years. With the help of a financial planner she knows approximately what her living costs will be in retirement. The only unknown factor was the rate of inflation so she tried to have more than she thought would be necessary available from her investments. If inflation is greater than anticipated she hopes the "extra" will cover the rising costs of living. On the other hand, if inflation is not as great as she thought it would be she will have extra funds, which of course is what Rachel is hoping for.

In year one of her retirement a Certificate of Deposit matures and is used to fund the first five years of Rachel's retirement.

In the fifth year of Rachel's retirement, a fixed rate traditional annuity is annuitized to provide monthly income for the next five years. Because it will pay out all funds over just a five year period Rachel will actually be able to put part of the income into a liquid savings account to cover unforeseen emergencies, such as health care needs or dental costs. This expectation of extra funds may not materialize if inflation soars but if it does not she will be over-funded. Although she could use the extra money for travel or other pursuits Rachel is wise enough to realize the future may cost more than the present.

In the tenth year, when Rachel is 72 years old (she retired at age 62 when she could begin collecting Social Security benefits) an equity indexed annuity matures. This annuity promised better returns than her traditional fixed rate annuity so she chose to have it mature when she was older. She felt it may give her more income at a time when living costs would possibly be higher due to inflation. By this time she also hopes her modest stock investments will have grown sufficiently to produce any additional funds that she might need for such things as higher insurance premiums on her health insurance or medical needs associated with growing older. Rachel knows she took on an extra risk when she chose not to buy long-term nursing home insurance. She felt she would not be able to pay the potentially rising premium rates of such insurance. Rachel hopes she will not need nursing home care even though historically she is likely to, if just from the frailty that comes with aging (especially for women who make up the majority of nursing home residents).

In the 15th year of Rachel's retirement, when she is 77 years old, her final investment will be utilized, a bond fund. Obviously Rachel does not know how long she will live but Americans continue to live longer than those before them. It is certainly possible that Rachel could live to be 100 years old. She can only hope her money will last as long as she does. Rachel could have chosen lifetime income from her annuities to guarantee funds for as long as she lives. She chose to receive income for shorter periods of time because she felt lifetime payments would be too small to cover her expenses. Rachel can only hope she made the best choices for herself.

While equity indexed annuities might be classified with cash and cash-equivalents because of their high level of safety they tend to offer some advantages:

- Some EIAs offer a minimum interest rate that could be compared to that offered by CDs and money market funds.
- The interest earned on equity indexed annuities is tax-deferred. This offers a substantial gain over a period of growth years. If withdrawals are taken when the investor is in a lower tax bracket this could be a substantial advantage over other types of investments.
- EIAs offer the ability for equity-like participation in the stock market according to the index linking feature. Obviously money market accounts and certificates of deposit cannot do this. Most financial advisors feel this could offer a greater chance of beating inflation.

It is easy to see why professionals who are familiar with equity indexed annuities might choose them over Certificates of Deposit and money market funds. Still most people tend to keep more money in certificates and money markets than they do in annuities, since funds in the local bank are more accessible than funds held in an annuity.

Agents may sometimes see equity indexed annuities compared to some types of bonds. Investment returns may be similar, although most bonds do not enjoy the tax deferral that annuities enjoy. Even so, if withdrawals may be needed before an annuity would mature bonds might be a better choice for the investor. However, if liquidity is not a concern, it is typically better to invest in the annuity because:

- The annuity will be tax deferred; some types of bonds may also enjoy this feature (municipal bonds for example) but they usually have very low returns.
- Bond values can go down if interest rates go up. This would mean holding the bonds to maturity to get the full values from them.
- Bonds are subject to market risks, such as inflation and speculation.
- Equity indexed annuities may do better than minimum rates if the index they are linked to perform well. That would mean better performance than bonds are capable of.

This does not mean that bonds have no place in the investor's financial portfolio since they do offer liquidity that is not available in annuity products. Bonds are used for liquidity while annuities are used for long-term performance. Bonds might also be the investment choice if funds will be needed prior to age 59½ since annuities would be subject to IRS early distribution penalties for withdrawal prior to that age. As we previously noted, it is always an issue of product suitability.

There is another difference between bonds and some types of annuities: investors cannot wait for annuities to decline in price and then buy them. Since bonds can go up and down in price, investors might wait for bond prices to go down before they buy them. Equity indexed annuities can only go up in value and have only positive correlations to the asset classes that overlap the index the product is linked to.

Agents and financial planners may sometimes want to compare equity indexed annuities to mutual funds or index shares. Mutual funds are vehicles made up of various stocks. Index shares are stocks that track the index. EIA critics often do not like that the annuities limit participation in returns if the index rises. It is true that the investor would do better with mutual funds and index shares if the index goes up, but what if it goes down? Investors that want to enjoy guarantees typically realize there is give-and-take when it comes to lowered market risk.

EIAs are subject to participation rates, caps and other limitations. Utilizing equity indexed annuities should not mean anticipating higher gains than those stated; instead the investor should only consider the minimum guarantees. Higher gains are merely a plus to the diversified portfolio.

Mutual funds typically have fees and expenses that affect the final performance. That does not mean they should not be part of a diversified portfolio but product costs should be considered. Mutual funds carry risks besides fees; managers are not always the best or a good manager may not remain. Managers may take excessive risks, putting the funds in a position to take a loss. Mutual funds are not necessarily tax efficient. Most equity indexed annuities do not have fees or expenses and do not experience annual taxation.

For some investors who track the index mutual funds may be their investment of choice but generally a well rounded portfolio is best. That means having some of many different investments, including annuities.

Tax-Deferred Status

As every agent 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.

Annuities are tax deferred so during the accumulation phase no taxes are due on the interest earnings. When partial withdrawals are taken, interest is considered to be withdrawn first and principal (premiums) withdrawn last. Therefore, taxable gains are the first to be withdrawn and gains would be 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 out come, 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's why Roth IRAs are so popular – no taxation upon withdrawal). If annuity growth was taxed as capital gains, taxation rates would be much lower. Of course, anything taken out prior to age 59½ will also feel the pinch of the IRS 10% 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 at ordinary income tax rates – if held to maturity. If not held to maturity they could be devaluated.

There is no point in comparing annuities to 401(k) Plans or other vehicles that are designed differently. Once again, it would be comparing apples to oranges: both are fruit, but they are very different types of fruit. Annuities are taxed no worse than other *similar types* of investment vehicles.

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 of 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. 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 hire a tax specialist.

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 very 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. However, a wise investor will certainly consider all aspects of their investment portfolio. This applies not only to annuities but to all investment vehicles.

The purpose of most annuities is to fund the investor's retirement. While taxation and estate issues are certainly important they should not cloud the real purpose of saving for retirement. Annuities are one aspect of saving for retirement; they should be considered primarily for that purpose. When investors get so side-tracked by other issues that they lose sight of their primary purpose it is difficult to stay focused on saving adequately. Annuities were designed to provide income for life.

Annuities Might Protect Assets

Generally speaking, 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.

However, aside from situations that are used to either obtain funds fraudulently or transfer funds fraudulently, annuities are typically safe from creditors.

Most annuities are not purchased with asset protection in mind; they are purchased as a means of retiring in comfort. However many people are involved in occupations that have a high liability, such as physicians, financial planners, and insurance agents. These occupations are regularly and successfully sued by their clients. For those in such high-risk occupations annuities should have special appeal: safety from creditors. It is not possible to transfer funds into an annuity after the lawsuit has been filed, because that would then become a fraudulent transfer. Annuity investments must be made prior to legal issues.

It is always important to consider the laws of the domicile state, since annuities are not equally protected in all states. Some states completely protect a lawfully purchased annuity from all creditors, even during bankruptcy. The 2005 bankruptcy reform legislation left annuities with that protection, even though many other types of investments suffered changes.

A better option for financial protection might be use of a trust that lends legal protection to the annuity values and other assets. Such trusts are not simple documents and may be expensive to have prepared. Even so, for the physician that knows even good doctors are sued it is worthwhile to do so. Even good financial planners and insurance agents face lawsuits in this very lawsuit prone society.

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. There are certain types of trusts that perform very well in specific situations (a spendthrift trust for instance). Trusts can be drafted by anyone and there are companies knocking on consumer's doors offering to provide them. In fact, insurance agents may be in the business of offering revocable living trusts to their clients (attorneys are usually also involved in drafting the documents) but it is seldom wise to accept services of this kind. Expert, specialized attorneys do not send agents and other salesmen out to knock on consumer's doors. Their experience and knowledge bring in sufficient clientele.

Probate

Annuities bypass probate procedures (although annuity values must still be listed during probate). 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 very 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.

An Annuity Might be a Bad Idea When:

Far too many investments are purchased for the wrong reasons. Maybe Uncle Joe had an annuity that paid well for him so he advocates everyone have them. Maybe the age restrictions for withdrawal are misunderstood by the young couple wanting to save for a house. Maybe the agent knew too little and misunderstood too much about the product he sold. Whatever the reason, annuities are not always the right choice for consumers.

Considering Applicant Age

Yes, we have said this multiple times, but it is important: withdrawals made prior to age 59½ will incur a 10% Internal Revenue Penalty for early withdrawal. Annuities were created with retirement in mind, so regardless of whether it happens to be an equity indexed annuity or a traditional fixed annuity, early withdrawal penalties apply. Most annuity contracts allow for free withdrawals even during surrender periods, but that does not apply to age and the IRS penalties. Anyone who might need a portion of their money prior to age 59½ should not buy annuities.

Surrender Penalties

Surrender periods are in annuity contracts to discourage contract surrender for the first seven to ten years; the exact length of the surrender periods will vary among contracts. Anyone selling or buying an annuity must be well aware of the length of the surrender penalty period. An investor who anticipates needing the premium paid for the annuity during the surrender period should consider an alternative investment. Even in the last year when the penalty amount may be only one percent caution is still advised. If the amount they anticipate needing is small the contracts that allow for surrender-free withdrawals might still work but even then the agent should be cautious in selling the product. Of course agents must always disclose all possible penalties; agents must ask the investor if he or she anticipates needing any substantial amount during the early withdrawal surrender penalty period. This comes down to suitability. Investors who think they might need the money during the surrender years are not suitable for an annuity product in most cases. This is true of an equity indexed annuity and it is true for a traditional fixed annuity product.

Some annuities may waive early surrender charges under specified conditions. This should never be assumed however. Consult the policy to see if the contract being considered has this feature. If it does, there will be specific conditions that must first be met. Look for a heading similar to "Extended Care Waiver" or wording that is substantially the same. While there may be variations it is likely to say something similar to 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."*

Proof will be required of the confinement and of course that proof must substantiate what the insured has stated. Proof must be provided *prior to withdrawal of funds*, never after the fact.

Grasping Fundamental Aspects of the Product

In all cases with all investments the investor (buyer) must understand what he or she is purchasing. If the selling agent 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 agent 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 agent 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 can be touched, felt, and shown off. When a new car is purchased the family members might not agree with the purchase but at least they understand the reasoning behind it. An equity indexed annuity is not likely to be shown off as a new car would be. The buyer may have every confidence in their decision but if the children become involved it could change into a "the-agent-took-advantage-of-my-aging-father" situation. We are not suggesting that older investors not be allowed to purchase an annuity; all ages have a right to invest in any fashion they wish. We are advocating that agents take extra time going over the aspects (both good and bad) of the annuity if there is any doubt whatsoever that the product may be misunderstood or if there appear to be lingering doubts about how the product functions.

Some annuities, such as equity indexed annuities, can be complex, especially to an individual without past annuity experience. Even agents can misunderstand some annuity characteristics so it stands to reason that many investors will be learning about the product for the first time. Clear communication is vital to the investor's satisfaction with the product over many years. Obviously, it is necessary to disclose all pertinent information about the product prior to the sale. This is true of all investments.

Agents must be aware that there always seems to be so-called experts that do not agree with the annuity concept. Many of these individuals are more interested in selling their books than actually educating the public, but if it causes your clients to doubt their purchase it won't matter if the author actually knows anything about annuities. The only way to prevent your clients from doubting their purchase is to cover the product well enough for the buyer to remain satisfied with their decision; remain satisfied even if their children question their buying decision and satisfied enough to ignore the so-called experts hoping to sway them to their personal investing views.

Basic Information Requirements

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

1. The name and contact information of the issuing insurance company;
2. The name and contact information of the selling agent;
3. The financial rating of the issuing insurance company;
4. The length and amount of the surrender penalties (policy term);
5. The point at which the insured will reach age 59½ and no longer have to 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. Are there 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 must be known, such as taxation as ordinary income when funds are withdrawn. There may be tax matters that are specific to an individual so agents are wise to suggest buyers consult their personal tax accountant.

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

Annuities, including equity indexed 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. Therefore, EIAs are not subject to customer suitability, disclosure and sales practices requirements that registered securities must meet.

Terminology for Equity Indexed Annuity Products

Most agents are accustomed to specific product terminology but equity indexed annuities are not like the traditional fixed rate annuities so there may be terms the agent is not already familiar with, but that are very important to know. These include:

Adjusted Change: The change in the Index Value for a segment, with adjustments as described in the indexed interest rate provision.

Annual Reset Indexing Method: Index-linked interest, if any, is determined each year by comparing the index value at the end of the contract year with the index value at the start of the year. Interest is added to the annuity each year during the term.

Annuity Benefit: The payments that may be made under the "benefit on annuity commencement date" of the contract.

Averaging: Some annuities use an average of an index's value rather than the actual value of the index on a specified date. The index averaging may occur at the beginning, the end, or throughout the entire annuity term.

Beneficiary/Beneficiaries: The person or people entitled to receive death benefits if the annuitant should die prior to withdrawing all annuity funds, unless annuitized for a lifetime benefit, in which case beneficiaries receive nothing even if the annuitant did not use all premiums deposited.

Cap or Cap Rate: Some contracts will state an upper limit, called a cap, on the index-linked interest rate. This is the maximum rate of interest the annuity will earn. It is the highest Adjusted Change for each segment of the indexed strategy.

Code: The Internal Revenue Code of 1986, as amended, and the rules and regulations that are issued under it.

Commencement Date: The annuity commencement date if an annuity benefit is payable; the death benefit commencement date will be shown on the contract specifications page.

Contract Anniversary Date: the date each year that is the annual anniversary of the contract effective date, shown on the contract specifications page.

Contract Year: A contract year is each twelve (12) month period that begins on the contract effective date or on the contract anniversary.

Death Benefit Commencement Date: the first day of the first payment interval for a death benefit that is paid as periodic payments or the date of payment that is paid as a lump sum if periodic payments will not be made.

Death Benefit Valuation Date: Although contracts may vary, typically it is the earlier of:

1. The date that the insurer has received both Due Proof of Death and a written request with instructions as to the form of death benefit (lump sum or systematic payment); or
2. One year form the actual date of death.

Due Proof of Death: Due proof of death is typically one of the following:

1. A certified copy of a death certificate, or
2. A certified copy of a decree that is made by a court of competent jurisdiction as to the findings of death (this is generally only used when the person or person's body cannot be located). Companies may accept other types of proof in some circumstances.

Floor: The lowest Adjusted Change for each segment of an index strategy is called the "floor." It is the lowest point on equity index-linked interest. It is the minimum index-linked interest rate the investor will earn. The most common floor is 0% (zero). While that looks like a bad thing, it actually assures that even if the index decreases in value, the index-linked interest will not go negative, losing money. Yes, no interest would be earned but neither would any principal be lost. Not all contracts have a stated floor on index-linked interest rates but fixed annuities will have a minimum guaranteed value.

High-Water Mark Indexing Method: The index-linked interest, if any, is decided by looking at the index value at various points during the term, typically the yearly anniversary date of purchase. The interest is based on the differences between the highest index value and the index value at the start of the term. Interest is added to the annuity at the end of the term.

Index: An index is the specified index that will apply to an Indexed Strategy for the term shown in the equity indexed annuity contract, usually on the specifications page. If the index is no longer published or its calculation is changed, the insurer may substitute a suitable index at their discretion. Insurers should notify their policyholders if a substitution is made. Sometimes the insurers are required to first get approval of the substitution from the state insurance department.

Index Value: The index value is the standard industry value of the index. The index value for a particular date is the value of the index as of the close of business on that date. For any date that the New York stock Exchange is not open for business, the index value will be determined by the insurer and stated in the policy, but often it is the index as of the close of business on the most recent day on which the Exchange was open prior to that date.

Indexing Method: The indexing method is the approach used to measure the amount of change, if any, in the index. Some of the most common indexing methods include annual reset, or ratcheting method, high-water mark method and the point-to-point method.

Index Spread: An amount by which the Index Change is reduced when computing the Adjusted Change.

Index Term: The index term is the period over which index-linked interest is calculated. In most product designs, interest is credited to the annuity at the end of the term, which may be ten years although the average term is more likely around seven years. Products may offer a single term or multiple consecutive terms. Those with multiple terms usually have a window at the end of each (generally 30 days) during which the policyowner can withdraw his or her funds without penalty. For installment premium annuities, the payment of each premium may begin a new term for that premium.

Index Value: The standard industry value of the index is the index value. The index value for a particular date is the value of the index as of the close of business on that date or the most recent date the Exchange was open.

Interest Compounding: Some annuities pay simple interest during an index term. That means index-linked interest is added to the original premium amount but it does not compound during the term. Others pay compound interest during a term so that the index-linked interest hat has already been credited earns additional interest. In either case the interest earned in one term is usually compounded in the next however.

Participation Rate: The participation rate is the portion of the index change that is used to compute the adjusted change. It decides how much of the increase in the index will be used to calculate index-linked interest. It is the portion of the index change that is used to compute the Adjusted Change. Note the definition of "adjusted change" above. Participation rates are typically guaranteed for stated amount of time, but the company will change the rates after that time.

Point-to-Point Indexing Method: The index-linked interest, if any, is based on the difference between the index value at the end of the term and the index value at the start of the term. Interest is added to the annuity at the end of the term.

Segment: Segment is the period of time over which the change in the index is measured for an indexed strategy. A segment may never be longer than the term of that strategy. The initial segment begins on the first day of the term. Subsequent segments begin upon the expiration of the preceding segment. Daily segments that end on a day that the New York Stock Exchange is closed are often disregarded.

Term: For a declared rate strategy, the period of time during which the interest rate is declared; for an indexed strategy, the period over which an indexed interest rate is calculated. The initial term begins on the first interest strategy application date. Subsequent terms begin upon the expiration of the preceding term.

Valuation Date: A date on which the index value is measured to compute the Index Change. If an indexed strategy uses valuation dates that are daily, then dates on which the New York Stock Exchange is closed are disregarded. If an indexed strategy uses valuations dates that are other than daily, the valuation dates are the dates within a month that correspond with the first day of the term.

Vesting: Some annuities do not credit any of the index-linked interest, or only part of it, if the investor withdraws their money before the end of the term. The percentage that is vested, or credited, generally increases as the term comes closer to its end and is always 100% vested by the end of the term.

General Contract Provisions

All contracts have general provisions. In life and annuity insurance policies the general provisions establish what might be called the "ground rules." The following is a sampling of what might be seen in an annuity policy. In our example we have used an equity indexed contract since they are typically more complex than the traditional fixed rate annuity product. However, it is important that all agents review a copy of the product, whether it is an equity product, a traditional annuity, or a variable product.

Entire Contract

The contract must be identified. It might state something similar to: *"This Contract is an individual deferred annuity contract. It provides for both declared and indexed interest rates. It is restricted as required to obtain favorable tax treatment under the Code. This contract, any riders or endorsements to it, and the application for it, if any, form the entire contract between the owner and the issuing insurer."*

Changes and/or Waivers

The contract is always the final word on the terms and conditions of the annuity. Agents do not have any authority to make changes or waive any part of the contract. The policy will state this in wording similar to the following:

"No changes or waivers of the terms of this contract are valid unless made in writing and are signed by the insurer's President, Vice President, or Secretary. No other person or producer, including the writing agent, has any authority to change or waive any provision of this contract. The insurer reserves the right both to administer and to change the terms of this contract to conform to pertinent laws and government regulations and rulings."

Misstatements

We usually think of misstatements in terms of age but it can relate to any misstatement. Some errors affect the performance of the policy while others have little effect. Often misstatements change the premium cost of the policy but annuities typically do not have this concern since they are based on the amount earning interest, usually not the age of the insured. In some cases, age does have a bearing however since many annuities will not issue coverage to anyone above a specified age. Misstated age can also affect the amount of systematic payments upon annuitization since age is a major factor is determining projected length and amount of those payments.

Most policies address the issue of misstatements. In an equity indexed annuity it might read similar to the following:

"If the age of a person is misstated, payments shall be adjusted to the amount that would have been payable based on the correct age. If payments based on the correct age would have been higher, we (the insurer) will immediately pay the underpaid amount in one sum, with interest, at the rate of __% per year. If payments based on the correct age would have been lower, we (the insurer) may deduct the overpaid amount, with interest at a rate of __% per year, from succeeding payments and pursue other remedies at law or in equity."

Of course the interest rate will be filled in, but for our example we felt it best to leave it blank.

Required Reporting

The state insurance departments probably have some requirement for notifying clients of changes in policy status or earnings. Policies will state how often such reports will be issued to their policyholders. Generally companies notify at least yearly of changes that will affect their policyowners. The policy will state how reporting may be expected. It might read similar to the following:

"At least once each contract year, we (the insurer) will send you a report of your current values. We (the insurer) will also provide any other information required by law. These reports will stop on the earliest of the following dates:

1. *The date that this contract is fully surrendered;*
2. *The annuity commencement date; or*
3. *The death benefit valuation date.*

The reports will be mailed to the policyowner's last known address. If permitted by law, in lieu of that we may deliver these and other required documents in electronic form. The reported values will be based on the information in our possession at the time that we prepare the report. We may adjust the reported values at a later date if that information proves to be incorrect or has changed."

State Law

Certainly, states may have laws in place that affects how the annuity contract may be written and laws change from time to time. It stands to reason that insurance companies must follow whatever laws are in place and any laws that come after the contract was written, if they affect the contract. There is likely to be some statement in the equity indexed annuity regarding state laws; it may read similar to the following:

"All factors, values, benefits, and reserves under this contract will not be less than those required by the laws of the state in which this contract was delivered."

Claims of Creditors

Some states will better protect against creditors than others. Your annuity will follow what ever the state dictates by law. It may be stated as the following: *"To the extent allowed by law, this contract and all values and benefits under it are not subject to the claims of creditors or to legal process."*

The important part of that statement is "to the extent allowed by law." At any point creditors become an issue the insured should obtain legal advice from a competent attorney that specializes in contracts or consumer law. Since laws do sometimes change the policyowner should not rely on information obtained at an earlier date.

Other Contract Items

There will be other items covered in most contracts, such as Exclusive Benefit (who may benefit from the contract), liability issues, tax issues, incontestability and transfer by the company. In all cases, agents must be fully aware of the products they are representing and selling. Of course, applicants have a responsibility to fully read the contracts but as every agent knows, they seldom do. Instead, they rely upon their agent to fully disclose all facts and figures.

Even when an insurance producer believes he or she has fully disclosed all relevant facts and features of the product, there is no way to keep the information fresh in the buyer's mind. Since agents do not want lawsuits simply because the consumer forgot what he or she was told it is the wise agent who delivers the policy personally and goes over the features a second time. It is an even wiser agent who obtains the buyer's initials on all key points within the policy. This can be done on a separate paper or form that the agent keeps in the client's file at the producer's office. Having the policy initialed is fine as long as the agent has access to it in case of a lawsuit, but that is unlikely.

Additional Payments

Some annuities will allow only one initial payment; others will allow additional payments. Too often insurance producers do not think to inquire whether buyers might wish to make additional payments in the future. It is an important question to ask since the buyer might simply assume he or she can do so.

When a contract allows additional premiums (deposits) it will specifically state so. The heading might vary, but should say something similar to "Purchase Payments" or "Additional Premium Payments." If additional premium payments are allowed it will state something similar to the following:

"One or more purchase payments may be paid to us (the insurer) at any time before the annuity commencement date, so long as you (the buyer) are still living and the contract has not been fully surrendered or annuitized."

Since annuitization locks in payments it would not be possible to make additional payments once annuitization was initiated.

Most equity indexed annuities have minimum premium deposit requirements. Many have a $10,000 initial deposit requirement, but that can vary even among policies of the same company. Traditional fixed rate annuities may also have minimum initial payments. Since this varies among products, agents can often find a product that suits the needs of the buyer.

Some contracts may offer a purchase payment bonus. If so, it will be specifically stated in the contract.

Stranger-Originated Annuity Transactions (STAT)

A STAT involves a transaction for the purpose of financially gaining from the death of an annuitant. A stranger originated annuity transaction occurs when an investor approaches a terminally ill patient and offers to pay them for use of their identity in an investment annuity. It is similar to stranger-originated life insurance transactions utilized in the life insurance industry where life insurance is taken out on terminally ill persons. The individual used as the annuitant is usually a complete stranger to the investor, and not expected to live for longer than a year. In some cases, they may find the target by approaching elderly individuals in the nursing home or in hospice care.

The investor then sets up an annuity transaction in the patient's name, ensuring that the policy guarantees a minimum payout in the event of the patient's death. In order to keep from being discovered, the investor will usually ensure that the guaranteed minimum death benefit falls below an amount that would violate certain underwriting guidelines. The investor also names an organization as the beneficiary, rather than their personal identity, in order to avoid being exposed. Obviously this practice is not considered ethical and could even be illegal since the issuing insurer does not know the actual circumstances of the application.

Ethical professionals do not generally favor use of STATs often voice opposition to the growing use of the practice. Many insurance trade groups have formally stated their opposition to the practice.

The National Association of Insurance and Financial Advisors (NAIFA), representing about 200,000 agents and financial service professionals, voted to oppose the transactions several weeks ahead of a National Association of Insurance Commissioners (NAIC) public hearing May 20, 2010 to investigate the practice. The National Conference of Insurance Legislators may begin investigating STATs at some point.

In both stranger-originated life insurance (STOLI) transactions and stranger-originated annuity transactions (STAT), the policy application is initiated for the benefit of an investor who has no relation to the person whose life the insurance policy or annuity is based upon. When the transaction is completed, neither the insured nor his or her beneficiaries will have any further legal interest in the policy or annuity's benefits. As with STOLI transactions, many STAT transactions are not being initiated for a typical or historically legitimate insurance purpose.

Thomas R. Sullivan, the Connecticut insurance commissioner and head of the NAIC Life Insurance and Annuity Committee, initiated the May 20th public hearing so the NAIC could learn more about stranger-oriented annuity transactions. The NAIC represents state insurance commissioners and are often the individuals who enact certain practices to protect consumers. Obviously targeting elderly Americans and terminally ill individuals with the promise of payment for taking out these policies raise some serious questions. Insurers must have full disclosure in order to properly underwrite the risks that insurance policies represent. If numerous applications represent risks the insurers are not aware of that will eventually affect all policyholders as insurers pay out artificially high death proceeds. STATs are not for the insured individuals and their beneficiaries but rather for the benefit of investors and intermediaries.

There are many questions surrounding the use of life and annuity transactions that benefit primarily investors and intermediaries. It is likely that similar regulation as those in the viatical life insurance industry will follow for annuity products. All insurance transactions must, of course, be legal and follow current model laws and regulations.

Like stranger originated life insurance transactions (STOLI), producers or investors offer a stranger a nominal fee for the use of their identity as the measuring life on an annuity. While fixed annuities have not typically been used, some instances of deferred bonus annuities have been. Usually the individuals targeted to serve as annuitants are in extremely poor health and are not expected to live beyond the first year of the policy. In order to find individuals who meet the above criteria, producers and/or investors have been known to take out advertisements in papers as well as solicit individuals residing in nursing homes or hospice care.

Once the individual has agreed to the proposal, the producer or registered representative will complete the annuity application, ensuring particular features, such as a bonus rider or a guaranteed minimum death benefit, to facilitate a specific rate of return for those financing the annuity purchase. Depending on the number of companies represented and the commission policies in effect, producers or registered representatives may purchase multiple policies from multiple companies or use a variety of techniques to fly under the insurer's underwriting radar.

To avoid added insurer scrutiny of the submitted application or detection of the actual goal, producers and registered representatives often take precautions to ensure the annuity dollar amount falls below specific underwriting guidelines or policy maximums. A trust or an organization will probably be named as beneficiary of the annuity in order to hide the true identity of those who will benefit from the annuitant's death.

Financial implications of stranger originated annuity transactions can be detrimental to the industry as well as consumers. NAFA suggests that insurance companies and marketing organizations protect customers by:

- Reviewing chargeback policies to ensure producer/registered representative commissions are adjusted if a policy is annuitized within the first year of the contract.
- Creating detection methods to identify producer/registered representatives who may be involved in the facilitation of stranger originated annuity transactions.
- Ensuring annuity applications conform to suitability review guidelines and the suitability review process creates red flags that identify questionable applications and refers them for additional review.
- Reporting potential stranger originated annuity transactions to the appropriate Department of Insurance.

As we know, annuities protect consumers by offering guaranteed benefits, including death benefits and income for life. Since investors are seeking terminally ill consumers to act as annuitants the annuities are being used as a wagering contract on the annuitant's death. Clearly that is not the insurer's intent when they issue the contracts. Those who encourage application of the contracts are aware of that or they would not be taking such great measures to hide their intentions.

Most annuities are purchased for the traditional reasons, not to benefit an investor, and are therefore legal. The current NAIC Suitability in Annuity Transactions Model Regulation or some version of it has been adopted in most states. This and the NAIC

Disclosure Model Regulation provide a framework for carriers to obtain information to identify sales that are unsuitable and do not benefit the consumer. With the heightened awareness of the use of annuities by investors to wager on the death of annuitants, carriers, as well as producers, have some tools to prevent these sales but it is often more difficult than merely following standard procedures.

Currently it is unclear if applicants have fully understood the transactions they participated in. Since they are terminally ill, their need for income is often great and make it likely that they do not care if they fully understand what is going on. In life insurance transactions, insureds sell their contracts for a portion of the death benefit; the quicker the individual dies the more investors earn. The longer the insured lives, the less the investors earn because premiums must continue to be paid. In the annuity field, there are no continued premiums so investors have a greater capability for gain. Selling their life insurance policies allowed policyholders to receive money they might not otherwise have had access to. If the policy was purchased *prior to the terminal diagnosis* then there is nothing wrong with selling their insurance contracts to an investor. If, however, the terminal illness was known at the time of application there are many ethical and legal questions involved. For example, was the insurer aware of the applicant's pending death? It seems unlikely an insurer would issue a policy on an individual that has an expected date of death.

In a STAT transaction an unrelated investor is the buyer and owner of an annuity purchased on the life of a terminally ill person. Generally, a variable annuity is purchased but indexed annuities are also a possible choice. Traditional fixed annuities do not perform sufficiently to be used in a stranger-originated annuity transaction. Since the investor is looking for a good profit, fixed rate annuities are not generally the type of annuity chosen. Investors want annuities that might perform well in the market and traditional fixed rate annuities have no ability to earn based on market performance. According to NAIFA, the terminally ill annuitant typically receives an up-front payment ranging from $2,000 to $10,000 for participating in the transaction, and receives no further payment or benefits from the transaction.

The annuity contains a guaranteed death benefit rider (GDB) which guarantees that at the time of death, the owner/beneficiary will receive at least as much as was invested in the annuity, and possibly more depending on market performance and the terms of the rider. Because of the protection provided by the GDB, the investor/owner will likely choose more speculative sub-accounts as the investment vehicles for the STAT. If the market performs well, the investor will benefit from the account's performance; if the market does not do well, the investor's investment is protected by the minimum return guaranteed by the GDB.

Since this could appear to be good for both the terminally ill individual and the investor one might think it is merely a good investment avenue. However, in order for the insurance industry to continue performing well the insurance companies issuing these products must be able to correctly assess their risk. That is not possible in the case of STATs because the insurer is likely to lose over and over again. Eventually the insurers must raise the costs of insurance for everyone. Clearly it is not the intention of insurers to issue policies that are likely to create losses for the issuing companies. There is also concern that the annuitants are not aware of all these contracts involve. They may not be aware of their own liability when they state false information on the application or if they fail to disclose known medical information.

This Completes Your Reading Material

This completes your reading material. Annuities range from simple fixed-rate products to the riskier variable annuity products. Agents who market annuities must understand all annuities to some degree, but especially the particular projects the agent represents.

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