INDEXED ANNUITIES

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How to Gain Maximum Knowledge from this Course!

In order to enhance the learning and knowledge process, this course incorporates several adult learning strategies designed to increase comprehension and retention of the material.

Since it may have been several years since you were involved in a formal learning process, we have included a brief description of the learning concepts employed by this course.

The format of this text includes the traditional headings and subheadings as well as highlighting and text borders to bring attention to critical concepts and facts.

1. **Highlighting: As you study the text, pay particular attention to areas of text that are highlighted in Yellow and those areas that are highlighted in Gray. Understanding the concepts and facts contained within the yellow highlighted areas are critical to successful completion of the final examination. Material within the Gray highlighted areas will be reinforced later in the course through the use of Chapter Review Questions.**
2. **Case Studies:** Some of the more variable concepts will be illustrated using case studies. These case studies are designed to reinforce the concept being discussed and it is recommended that you take the necessary time to digest the points made within the case studies.
3. **For Insurance Licensees in Non-Monitored States, our exclusive web-based search feature allows quick retrieval of important data for maximizing the learning process. Simply execute Ctrl + F and enter keyword(s) or key phrase(s) to locate those items electronically within the course material.**

Understanding all of the material in this text is necessary to achieve the overall learning strategies that have been incorporated to Success Continuing Education copyrighted courses to increase exposure to portions of the text that are fundamental to the learning process.

INTRODUCTION

COURSE DESCRIPTION AND OBJECTIVES

Due to the public's demand for – and benefit from - guarantees, flexibility and diversity in financial products; and the need for the manufacturers, issuers, distributors, regulators and the media to contribute to the flow of information about fixed indexed annuities, the National Association for Fixed Annuities has developed a course to provide insurance agents with the education and knowledge tools necessary to market, sell and service fixed indexed products. This course will cover the different types of indexed products, which include fixed life insurance and fixed annuities. The NAFA Fixed Indexed Product Training Course will explain fixed indexed annuities and life insurance products:

- Mechanics;
- Features;
- Terminology;
- Restrictions and limitations;
- Benefits and guarantees;
- Suitability;
- State requirements for disclosure and illustration; and
- Product riders and their background, evolution and popular appeal.

Fixed indexed insurance products are a natural evolution of the traditional fixed insurance product, which offers one method of crediting interest. Fixed indexed insurance products are nothing more than a traditional fixed insurance product that offers owners an opportunity, often on an optional basis, to receive interest based on positive changes in a financial markets index coupled with insurance guarantees of purchase payments and minimum rates of interest. In other words, fixed indexed insurance products offer guaranteed preservation of purchase payments coupled with guaranteed growth in value, even when indexed-based interest is small or non-existent.

Fixed indexed insurance products generally provide all of the insurance coverage of traditional insurance products, including death benefits, withdrawal options, payout options and benefits triggered by disability or incapacitation.

These insurance guarantees mean that only life insurance companies and certain financial institutions that meet exempt rules under the Securities Act of 1993 can issue fixed indexed insurance products. Life insurance companies are subject to strict regulation by the states. State regulation is designed to assure that life insurance companies will have sufficient assets to make good on their guarantees, even if the general economy and the business fortunes of an individual life insurance company fall. Moreover, fixed indexed insurance products are backed by state guarantee funds. These funds provide the money to compensate owners if a life insurance company defaults.

CHAPTER 1

DEFINITION AND TYPES OF ANNUITIES

An annuity is a financial product sold by financial institutions that is designed to accept and grow funds from an individual and then, upon annuitization, pay out a stream of payments to the individual at a later point in time. Annuities are primarily used as a means of securing a steady cash flow for an individual during their retirement years.

The first annuity type is identified according to when benefits are paid out.

- **Immediate Annuities** — An immediate annuity is a contract that is purchased with one payment and has a specified payment plan which starts immediately. This type of annuity is sometimes used when a person turns 65 or reaches retirement age.
- **Deferred Annuities** — Currently, most fixed indexed annuities are deferred annuities. All annuities offer an owner the opportunity to receive, usually after retirement, periodic annuity payments guaranteed for life. Deferred annuities offer an owner the additional opportunity to accumulate purchase payments with interest, before retirement, on a tax-deferred basis.
- **Split Annuities** — A split annuity is the term given to an effective strategy that utilizes two or more different annuity products – one designed to generate monthly income and the other to restore the original starting principal over a set period of time. The split annuity typically uses what is known as a single premium deferred annuity and a single premium immediate annuity. Within the split annuity, the immediate annuity repays you a set sum of money each and every month over a specified period of time. The other annuity is left in place to grow on a fixed interest basis, with the goal being that by the time the monthly payments are depleted, the deferred annuity will be fully restored to the original starting principal. You can then restart the process with prevailing interest rates or reevaluate the retirement and investment strategy as needed.

The two types of annuities that are identified according to how and when premiums are paid are called **Single Premium Annuities** and **Flexible Premium Annuities**.

Single premium annuities accept one premium up front at the beginning of the contract. Flexible premium annuities allow one premium up front and then subsequent premiums. The period of payment, as well as the minimum and maximum premium payment amounts, is defined in the contract and any changes to the increase the periodic payment schedule, decrease the minimum and increase the maximum may be made by the company if it improves the customers contractual restrictions.

State insurance authorities regulate fixed life insurance and annuity insurance products, including indexed annuities, under state insurance laws. The Securities and Exchange Commission (SEC) regulates variable annuities and variable life insurance because these products differ in three important ways from those of fixed insurance products. These differences are investment risk, investment account, and benefits. The SEC has examined Indexed annuities and has not required that they be regulated under the federal securities laws.

VARIABLE INSURANCE PRODUCTS

The owners, not the insurance companies, assume the investment risk that the value of their benefits will decrease rather than increase under management of their money through the insurance companies. The federal securities laws apply to protect owners in light of this investment risk.

Purchase payments and earnings under these products are invested, usually through separate accounts of life insurance companies, in funds of stocks, bonds or money market instruments. Benefits vary up and down in dollar value with the increases and decreases in the investment performance of these stocks, bonds or money market instruments.

FIXED INSURANCE PRODUCTS

The insurance company, and not the owner, assumes the investment risk regarding payment of the rate of interest derived by a formula with reference to an index.

An insurance company invests premiums in its general account. To fund the obligations under the indexed annuities, the general account includes an investment portfolio of options and futures or a reinsurance contract.

Benefits can increase in amount depending on the changes in financial market indexes. At the same time, benefits have guaranteed floors that protect against loss

of principal and previously credited interest if the performance of financial market indexes is not favorable

TWO-TIRED ANNUITIES

This section will discuss two-tiered annuities. The definition, difference in benefit levels and accessing the different benefit levels and what that means to the policyholder. In addition, we will discuss the advantages and disadvantages of two-tiered annuities.

A two-tiered annuity is a product with three different values. These values are tier-one value, the surrender value and the tier-two value.

1. **Tier-One Value** — The first value is the **tier-one value**, which is the premium accumulated with interest earnings, just like a regular fixed annuity. This value is available to the client if they decide to surrender their contract as a lump sum after the surrender charge period.
2. **Surrender Value** — The second value is the **surrender value**, which is the tier-one value less the surrender charge. This value is available to the client if they decide to surrender their contract as a lump sum during the surrender charge period.
3. **Tier-Two Value** — The third value is the **tier-two value**, which provides a benefit typically higher than the tier-one value and is only available to the client if they annuitize the contract. Tier-two benefits could include higher interest rates, higher index crediting, bonuses or other benefits, which encourage the client to annuitize thereby leaving assets longer with the insurance company. In some products clients must wait a certain period of time before they can access these higher tier-two values.

Why would a client buy a two-tier product?

Two-tier products can be valuable for the right client in several ways. If clients have a need for a lifetime stream of income, they could receive higher lifetime benefits under a two-tier product than under a regular deferred annuity that is annuitized or immediate annuity. Secondly, due to the design and pricing of two-tier products, tier-one credited rates could be higher than a non-tiered deferred annuity in the form of better participation rates, caps or fees.

What are some of the disadvantages of two-tier products?

These products may not be suitable for clients that have short-term liquidity needs or a desire to pass on lump sum benefits to their heirs. In addition, clients usually have to wait a period of time to receive the higher tier-two values and annuitization is required to receive those values, which spreads the benefits out over a period of time.

Insurance agents should be very clear that their clients who are considering a two-tiered annuity understand the different values, how to access their values and the restrictions or consequences when they do. Clients should assess their needs and examine all aspects of an annuity product before determining if that particular annuity design fits their needs and financial goals.

CHAPTER 1 REVIEW QUESTIONS

Which of the following answers each sentence the best?

(Answers are in the back of the text.)

1. A _______________ Annuity is an immediate annuity contract that is purchased with one payment and has a specified payment plan that begins immediately.

   a) Deferred
   b) Split
   c) Immediate
   d) One-Tier

2. Most fixed indexed annuities are:

   a) deferred annuities.
   b) split annuities.
   c) immediate annuities.
   d) tier annuities.

3. The _______________ Annuity typically uses a single premium deferred annuity and a single premium immediate annuity.

   a) Deferred
   b) Split
   c) Immediate
   d) One-Tier

4. The _______________ regulates variable annuities and variable life insurance because these products differ in from fixed insurance products.

   a) State Insurance Department
   b) State Insurance Commissioner
   c) Department of Commerce
   d) Securities and Exchange Commission

CHAPTER 2

ANNUITY CONTRACT PROVISIONS

INTEREST RATES

Initial rates can be defined as one-year guarantees or multiple year guarantees. Many fixed annuities will guarantee the rate for the first year and then rates will be declared each year thereafter. Other versions will guarantee rates for part of the term. Annuities that offer multiple year guarantees will guarantee the rate for the full term that you select. Terms are available for two years to ten years. Generally, the longer the term the higher the guaranteed rate will be. Another version will have guaranteed rates that increase each year for a period of five years or seven years or ten years. A new version of this annuity is available where in just one annuity contract you have the freedom to allocate the initial deposit into one term or up to all of the terms available (it includes a 2-year term, 3, 4, 5, 6, 7, 8, 9 and a 10-year term). In essence, you can employ an effective laddering strategy using annuities.

BONUS RATES

Bonus rates are also versions of this type and may pay a BONUS Rate in the first year or for a predefined number of years. This bonus rate is paid in addition to the initial rate and may or may not be forfeited depending on the provisions of the contract. In many cases, a bonus rate of interest is forfeited if you take the money prior to the end of the surrender period or early than a stated policy year of the contract. Sometimes and in some products the bonus rate is forfeited if you don't annuitize the contract at some future date. Bonus rates may also be paid at certain times throughout the contract period. For example, bonus rates may be paid on the 5th, 10th, and 15th policy anniversary. Some bonus rates are paid out when you annuitize the contract.

RENEWAL RATES

Renewal rates are the rates that are paid after the guaranteed period during which the initial rate is paid. The guaranteed period and the interest rate or the method of determining the interest rate is defined in the contract.

MINIMUM GUARANTEED RATES

Under fixed annuities, including FIPs, state insurance law requires insurance companies to guarantee some minimum rate of interest. This guaranteed minimum rate of interest historically was at least three percent but, under current state law, the rate can range from one percent to three percent as a function of the five-year constant maturity treasury yield. Variable annuities do not have any state mandated minimum interest crediting rate or minimum guaranteed surrender value requirements.

Under fixed annuities the owner has assurance of earning a declared or specified minimum rate of interest, in other words, some rate of interest. Under variable annuities, the owner's rate of return is linked to the earnings realized on a pool of assets, and the owner has no assurance that the pool will experience a high, low or, indeed, any increase in investment performance. In fact, investment performance may result in a decrease of the assets and the benefits to which the owner is entitled or under some circumstances the lapse of the policies.

ANNUITY PARTIES AND ISSUE AGE GUIDELINES

There are three parties to the annuity contract: (1) The owner, (2) the annuitant, and (3) the beneficiary.

The owner is the individual or, as we mentioned previously, the entity that purchases the annuity, designates the annuitant and the beneficiary, determines payout options and in all respects controls the contract.

The annuitant is the person whose age is used to calculate payments and may also be the person who receives the payment at annuitization or payout of the annuity. In many cases, the same individual is both owner and annuitant. If they are different, the owner is responsible for all income taxes due on any payments made to someone other than the owner.

The beneficiary is generally the person who receives the death benefit of the annuity if you die before the annuity starting date or who becomes the owner upon the death on or after the annuity starting date and receives any payments remaining at the death.

Most annuity contracts have minimum and maximum age limits for the owner and the annuitant. Since the beneficiary is the one receiving the proceeds of the annuity at death and the contract is terminated at the payout, there are no age limits on the

beneficiary. The minimum and maximum age is used to determine the minimum age at which an annuity contract may be issued and the maximum age that the annuity contract may be issued. Some annuity contracts state the minimum and maximum age of both the owner of the annuity contact and the annuitant. Typically the minimum age is 0, but in some cases it is 18. Maximum age depends on the insurer and ranges between 60 and 90 with the majority being 85 or 90.

ANNUITY DATE

The annuity date is the date in which you begin to receive annuity payments. This date is the earlier of the optional date you elect or the maturity date. The maturity date is the latest date you may defer your annuity payout options and is stated in the contract. Many contracts stipulate that the owner may change the maturity date but the new maturity date may be the last day of the term but may be no later than the maximum age stated in the contract. The maturity date is often misunderstood. The maturity date is typically the LAST date by which the client must take receipt of the proceeds, not the first date on which they may do so without surrender penalties.

SURRENDER AND WITHDRAWAL WAIVERS

Waivers are product features that that trigger the distribution of the annuity account value without incurring surrender charges if certain conditions or situations are met under a specific event. Not all contacts include all these waivers and some do not include any. Typically contracts apply the waivers after the first full year of the contract, but some may be longer and you should always check with each carrier and each product. Also products differ on whether the waiver is applied when the annuitant meets the criteria or the owner meets the criteria.

DEATH BENEFIT WAIVER

This waiver passes on the annuity to the beneficiary if death occurs before the surrender period is over or before annuitization.

NURSING HOME WAIVER

If the owner or annuitant is confined to a licensed nursing home for more than a number of days specified in the contract and typically beginning after the first year of the annuity, no surrender charges will be deducted from the account value upon a full or partial surrender.

Terminal Illness Waiver

If the owner or annuitant is diagnosed with a terminal illness with a life expectancy of a given number of months or years (typically the life expectancy is less than one year) and typically diagnosed **after** the first year of the annuity, no surrender charges will be deducted from the account value upon a full or partial surrender.

Disability Waiver

If the owner is under a specified age (e.g., 65) and becomes disabled after the annuity is issued, and remains disabled for a consecutive period of time, the company will not deduct a surrender charge from the account value upon a full or partial surrender, while the owner is disabled.

Unemployment Waiver

Many companies have an Unemployment Waiver, an example of which is the following:

"If the owner is under the age of 65 and becomes unemployed any time after the annuity is issued, and remains unemployed for at least 30 consecutive days, the [annuity carrier] will not deduct a surrender charge from the account value upon a full or partial surrender while the owner is unemployed."

Premium Payments

Single premium annuities accept one premium up front at the beginning of the contract. Flexible premium annuities allow one premium up front and then subsequent premiums. The period of payment as well as the minimum and maximum premium payment amounts (required versus optional) are defined in the contract and any changes to the increase the periodic payment schedule, decrease the minimum and increase the maximum may be made by the company if it improves the customers contractual restrictions

Withdrawal and Surrender Charges

Fixed declared rate and indexed annuities typically impose a surrender charge which is a type of sales charge you must pay if you sell or withdraw money from an annuity during the "surrender period" – a set period of time that ranges from today's low of three years to more than ten and declines to zero at the end of the period. The amount and duration of the surrender charge varies among contracts and as

applicable state laws permit. As with any insurance product, an annuity must be selected to fit the particular needs of the person buying it. As with any financial product, they will be suitable for some, but not all people, and for some, but not all, of their financial assets.

Like most insurance retirement products, annuities are designed to be held for a number of years. Accordingly, annuities—whether fixed or variable—may not suitable for persons, regardless of age, who could not be expected to keep their product in force for the long term.

Early termination or withdrawals above a specified amount may be subject to surrender penalties as well as potential tax penalties.

Surrender charges are waived in many circumstances: Death, terminal illness, nursing home confinement, RMDs, conversion to a stream of income, unemployment and most annuities have a specified annual free withdrawal amount such as 10% of the accumulated value. And all without the potential loss associated with market risk. Longer surrender charge durations afford the insurance carrier to the ability to invest longer term which generally offers higher interest returns to the client. This means that those who surrender early are not being subsidized by those who stay the course. No other financial instrument offers the ability to avoid surrender charges under so many circumstances and market risks as well.

MARKET VALUE ADJUSTMENTS

Some fixed annuities impose a market value adjustment (MVA) on surrenders and withdrawals prior to the end of the period noted above. MVAs adjust the amount surrendered or withdrawn to reflect the effect of then current economic conditions on the value of the insurance company's invested assets (generally bonds) supporting the guaranteed crediting rate of fixed indexed annuities. Under some fixed indexed annuities, the MVA adjustment can be "positive," in which case, in actuarial parlance, the withdrawal or surrender proceeds will be reduced, or "negative," in which case, in actuarial parlance, these proceeds will be increased to reflect asset gains. In every case, however, an MVA adjustment will not be allowed to reduce product values below the minimum guaranteed values required by state insurance law. This maintains the insurance status of the product by limiting the degree of investment risk that the insurance company transfers to the owner.

CONTRACT ADMINISTRATION CHARGES AND FEES

These are terms that should be associated, and usually are, with variable annuities. Variable annuities have Administration fees and distribution costs. Many variable annuities charge a fee for administration expenses. These fees can range from .15 percent to .40 percent (.15%-40%) of the total account value and these fees are in addition to other fees in the contract. Fixed indexed annuities use a term called spread or asset fee, which we'll discuss in detail later. A few insurance companies have referred to these terms as administrative fees. However, this is a misnomer because it makes this adjustment approach sound similar to fees for variable annuities or mutual funds, which they are not. These fees are not to pay for administrative or investment services rendered but rather, like all adjustments, to provide the company a "lever" to balance the hedging budget with the cost of hedging or reduce the risks inherent in hedging.

WITHDRAWAL PRIVILEGE OPTIONS

Withdrawals can be defined in two ways or types — Partial and Full. The insurance company allows the owner to withdraw some (partial) or all (full) of the owner's money and to surrender the owner's fixed indexed annuity. While most fixed indexed annuities impose a charge if the owner withdraws or surrenders during the first several years of an annuity – called a surrender charge discussed earlier. At the same time, most fixed indexed annuities waive surrender charges for partial withdrawal of up to 10% of accumulated purchase payments annually, withdrawal of the interest earned only or upon the owner's disability, confinement to a nursing home or becoming terminally ill or upon any "required minimum distribution" as mandated by federal income tax law. Many contracts waive surrender charges if the owner annuitizes their contract over a period of five years or longer.

ANNUITIZATION OPTIONS

When the policyholder is ready to start receiving payouts from an annuity (immediately with immediate payout annuities or deferred to a later date with deferred annuities) the accumulated value of the annuity will fund the benefit payments. The payout settlement option provision in an annuity contract describes the available payout options. Here are some of the most common ones. However, in today's competitive marketplace there are many more available, including the following options.

- Period Certain

- Amount Certain
- Straight Life Annuity
- Life Income With Period Certain
- Life Income With Amount Certain
- Joint and Survivor

PERIOD CERTAIN

With this option, the insurer pays annuity income benefits for a specified period of time (e.g., 10 or 20 years). The stated period over which the insurer will make the benefit payments is called the period certain. Even if the annuitant dies during this period, it will not affect the income benefit payments. When the period certain ends, so do the payments.

AMOUNT CERTAIN

With an amount certain option, the insurer pays a fixed benefit amount for as long as the accumulated value of the annuity lasts.

STRAIGHT LIFE ANNUITY

A straight life annuity provides benefit payments for the lifetime of the annuitant. It continues to pay as long as the annuitant is alive, even if the accumulated value of the annuity has been depleted. However, once the annuitant dies, the benefit payments end, even if all of the money in the annuity account has not been paid out. This payout option is sometimes selected by those who need a maximum amount of income and have no dependents.

LIFE INCOME WITH PERIOD CERTAIN

A life income with period certain option guarantees that annuity benefits will be paid throughout the annuitant's lifetime. It also guarantees that payments will continue to the beneficiary if the annuitant dies before the end of a pre-set period, usually 5, 10, 15, or 20 years.

LIFE INCOME WITH AMOUNT CERTAIN

This option provides for monthly income payments to be made throughout the life of the annuitant and continues to the beneficiary until the total payments equal the amount paid for the annuity.

JOINT AND SURVIVOR

This option provides for fixed monthly income payments to be made throughout the lifetime of two (or more) persons. The payments continue until both (or all) of the individuals die. In some plan variations, the payment amount is decreased after the first death. A period certain may also be available with this option.

For more flexibility, some contracts allow for systematic withdrawals. In this case, you would receive a fixed percentage of the account value or a fixed monthly amount. You could stop this arrangement at any time and simply withdraw the remaining balance. Although systematic or extended payout may have advantages over annuitization, note these two differences.

- With annuitization as the annuity settlement option, you can lock in a guaranteed monthly income regardless of the performance of the annuity.
- In addition, annuitization lengthens the tax deferral period since only part of each payment is taxed. The IRS considers the other part of the payments a return of principal.

DEATH BENEFITS

Fixed indexed insurance products generally provide all of the insurance coverages of traditional annuity and life insurance products, including death benefits. The death benefits a deferred annuity (whether declared rate or indexed) are so named because they are triggered at death and understandably ending the deferral phase and beginning the payout phase to a named beneficiary. Again, many fixed annuities including indexed annuities waive surrender charges for significant events including death. The options available are stated in the contract and are often similar to the annuitization options discussed earlier and are variations of the following.

- Lump sum – the full death benefit account value as defined by the contract paid out in one payment.

- Extended payout or settlement options are either lifetime income – a stream of payments for life; or period certain – a stream of payments for a specific stated period.
- Also many contracts provide settlement options that are a combination of some period certain and lifetime payout.

PRINCIPAL GUARANTEE AND LOAN PROVISIONS

The owner is protected by a guaranteed value that must grow over time and result in return of principal within a short period of time. The owner is always assured of receiving at least these guaranteed values and more if credited excess interest raises then current value above guarantees. This is true because a true interest credit cannot be undone or lost in a fixed annuity. Thus, while the owner can not be sure of what future values will be (nor can the owner in an annually declared fixed interest rate approach) the owner does know guaranteed minimum values in advance and can use these to compare to other products, as well as whether the guaranteed minimum values approximate his or her minimum needs. Measured against a variable product or a mutual fund product, the owner is in a very different posture due to the guaranteed minimum values.

In summary, regardless of the specific product features by which an insurance company balances its assets and liability for interest credit, the owner is guaranteed the return of principal and a minimum rate of credited interest regardless of the insurance company's investment management skills. The insurance company accepts the risk, for example, that the S&P 500 Index or the bond market will perform well enough, and/or the company will manage its hedges well enough, to eliminate the insurance company's need to provide the guaranteed values.

Most qualified annuity contracts offer loan provisions (though some do not) to offset the IRS regulations concerning withdrawing money from an annuity. Some companies have accounts that do carry loan provisions and other accounts that do not have loan provisions. These loan provisions are highly regulated by the federal government; therefore, most are very similar. Some deviations exist in the amount of the money you can access and the interest rate you pay on money borrowed.

In general employees or owners of qualified individual annuities (IRA) are permitted to take one loan per a specified period (typically twelve-months) Interest is typically charged and the loan must be repaid from within a specified timeframe (e.g., five or up to ten years). The loan is often required to be used to purchase a primary residence there are other, restricted uses like education and medical care. How much

you can borrow depends on the amount currently in the account that the contract stipulates is available for loan. Often a maximum and a minimum loan amount is also stipulated. There are tax consequences if a loan is not repaid in accordance with the terms. If the loan is in default, it will be considered a “deemed distribution” and the outstanding loan balance (including accrued interest) will be reported to the Internal Revenue Service (IRS) as current taxable income, which may result in a substantial and immediate tax liability. In addition, if you are under 59½, the default may also be subject to an additional 10% federal tax penalty for an early distribution.

INDEX CREDITING STRATEGIES

Nearly all fixed indexed annuities make provision for an adjustment factor to modify the index value percentage change. The purpose of the adjustment is to allow the insurance company to balance the amount that it has available to spend for an interest credit with whatever it costs the insurance company to provide the index percentage change method.

For example, if an insurance company would normally credit a fixed interest rate of four percent per year, this roughly becomes the budget for purchasing or constructing a financial hedge which will provide the interest credit promised in the policy, regardless of what index changes occur. It will be rare that, say a hedge for a point to point strategy would cost the company exactly four percent. Perhaps it costs five percent. The insurance company needs some way to provide the policyholder with an interest credit that costs the company only four percent to provide. The company must reduce the cost of the liability hedge to four percent while still providing interest under the basic method promised in the contract, subject to the risks inherent in virtually all hedging techniques.

FLOOR OR MINIMUM

The first and nearly universal adjustment is a floor or minimum of zero percent (0%) on the index value change percentage. This prevents a negative interest credit from ever occurring. It effectively locks in prior interest credits by keeping them from being invaded by a future negative credit. Indexed approaches with this feature are referred to as “ratchet” approaches, because policy values can go in only one direction (up) as a result of interest credits. A few products have a higher floor than zero percent.

Participation Rate

This term may be an unfortunate misnomer in that a fixed annuity cannot “participate” in any, market, or index. A FIP can only credit interest as declared or promised by the insurance company. A fixed annuity has no direct participation in any other investment. Regardless of how an insurance company hedges or assures itself of having funds available to provide the interest credit, it is guaranteed to be paid by the company. This method credits a percentage or proportion of the index value change percentage as interest. For example, an 80% participation rate applied to an index value change percentage of 10% will yield a credit of eight percent (8%). When interest rates are low or hedge costs are high, participation rates will usually be less than 100% and vice versa. Should the product allow the insurance company to change participation rates for future interest terms, they must state a minimum guaranteed level of participation rate; e.g., 25%.

Spread, Margin or Fee

These are all terms for a deduction from the index value change percentage. For example if the spread is two percent and index value percentage change is 10%, then interest credit would be eight percent. That is, the first two percent of the index value change percentage is not credited as interest. Most products have a zero floor. If the index value percentage change is zero percent, and the index value percentage change is less than the spread, interest credit will be zero percent, not negative. A few insurance companies have referred to these terms as administrative fees. However, this is a misnomer, because it makes this adjustment approach sound similar to fees for variable annuities or mutual funds, which they are not. These fees are not to pay for administrative or investment services rendered but rather, like all adjustments, to provide the company a “lever” to balance the hedging budget with the cost of hedging or reduce the risks inherent in hedging.

Cap

A cap adjustment is a maximum limit on the index value change percentage. For example, if the index value change percentage is eight percent and the cap is 10%, then the interest credit is eight percent. In no case would a credit for any interest term be higher than 10%, no matter what the index value change percentage is.

<u>BINARY OR TRIGGERED SPECIFIED RATE</u>

The specified rate is the specific interest credit that will be paid if the trigger or hurdle IVPC is reached. For example, if the trigger is zero percent and the IVPC is 10% and the specified rate is six percent, then the interest credit will be six percent.

Within a given index interest formula, any floor is always guaranteed for the life of the product. Similar to fixed interest rate strategies, the other adjustments for indexed strategies may be guaranteed for only one interest rate period or for multiple periods. Adjustments are always declared in advance for the interest credit term. Adjustments for subsequent interest terms, if not guaranteed are declared by the insurance company based on then current investment yields, required spreads and cost of hedging. The participation rate and caps must generally have a guaranteed minimum below which an insurance company may not reduce in subsequent interest terms. Margin adjustment must generally have a declared maximum above which an insurance company may not increase in subsequent interest terms.

GENERAL

The distinguishing feature of FIPs is that the owner earns a rate of interest derived by reference to an index. The index is solely a benchmark or a measuring stick for the interest rate that the insurance company credits to the owner. The owner, in no way, “participates” in the performance of the index or in the performance of a specified group of stocks, bonds or other financial instruments in the market that the financial index measures. The index is a reference point, outside the control of an insurance company who provides an objective standard from which an insurance company can derive an interest rate to be credited to an owner.

The insurance company derives the interest rate to be credited to an owner by using the index performance as a starting point, not the final result. The insurance company does not necessarily credit an interest rate equal to the index performance. Instead, the insurance company derives an interest rate to be credited with reference to the index performance and to other factors in accordance with the terms of the FIP. These factors include:

- The period of the interest credit;
- The index used;
- The calculation of the index value change in percentage terms;
- The adjustments made to the index value percentage changes;
- The benefits to which the indexed interest is applied.

PERIOD OF THE INTEREST CREDIT

The period or "term" of the interest credit establishes the point at which interest will be credited to the owner. The most common term today is one year. Since interest is typically credited on not only purchase payments but past interest earned, these interest credits "compound," i.e., interest is earned

on prior credited interest. The credits "lock in" and cannot be lost. This is often referred to as "ratcheting." In contracts with periodic ratcheting, future interest cannot be negative, and contract values cannot decrease due to interest credits.

Some FIPs have multi-year terms for interest crediting, ranging from two years to the entire surrender charge period. Those products with terms up to three years (including annual terms) usually have no provision for any interim interest credit. Only monies in the contract for the entire term receives indexed interest at the end of the term.

FIPs with terms over three years usually make some provision for an interim interest calculation should a benefit calculation be necessary (upon annuitization, death, surrender or withdrawal). Sometimes this will take the form of a calculation from "inception to date of benefit," using the index on date of calculation of benefit rather than the end of term index which would not be available at that point. In other contracts, the highest of a calculation done on every prior anniversary is used (often called a "high water" calculation). This requires a calculation on every anniversary of total interest to date in order to determine which is the highest. The provision for interim interest in longer-term, multi-year interest crediting formulas makes the interest crediting term flexible depending on the need for a benefit calculation, including interest, upon surrender, withdrawal, death or annuitization.

One recent approach to indexing creates variable length crediting terms. This approach is a form of the Triggered Indexed Value Percentage Change. When a certain level of increase in the index value occurs, it triggers an interest credit and the beginning of a new term of interest crediting.

FINANCIAL INDEX

An index reflects the investment performance of a specified group of stocks, bonds or other financial instruments in a market or a segment of the market. Most indexed products specify the S&P 500 Composite Stock Price Index, which does not reflect dividends (the S&P 500 Index). That index is popular because it is widely recognized by the public and reflects the investment performance of the stock of 500 companies

that Standard & Poor's Inc. has selected as representing a broad segment of the stock market. Some FIPs specify only one index, but others permit an owner to choose among several approaches and reallocate among strategies at the end of interest credit terms. Approximately a dozen other indexes are used by insurance companies today in their FIPs. However, the future variety seems limited only by:

- The ability of a company to find appropriate hedges, as explained below;
- The ability of a company to develop the volume of purchases to make it cost-effective; and
- Market acceptance of the index.

Other indexes used in products today include indexes such as the Dow Jones 30 Industrials, the NASDAQ 100, and Russell 2000. Indexes do not have to be based on groups of instruments. A few products have used interest crediting formulas linked to Treasury Bills interest rates and published and independently maintained bond indexes.

INDEXED VALUE PERCENTAGE CHANGE

There are a variety of methods of determining the percentage change. The term of the interest credit is usually annual but may be any number of years. In this section, the Indexed Value Percentage Change is abbreviated as IVPC.

Point to Point — Percentage change of starting index value to end of term index value. For example, if starting index is 1000 and ending index is 1200, then IVPC is 20%.

Point to Final Average — Percentage change of starting index value to average of a series of index values. This approach can be used in a one-year interest crediting term; e.g., starting point to final three month average at the end of the year. For example, if the interest crediting term begins January 2nd with an index of 1000, and the average of index values on November 2nd, December 2nd, and the following January 2nd is 1100, then the IVPC is 10%. This approach tends to reduce the volatility of the IVPC due to the averaging. This approach is more common in multi year crediting, where much more ultimate interest is dependent on a final series of index values, e.g., final six month average over a five year crediting term.

Averaging — Percentage change of starting index value to the average of an evenly spaced series of index values. This approach is most commonly manifested in a point to 12-month average over a one-year term. For example, if the crediting term begins January 2nd with an index of 1000, and the average of index values on the second of

every month for the next 12 months is 1100, then IVPC is 10%. This approach tends to reduce volatility of IVPC even more than Point to Final Average, and presents a greater potential for significant positive index changes at any point or points to be more than offset by negative index changes at other points. Additive Serial Point to Point (sometimes referred to as monthly point to point) - percentage change of a starting index value to the sum of a periodic series of index changes, usually with positive changes capped at a maximum. Negative changes are not adjusted or floored. This approach is used in interest crediting periods of one to three years and the frequency of the period is monthly. This method is somewhat unusual in that the adjustment is applied within the IVPC calculation rather than after. A quarterly example is shorter and simpler. Assuming the crediting term begins January 2nd at an index value of 1000 and the declared quarterly cap for the year is five percent and the index values result in a series of quarterly percentage increases and monthly capped percentage increases as follows.

CAPPED DATE	INDEX VALUE	PERCENTAGE INCREASE	PERCENTAGE INCREASE
January 2	1000.00		
April 2	1050.00	5.00%	5.00%
July 2	1155.00	10.00%	5.00%
October 2	1212.75	5.00%	5.00%
January 2	1139.99	-6.00%	-6.00%
		Sum 9.00%	

High Water — Percentage change of starting index value to the highest of a periodic series of index values. This approach is almost always used over multiple years with the high water period being annual. For example, assume a 10-year Point to Point interest term begins January 2nd with an index value of 1000. On January 2nd, five years later, the index value is 1100, however, the highest index value of the last five years was 1400. The IVPC is 40%.

Low Water — Percentage change of the lowest of a periodic series of index values to the end of term index value. This approach is rare, but is usually used for a one-year interest term. For example, assume a one-year Point to Point interest term begins January 2nd with an index value of 1100 and one year later on January 2nd, the index value is 1200. If the lowest index value of the beginning January 2nd index value and the next 11 month's index values through December 2nd is 1000, then the IVPC is 20%.

Binary or Triggered — A version of Point to Point where a specified interest percentage is credited only if the Point to Point Index Value Percentage Change is

achieved (usually 0%). For example, assume an interest term begins January 2nd with an index value of 1000, the trigger point is zero percent increase and the specified interest rate is six percent. The index value one year later is 1100. Because the index value increased by greater than equal to zero percent, the IVPC is six percent.

Indexed interest approaches use various methods of determining what index value is used for any particular date. For example, some insurance companies use the first available index value after the policy anniversary if there is not one available, because the date is a holiday or non-market day.

At the end of a term, a credit is made. Therefore, most products start anew with an interest crediting term of the same length. For example, if a product has an annual term and the ending index value of the prior term becomes the beginning value of the next term, the product is said to be an “annual reset” calculation, because the beginning index value is reset at the beginning of the next term to where the index finished in the last term.

An index value is a number measuring the value of a specified group of stocks, bonds or other financial instruments. Many indexed products specify the S&P 500 Composite Stock Price Index, which does not reflect dividends (the “S&P 500 Index”). Currently, insurance companies use less than a dozen other indexes. Some FIPs specify only one index, but some permit an owner to choose among several approaches and reallocate among indexes as well as declared-rate fixed account at the end of interest crediting terms.

A fixed annuity has no direct participation in any other investment. Regardless of how an insurance company hedges or assures itself of having funds available to provide the interest credit, it is guaranteed to be paid by the company. This method credits a percentage or proportion of the index value change percentage as interest. For example, an 80% participation rate applied to an index value change percentage of 10% will yield a credit of 8%. When interest rates are low or hedge costs are high, participation rates will usually be less than 100% and vice versa. Should the product allow the insurance company to change participation rates for future interest terms, they must state a minimum guaranteed level of participation rate, e.g., 25%. Adjustments to the full upside are necessary because rarely would the cost of providing the underlying guarantees leave enough available to exactly match the full upside potential. How much upside can be purchased depends on the rate of return on the underlying assets (bonds), the guarantee that is being provided and volatility of market.

The company does not invest financial assets in the instruments making up the index. The carrier invests primarily in bonds to provide the underlying guarantees as well as other financial instruments (or hedging strategies) that provide the pre-stated portion of the index return that the client will receive.

Almost always mid-term withdrawals or partial surrenders will not earn interest credit for period during which it was withdrawn or surrendered. The withdrawal or surrender amount and any surrender charges will be deducted from the account value before the interest earned for the term is credited. Minimum nonforfeiture or minimum guarantee is a specified percentage of total purchase payments (ranging between 87.5% and 100% of purchase payments, thereby generally reflecting the deduction of expenses and less any withdrawals), which is referred to as “principal”; plus a guaranteed rate of interest in the form of a minimum rate of interest required under applicable state insurance nonforfeiture laws (historically and currently, three percent annually, but, at times, ranging between one percent and three percent depending on the then-current yield curve as indexed to five-year Treasury yields), which becomes part of the principal. This is commonly referred to as the minimum guaranteed account value. However, in addition to the minimum guarantee the principal may earn a rate of interest (sometimes refereed to as the “excess rate interest”) that is calculated under a guaranteed formula by reference to an index, which becomes part of the principal plus an additional rate of interest (sometimes refereed to as the “excess rate interest”) that is calculated under a guaranteed formula by reference to an index, which becomes part of the principal and may b e thought of as the premium accumulation value. is typically referred to as the current account value. The owner’s account value will be the greater of the minimum nonforfeiture value or premium accumulation value less any withdrawals, surrenders or surrender charges.

NAFA’s states its concern with any historical analysis that is used primarily to determine product performance because you cannot economically, actuarially and mathematically recreate the volatility formulas used to price the index options, the investment portfolio used to determine the share of expenses for option purchases and guaranteed benefits, the general expense formula for the product, and the companies profit requirement. Simply recreating an historical reconstruction of the index performance and applying that to a crediting methodology cannot and should not be used to inform the customer of potential performance.

NAFA believes that selling these products based on backdating performance inappropriately assigns performance as the main reason to buy a fixed indexed annuity. NAFA believes fixed indexed annuities should be purchased by individuals who want to use the unique combination of insurance and investment features that they offer - guaranteed principal protection, guaranteed prior earnings protection,

guaranteed minimum interest and tax deferred savings. Fixed indexed annuities can be a useful retirement planning tool for unsophisticated purchasers and retirees or those close to retirement who, probably more than others, cannot risk losing their principal and need some predictable guarantee of increases. The insurance element of minimum guarantee results in a predictable asset to fund the future liabilities of a person’s retirement years. This minimum floor is coupled with the upside potential of additional credited interest based on increases in an index.

Highest Index Annuity Interest Credited

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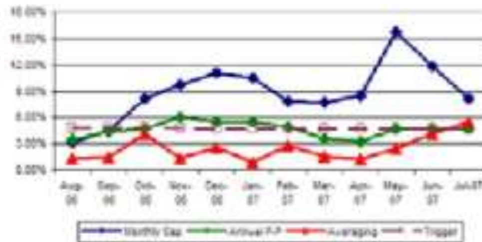
Lowest Index Annuity Interest Credited



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The previous charts show, respectively, the best and worst first year interest credited over the previous 12 months based on rates, caps and spreads in effect at time of purchase for all of the index annuities on the market. Please note, most index annuity carriers group the applications received, so the chart shows what interest would have been if all of the annuities had issued policies at the end of each month.

RIDERS

Riders are special additions to the policy provisions that offer benefits not found in the original contract, or that make adjustments to it. These special provisions are, in effect, attached to the policy. Riders are not necessarily found in all policies. Because all riders provide some kind of benefit to the policyowner, an extra premium may be charged for them. The riders typically offer the benefits that they are named after but the triggers, limitations and restrictions must be understood.

BENEFIT RIDERS

LONG-TERM CARE BENEFIT RIDER

The Long-Term Care Benefit Rider is also referred to as an Accelerated Death Benefit Rider. In some contracts the trigger for the rider is a determination by the attending physician that the insured is terminally ill and the life expectancy is limited and within the allowable time allocated in the insurance contract. The life expectancy is the amount of time the licensed physician expects the primary insured to live. In other cases the insurance contract allows the insured to access LTC when the attending physician has stipulated that the patient is unable to perform certain activities of daily lining. The amount allowed is the percentage of the policy face amount the insurance company will 'accelerate' or pay out. The maximum amount is simply the most the company will pay under the rider. It is important to note the amount accelerated is treated like a policy loan, and is deducted from the face amount of the policy along with any accrued interest and administrative fees. The Accelerated Death Benefit rider can be a valuable feature should you become terminally ill during the term of your life insurance policy. Proceeds can be used to pay related medical expenses, to prepay funeral expenses or to settle any other outstanding issues prior to an anticipated death. Of course, you may never choose to use the rider, which may be the best scenario of all!

NURSING HOME WAIVER OF WITHDRAWAL CHARGE PROVISION

The Nursing Home Waiver of Withdrawal Charge Provision gives the owner of an annuity who is seriously disabled or needs to go to a nursing home before retirement, an opportunity to take payments that are not subject to the usual surrender fees. Serious health changes may trigger annuity payments even if you don't—or can't—retire. Situations that trigger the waiver and allow you to make early annuity withdrawals vary from company to company. For instance, one insurer might require a 90-day nursing home confinement before your benefits are activated, while another might call for 60 days. In addition, one company may consider you disabled if you're unable to work in any occupation, while another may require only that you're unable to work in your current occupation. (For instance, a surgeon may be deemed disabled by one insurer if he or she cannot operate because of, say, arthritis in the hands. Yet another company might decide that the doctor is not disabled because he can still see patients in an office setting, without performing surgery).

GUARANTEED MINIMUM WITHDRAWAL BENEFIT RIDERS

Annuities come with a host of optional features that you can select for an additional annual fee. One increasingly popular type of variable annuity feature is the withdrawal benefit provision, also known as a GMWB (Guaranteed Minimum Withdrawal Benefit). GMWBs are designed for investors who need monthly, quarterly, or annual income from their investment, and want a guarantee that they will never lose their principal, regardless of market performance. If you purchase a GMWB Rider with your variable annuity, the insurance company guarantees that even if the market performs poorly, you will not lose the money that you have invested. Furthermore, over the lifetime of your contract, you can withdraw an amount equal to your total principal, typically in monthly, quarterly, or annual withdrawals. Depending on the insurance company issuing the annuity, you can typically withdraw from five percent to ten percent (5%-10%) per year.

GUARANTEED MINIMUM DEATH BENEFIT RIDERS

The Guaranteed Minimum Death Benefit Rider guarantees that the death benefit protection of your policy won't lapse even if the cash surrender value is insufficient to cover monthly deduction charges. In short, your policy's death benefit is guaranteed, no matter how the market is performing.

CHAPTER 2 REVIEW QUESTIONS

Which of the following answers each sentence the best?

(Answers are in the back of the text.)

1. _______________ are paid after the guaranteed period during with the initial rate is paid.
   a) Minimum Guarantee Rates
   b) Guaranteed Rates
   c) Bonus Rates
   d) Renewal Rates

2. State insurance law requires insurance companies to guarantee a minimum and a maximum rate of interest.
   a) TRUE
   b) FALSE

3. The unemployment waiver provides that if a qualified business owner becomes unemployed after annuity issuance, the surrender charge will not be deducted from the account value, provided the owner remains unemployed for:
   a) at least 30 consecutive days.
   b) more than 30 days.
   c) at least 45 consecutive days.
   d) more than 45 days.

4. Variable annuity administration fees and distribution costs range from ____________ of the total account value.
   a) .40% to 15%
   b) .15% to 40%
   c) .05% to 20%
   d) .20% to 5%

5. _______________ is the percentage change of starting index value to the highest of a periodic series of index values.
   a) High Water
   b) Low Water
   c) Binary
   d) Triggered

6. _______________ is the percentage change of the lowest of a periodic series of index values to the end of term index value.

   a) High Water
   b) Low Water
   c) Binary
   d) Triggered

CHAPTER 3

ADVANTAGES AND DISADVANTAGES OF ANNUITIES

NAFA believes that fixed indexed annuities are suitable for those with safe-money needs. Because of the variety of product and features choices someone wishing to protect some of their savings may benefit from a fixed indexed annuity regardless of age. And the advantages and disadvantages are measured on their financial objectives and their retirement needs.

There is a persistent misunderstanding on the suitability of fixed deferred annuities. Fixed deferred annuities offer lifetime guarantees and other benefits that set it apart from other financial products. The tax treatment of deferred annuities is different. If you understand these differences, you will see how these features are attractive to seniors, and more importantly, why fixed deferred annuities can be a suitable part of a senior's financial plan. Some of the features and benefits are explained below.

The ability to **elect an income that cannot be outlived at guaranteed rates** sometime in the distant future. This is a feature unique to annuities for those who require certainty in the income portion of their portfolio. Insurance companies are stepping up to the plate to fill a need, given their unique capability for insuring longevity risk. Moreover, in addition to specified guaranteed rates, the carriers also generally offer to turn the deferred annuity into an income stream at the customer's discretion guaranteed for a specific timeframe, even life, based on current factors that generally even more favorable than the guaranteed rates.

The **guarantees of fixed annuities** are the primary appeal to an older population, a dynamic that has been universally recognized across the financial services industry. Given their ability to safeguard and insure principal and previously credited returns, insurance companies are again in a unique position to meet the needs of seniors who are concerned about having their principal exposed to market risk. It is the convergence of this age group's need and the unique ability of insurance carriers that has created the substantial interest in fixed annuity products among seniors.

A secondary benefit of annuities is their **tax-deferred nature**. Accumulating and holding retirement funds in tax-deferred vehicles allows the asset to grow more

quickly than would otherwise be the case in a similar, but taxable, vehicle. Due to this significant advantage, Congress has imposed a ten percent penalty for taxable amounts withdrawn before age 59½ in recognition of the public good of holding these products into retirement years.

The tax treatment of deferred annuities lead to a significant proportion of owners over age 59½. Insurance companies have designed products in conformity with the tax laws and in response to the market demand for the product by those who have the most to gain from the benefits of these products.

While some casual observers may indicate that already-tax-favored funds such as IRA money and pension funds should not be held in an annuity because they are already tax favored and, therefore, there is no benefit to the use of annuity, they forget that it is the guarantees and longevity insurance that drive the use of the annuity in these situations.

Penalties for early withdrawal are common among financial products and annuities are no different. Still, **most annuities include a variety of withdrawal provisions, some of which provide substantial withdrawal rights without penalty**…and without exposure to loss of principal through market risk. Among the circumstances that commonly allow for early withdrawal of the entire proceeds without penalty are death, terminal illness, nursing home confinement, Required Minimum Distributions and unemployment. Furthermore, most fixed annuities also allow for a specified annual withdrawal amount without penalty. Most common is a **10% of accumulated value penalty free annual withdrawal**, but other options may include interest (often cumulative) or a specified annual percentage amount that accumulates annually. No other accumulation vehicle allows the owner to make withdrawals prior to the end of the penalty period without penalty fees or market risk to the asset. Surrender penalties are clearly spelled out in the contract.

The maturity date of the contract is also commonly misunderstood. A **maturity date is a term of the contract required by state law and it is often the last date by which the funds must be dispersed.** This legal requirement also ensures that the annuity complies with federal tax laws. Generally surrender charges will be over before the maturity date is reached—in many cases long before the maturity date is reached. As indicated earlier, in most cases there is liquidity each year and in many cases the client is able to convert the proceeds to a stream of income before the maturity date without penalty.

In addition to tax-deferral, there is another significant **tax benefit to recipients of Social Security** benefits that causes the annuity to be particularly beneficial to older individuals. Social Security benefits can be taxed on up to 85% of the benefit amount

at the client’s marginal tax rate if their income is above a certain provisional level. This is true even if the income is left to accumulate in a vehicle such as a CD or is generally considered to be tax-free as with municipal bond interest. Not only do returns left to accumulate in a deferred annuity escape current taxation, they do not count in determining whether, and to what level, Social Security provisional benefits will be taxed. This is a significant benefit to customers, and especially middle-class retirees who derive a significant percentage of their income from Social Security, not currently consuming all of their assets for living expenses.

Finally, because an annuity is a contract it generally passes to heirs through beneficiary provisions rather than through the probate process. For those without a will, this is one way in which assets can be passed to a named beneficiary **not subject to the intestacy provisions of the state and without the delays and costs associated with state probate.** Since the cost of probating assets for a decedent can be significant, again, especially for middle-class retirees, this is another benefit to a senior wise enough to have some of his or her assets in a fixed deferred annuity.

In the end, the two most important maxims for suitability are:

1. Target **safe money needs**, not age or demographic; and
2. Diversify products as well as risk by putting savings or investments into **more than one** financial product.

Suitability is always a matter for individual determination. Only a well-informed client can make an appropriate decision; therefore, it is important that all the features and benefits of the fixed annuity be fairly and accurately communicated to a prospective buyer.

INCOME DISTRIBUTIONS

Annuity settlement options can be puzzling just because there are so many choices. But each option itself is really pretty straightforward. Typically there are two major settlement options—lump sum or annuitization—to take payments over a timeframe that may include the rest of your client's life. At annuitization, payments are made monthly, semi-annually, or annually. Annuitization options usually include the following.

LIFE ANNUITY WITH PERIOD CERTAIN

Pays a monthly income to the payee for as long as the annuitant lives. If the annuitant dies before the payee receives the full period of payments (usually 10 or 20 years) the company will continue to pay the monthly income to the payee for the rest of the payments.

- **Advantage** — Guarantees a specific amount will be paid out if you die early and will continue pay you for life if you die after the stipulated period.
- **Disadvantage** — If you die early, your spouse will only receive the balance of the remaining payments and will forfeit the rest to the insurance company.

LIFE ANNUITY WITH INSTALLMENT REFUND

The company pays a monthly income to the payee for as long as the annuitant lives. If the annuitant dies before the sum of the payments equals the surrender value on the maturity date, we will continue to pay the rest of the payments to the payee until the total amount paid equals the surrender value on the maturity date.

- **Advantage** — The company doesn't keep a remaining account value.
- **Disadvantage** — Payment amounts are usually lower to pay for the guarantee of lifetime income and installment income.

LIFE ANNUITY WITHOUT REFUND

The company pays a monthly income to the payee for as long as the annuitant lives. No payments will be made after the death of the annuitant.

- **Advantage** — Larger payouts.
- **Disadvantage** — If you die before the account value is spent, the insurer gets the rest of the money.

JOINT AND 50% SURVIVOR ANNUITY

The company pays a monthly income to the payee while both annuitants are living. When the primary annuitant dies, we will reduce the monthly income to 50% of the original income. No payments will be made after the deaths of both annuitants.

Joint and 2/3 Survivor Annuity

The company pays a monthly income to the payee for as long as either annuitant lives. When the first annuitant dies, we will reduce the monthly income to 2/3rds of the original monthly income. We will continue to pay the reduced monthly income to the payee. No payments will be made after the death of the surviving annuitant.

- **Advantage** — It gives remaining spouse residual income if owner dies first.
- **Disadvantage** — Typically the payments are lower to cover the residual.

Joint and Survivor Annuity with Period Certain

A variation on the Life Income with Period Certain - The company pays a monthly income to the payee for as long as either annuitant lives. When either or both of the annuitants die before the payee has received all period payments, the company will continue to pay the monthly income to the payee for the rest of the payments.

Fixed Period Installments

The company pays payments to the payee in installments over a period you select based on a table in the contract.

Fixed Amount Installments

The company will make payments to the payee in amounts specified by you until all payments have been paid.

Both Fixed Period and Fixed Amount are advantageous if you live the period select or until the installments run out. A disadvantage is that if you die early, your beneficiary does not receive any left over amount.

Tax Ramifications of Annuitization — Nonqualified Annuities

The Annuitant or Owner

Generally it is recommended that you never have three parties to the contract. In other words, a different individual is named as owner, annuitant, and beneficiary. If you do have three different parties, you raise the possibility of all kinds of nasty tax results, including inadvertent gifts to payees from the owner.

While the owner and the annuitant may be the same individual during this phase, the annuitant is the individual upon whose life expectancy payouts are determined. The payouts are made to the owner unless he or she directs the company to pay them to the annuitant. If the individual receiving the payments dies before payouts are completed, the WHO becomes the beneficiary, as discussed later. The payment may be made as one lump sum, random withdrawals, or as a series of scheduled payouts over a specific period or a lifetime. These payments are taxed in various ways.

If the payment is made as a lump sum, income taxes will be due on the difference between the amount paid into that annuity and its value when it is paid out. Just like a traditional IRA, taxable withdrawals made prior to the annuitant's age 59 1/2 are generally subject to a 10 percent early withdrawal penalty.

When the contract is annuitized (a series of scheduled payouts over a specific period or a lifetime) part of each payment is considered a return of previously taxed principal (i.e., the premium paid in) and part a earnings. The taxpayer will owe income taxes on the part of the payment that is considered earnings. The amount of each annuity payment that won't be taxed is computed using an exclusion ratio, which is generally determined by dividing the premium paid into the contract by the total amount expected to be distributed during the payout period.

Assume Dick, age 62, has a fixed annuity into which he paid $100,000 of premium and will receive payouts of $700 a month for the rest of his life. According to IRS life expectancy tables, Dick will receive those payments for 22.5 years, so the contract's value is $189,000 (12 X $700 X 22.5). The exclusion ratio is 52.9 percent ($100,000/$189,500). So, out of the $8,400 the annuity pays each year, Dick may exclude $4,444 from income.

THE BENEFICIARY

If distribution payments had begun and the annuitant dies, the benefits would generally have to be distributed to the beneficiary at least as rapidly as through the method in effect at the time of the annuitant's death. Taxation will continue to apply to those proceeds based on the beneficiary's ordinary income tax bracket using the same exclusion ratio that was in effect when the annuitant was alive.

QUALIFIED ANNUITIES

DISTRIBUTIONS

Again, a qualified annuity acts like any other qualified account such as an IRA, 401(k), profit-sharing plan or other tax-deferred retirement account and is taxed the same in almost all cases. The government does not require you take any money out prior to age 70½ but should you do so, all that you take out is subject to ordinary income tax and if prior to age 59½ it is generally subject to an additional penalty (excise) tax of 10%. At age 70½ you must begin minimum withdrawals. The amount required is different based generally on the annuity's account balance and the age. However, there are additional details to consider and, again, you should consult a tax professional.

CHAPTER 3 REVIEW QUESTIONS

Which of the following answers each sentence the best?

(Answers are in the back of the text.)

1. Which of the following is/are the most important maxims for annuity suitability?
    a) Safe money needs
    b) Target age and demographics
    c) Diversification
    d) Target safe money needs and diversification

ANNUITIZATION OPTIONS:

2. ________________ pays a monthly income to the payee for as long as the annuitant lives; and if the annuitant dies before the payee receives the full period of payments, the company will continue to pay the monthly income to the payee for the rest of the payments.
    a) Life Annuity with Period Certain
    b) Life Annuity with Installment Refund
    c) Life Annuity without Refund
    d) Joint and Survivor Annuity

3. ________________ pays a monthly income to the payee for as long as the annuitant lives; and no payments will be made after the death of the annuitant.
    a) Life Annuity with Period Certain
    b) Life Annuity with Installment Refund
    c) Life Annuity without Refund
    d) Joint and Survivor Annuity

CHAPTER 4

FIXED INDEXED LIFE PRODUCTS

Term Life — Term life insurance provides coverage for a limited period of time, the relevant term. After that period, the insured can drop the policy or pay annually increasing premiums to continue the coverage. If the insured dies during the term, the death benefit will be paid to the beneficiary. Term insurance is often the most inexpensive way to purchase a substantial death benefit on a coverage amount per premium dollar basis.

Participating Whole Life — In a participating policy (also par in the USA, but known as a *with-profits policy* in the Commonwealth), the insurance company shares the excess profits (*dividends* in the USA, *bonus* in the Commonwealth) with the policyholder. The greater the success of the company's performance, the greater the dividend. For a mutual life insurance company, participation also implies a degree of ownership of the mutuality.

Universal Life — Universal Life is a type of permanent life insurance based on a cash value. That is, the policy is established with the insurer where premium payments above the cost of insurance are credited to the cash value. The cash value is credited each month with interest, and the policy is debited each month by a cost of insurance (COI) charge, which is drawn from the cash value if no premium payment is made that month. The interest credited to the account is determined by the insurer; often it is pegged to a financial index. Because only the amount of interest credited and not the cash value itself varies, UL policies offer a stable investment option.

Indexed Life (on any product chassis that offers excess interest earnings) — Indexed Universal Life contracts invest in Index Options on the movement of an Index such as the S&P 500, Russell 2000, and the Dow (to name a few). These types of contracts only participate in the movement of Index and not the actual purchase of stocks, bonds or mutual funds. They may have a cap (but not always) as to the maximum amount they will credit interest to and a minimum guarantee which keeps the principle of the contract from losing money in a down year. Typically each year the starting point is last year's ending point which means that: (1) The policy amount is locked in at the end of the year; and (2) the beginning value from which the movement measured is reset.

Interest Sensitive Whole Life — This type is fairly new, and is also known as either excess interest or current assumption whole life. The policies are a mixture of traditional whole life and universal life. 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 benefit remains constant for life.

Like universal life, the premium payment might vary, but not above the maximum premium guaranteed within the policy.

Variable Life — A form of whole life insurance, variable life insurance provides permanent protection to the beneficiary upon the death of the policyholder. This type of insurance is generally the most expensive type of cash-value insurance because it allows you to allocate a portion of the premium dollars to a separate account comprised of various instruments and investment funds within the insurance company's portfolio such stocks, bonds, funds, money market funds and bond funds. In addition, because of investment risks, variable policies are considered securities contracts and are regulated under the federal securities laws; therefore, they must be sold with a prospectus.

Variable Universal Life — VUL's allow the cash value to be directed to a number of separate accounts that operate like mutual funds and can be invested in stock or bond investments with greater risk and potential reward.

Distinguishing Characteristics Between Fixed and Variable Products

The major advantage to variable policies is that they allow you to participate in various types of investment options while not being taxed on the earnings (until you surrender the policy). You can also apply the interest earned on these investments toward the premiums, potentially lowering the amount you pay. The major disadvantage is that due to investment risks, when the invested funds perform poorly, less money is available to pay the premiums, meaning that you may have to pay more than you can afford to keep the policy in force. Poor fund performance also means that the cash and/or death benefit may decline, though never below a defined level.

FIXED INDEXED LIFE INSURANCE VERSUS FIXED INDEXED ANNUITIES

The dynamics of the market since the late 90's resulted in a new approach to permanent life insurance. Consumers like the higher return potential of linking cash value growth to a market index like the S&P 500. Additionally, some of them didn't like the possibility of losing cash value during market downturns or negative returns of an index. To meet these needs, insurance companies developed indexed universal life or FIUL.

FIUL can be thought of as an individual flexible premium adjustable life insurance policy, sometimes referred to as universal life with an indexed feature. This life insurance provides for an adjustable death benefit and flexible premium payments.

FIUL shares the coverage and premium flexibility of other universal life policies, but the crediting of interest is unique. Typically, cash value increases are linked to positive changes in an index and, in this feature, they are similar to indexed annuities. If the index is higher at the end of the policy year, the interest credited to the cash value will reflect this. So, if the calculated index is higher at the end of the year, the cash value will participate in a percentage of this increase.

What if the index goes down? If the index stays flat or declines, the cash value is still credited with a minimum guaranteed interest rate! This is the attraction of EIUL. When the index goes up, the policyowner shares in the increase; but if the index goes down, the policy still earns at least a minimum interest rate.

The Net Cash Value is based upon a number of factors, including premium payments, monthly charges, surrender charges, partial withdrawals, loans, and interest credited to the policy.

The guaranteed interest rate is the guaranteed minimum amount of interest that will be applied to the contract value. Many are at two percent today. For each indexed strategy, the minimum interest rate is applied if the index returns less than the minimum rate. For example if the minimum guaranteed interest rate is two percent and the index interest calculation is negative or 1.4 percent, then the two percent is applied. The minimum interest rate is guaranteed on the earlier of policy termination or end of indexed strategy term. The charges are guaranteed not to exceed the maximums listed in the life insurance contract.

Now, it should be noted that the cash value will probably not reflect all of the increase in the index nor are dividends or capital gains included in the index calculation.

Protecting the cash value from market loss and guaranteeing a minimum return costs money. Even so, FIUL offers many features:

- Tax-deferral of interest earnings;
- Tax-advantaged insurance protection;
- Indexed linked return;
- Cash value protection against market declines;
- Guaranteed minimum annual returns & annual lock-in of earnings;
- Premium flexibility & cash value access.

The indexed products are an attempt to fill the gap between these two sides of the spectrum. These products are still universal life insurance policies as they have an interest crediting rate, and you don't own shares in any kind of fund. But they do offer some of the appeal of a variable policy in that the crediting rate is impacted by the performance of the index. They also offer guaranteed minimum rates similar (but almost always lower) than traditional universal life policies to keep you from losing money—something that is always a possibility in a variable policy. But are these new products the best of both worlds? Let's take a look at both sides of the coin.

THE PROS AND CONS

One advantage of an indexed product is the potential for higher interest crediting rates than a traditional universal product. Another advantage is that it offers greater protection from market downturns than a variable product.

These products can offer some peace of mind to buyers looking for a mix of guarantees and some potential for cash accumulation.

However, there can be disadvantages of having an indexed product. The chief disadvantage of an indexed product is that it comes equipped with slightly higher risk than a traditional universal product. Also, the cap rate—the maximum rate you may earn—limits the upside potential compared to a variable product, and may be changed periodically by the insurance company. The crediting rate system in these products is probably not familiar to would-be buyers and agents. Since the concept is new and there are so many "moving parts" to one of these products, it is sometimes difficult to figure out what the product actually does at first.

These products do fill a void between the traditional bookends of the modern insurance marketplace, but it would be an overstatement to term them the best of both worlds. They have neither the appealing guaranteed rates of universal life nor

the true market participation of variable life. However, they do offer an attractive third option for buyers and may be ideal for a segment of the population whose needs have been overlooked by existing insurance products.

INDEX STRATEGIES

Typical Indexed crediting strategies include:

- One year Point to Point;
- One Year Monthly Average using multiple Indices or a single index;
- One Year Monthly Average;
- One Year Monthly Cap; and
- A two-year point to point may be used by some products.

In addition, many products have a fixed interest for a specified period of time often one, two and five years. A specific product may use one, two or all of these strategies. Policyowners with a multiple crediting strategy product may also use one, two or any number of the strategies. Policyowners with a multiple crediting strategy product may also use one, two or any number of the strategies.

TERMINOLOGY

Death Benefit — The death benefit is stated at on the policy at issue. The actual amount payable at death may be decreased by loans or withdrawals, or increased by additional insurance benefits.

Account Value — The sum of the value of the Basic Interest Strategy, the value of all Fixed Term Strategies, the value of all Indexed Strategies, and the outstanding balance of any Annually Declared (fixed) policy loans.

Cash Value — The Account Value less any withdrawals and any surrender charges that apply.

Surrender Charges — Surrender charges are charged against the account value and are charged for a period of time specified in the contract. It is not unusual to have a surrender charge period of 14-15 years.

Penalty Free Withdrawal — Each policy year, an amount up to a specified percentage of the cash value as of the date of the withdrawal, less any prior penalty free withdrawals taken in that policy year will be available without incurring a

surrender charge. However, the withdrawal fee will still apply. Typically, if less than the specified percentage is withdrawn in any policy year, the remaining amount does not roll over to future policy years.

Many aspects of a life insurance contract will be guaranteed including minimum interest rate and maximum charges. However, other aspects of the policy cannot be predicted and are not guaranteed. For example, the interest rate credited may exceed the guaranteed rate and monthly charges may be less than the maximum guaranteed charges.

The non-guaranteed elements can improve the value of the life insurance by increasing the contract's cash value and/or death benefit. Variations in these factors could affect: Death benefits, net cash value, or cash flow taken from the policy. The non-guaranteed pages in a policy or illustration provide snapshots of the contract values assuming higher interest and lower charges than those that are guaranteed. Since these elements cannot be predicted, ranges of results are shown in the illustration. The actual policy values will be less or more favorable than these illustrated results. The illustration also assumes all premium outlays are paid as shown. Unless otherwise stated, all values shown are determined as of the end of the contract year. All values are based on the actual model premium payment selected. The insurance company bases the non-guaranteed benefits and values on assumptions that are subject to change.

Indices — FIUL products use many of the same indices as FIAs — Dow Jones Industrial Average, Standard & Poor's, NASDAQ are the most common.

MECHANICS — HOW INTEREST IS CREDITED

Let's say that we have an accumulated value of $10,000 and a minimum interest rate of 2%. We'll further assume that we receive 50% of the calculated index gain for the year. At the end of the year the calculated index gain is 20%. The accumulated value would earn 10% for the year (20% x 50%) or $1,000. So, our accumulated value would now be worth $11,000 ($10,000 plus $1,000). But what if the market dropped 10% the following year? The locked-in value of $11,000 would be unaffected by the market decline and would earn 2% or $220 ($11,000 time 2%) leaving an accumulated value of $11,220. FIUL products may use one or a combination of the following methods to determine amounts credited to the cash value.

- **Participation Rate** — A percentage of the increase in the index that will be used to determine the amount to be credited to the cash value.

- **Spreads or Asset Fees** — A stated percentage that is deducted from positive increases in the index.
- **Caps** — A maximum annual increase to be credited to the cash value.

Because this is a universal life product with indexing strategies, periodic or flexible premiums are allowed as they are with traditional universal life products. Most policies state that the payment of the minimum monthly premium listed below, at the beginning of each policy month (or sooner), assures that the death benefit coverage is guaranteed for the specified period. In addition, some products allow for a single premium to be made and will calculate (or back into) the death benefit based on the single premium amount. Obviously changes in the non-guaranteed elements of the policy may affect the death benefit positively or negatively.

TERMINOLOGY ASSOCIATED WITH MULTIPLE SEGMENTS OR BUCKETS

Typical Indexed crediting strategies include One Year Point to Point, One Year Monthly Average using multiple Indices or a single index, One Year Monthly Average and One Year Monthly Cap. Also some products may use a two-year point to point. In addition, many products have a fixed interest for a specified period of time often one, two and five years. A specific product may use one, two or all of these strategies. Policyowners with a multiple crediting strategy product may also use one, two or any number of the strategies.

TIMING OF PREMIUM ALLOCATION TO INDEXED STRATEGIES

Each time a portion of the account value is directed to an indexed strategy, a new segment (bucket) is created. Each segment or bucket has its own Participation Rate and Cap. Participation rate and caps function much like they do in fixed indexed annuities.

- **Index Growth** — The percentage increase in the index from one interest crediting date to the next interest crediting date. The starting point is reset each time the growth is measured.
- **Participation Rate** — The percentage of the index growth the owner is eligible to earn. The participation rate is guaranteed to be no less than a specified percentage for the life of the contract.
- **Cap** — A limit on the index growth that can be credited to a segment. This cap may be reset for each segment, subject to certain minimums stated in the contract.

Most contracts require that premiums be allocated between interest strategies based on a term stated in the contract and the type of strategy. Most will likely be 12 months but may be as long as 24 months if the reset period is a two-year point to point.

The values and interest credited for each segment are calculated independently of other segments. For each segment created, no interest credits are credited between interest crediting dates. Interest credits are not credited if the policy terminates prior to the interest crediting date. Likewise, if amounts are withdrawn from a segment between interest crediting dates, no interest credits are credited on the withdrawn funds.

LIFE INSURANCE POLICY CHARGES

- Premium load
- Cost of insurance charges
- Expense charges
- Alternative approaches to handling monthly deductions

PREMIUM LOAD

The premium load is also called a "front-end load," – meaning the percentage of premium deducted from each premium payment to help cover expenses. Some policies provide for a "no load" feature.

COST OF INSURANCE CHARGE

The amount a policyowner pays to an insurer, minus what he or she gets back from the insurer. This expression is used when determining the true cost of permanent forms of Life Insurance to a policyowner. It considers the fact that premiums are paid in but also that an actual cash value is being built up, which is the portion that the insured will get back from the insurance. Another term to describe the charge for the pure insurance protection element of a life insurance contract. It is also known as the Mortality Charge.

EXPENSE CHARGES

Additional administrative charges are charged monthly and defined in the illustration with a guaranteed maximum change and taken from the cash value.

The Guaranteed Net Cash Value

This is the lowest amount available to the contract owner upon surrender of the policy and is contingent upon premium payments, timing, and other changes available in the contract. This value is based upon a guaranteed interest rate of two percent and maximum policy charges. Beginning at the end of the 10th year and continuing in all subsequent years, an additional 0.70 percent (0.70%) of the average month-end account values (net of any fixed interest loans) for that year is guaranteed to be credited to the policy. The guaranteed net death benefit is the amount available to the contract owner upon the death of the insured.

Death Benefit

The death benefit is stated at on the policy at issue. The actual amount payable at death may be decreased by loans or withdrawals, or increased by additional insurance benefits.

Account Value

The account value is the sum of the value of the Basic Interest Strategy, the value of all Fixed Term Strategies, the value of all Indexed Strategies, and the outstanding balance of any Annually Declared (fixed) policy loans.

Cash Value

The cash value is the account value less any withdrawals and any surrender charges that apply. Surrender charges are charged against the account value and are charged for a period of time specified in the contract. It is not unusual to have a surrender charge period of 14-15 years.

Penalty Free Withdrawal

Each policy year, an amount up to a specified percentage of the cash value as of the date of the withdrawal, less any prior penalty free withdrawals taken in that policy year will be available without incurring a surrender charge. However, the withdrawal fee will still apply. Typically, if less than the specified percentage is withdrawn in any policy year, the remaining amount does not roll over to future policy years.

Guarantees

Many aspects of a life insurance contract will be guaranteed including minimum interest rate and maximum charges. However, other aspects of the policy cannot

be predicted and are not guaranteed. For example, the interest rate credited may exceed the guaranteed rate and monthly charges may be less than the maximum guaranteed charges.

The non-guaranteed elements can improve the value of the life insurance by increasing the contract's cash value and/or death benefit. Variations in these factors could affect: Death benefits, net cash value, or cash flow taken from the policy. The non-guaranteed pages provide snapshots of the contract values assuming higher interest and lower charges than those that are guaranteed. Since these elements cannot be predicted, ranges of results are shown in the illustration. The actual policy values will be less or more favorable than these illustrated results. The illustration also assumes all premium outlays are paid as shown. Unless otherwise stated, all values shown are determined as of the end of the contract year. All values are based on the actual Modal Premium Payment selected. The insurance company bases the non-guaranteed benefits and values on assumptions that are subject to change.

Again – The cash surrender value is the account value less any applicable surrender charges.

TAX TREATMENT — SURRENDERS/WITHDRAWALS

Upon a cash surrender, it must be determined if the amount received exceeds the net premiums paid. *Net premiums paid* means the gross premium less any dividends received and outstanding loans. The difference is reportable as ordinary taxable income in the year it is received. If a withdrawal is made that is less than the net premium (i.e., a partial surrender or free withdrawal), there is no tax due on the amount.

Exceptions with **Modified Endowment Contracts**: The MEC came into being with the 1988 amendment to the tax code (TAMRA, IRC Sec. 72 and Sec. 7702A). People were putting large sums of money into policies to accumulate funds on a tax-deferred basis. TAMRA provided that if a policy was over-funded (whether at issue or at a later date), it would be classified as a MEC, and any distribution representing a gain from the policy would be taxed.

The seven-pay test establishes limits to the amount of premiums that can be paid within a seven-year period. “Material changes” that occur to an in-force policy can cause a policy to be retested as if the changes existed since the beginning of the policy.

If a policy is or becomes a MEC, distributions will be taxed on a last-in first-out, or LIFO, basis to the extent of gain, subject to a 10 percent penalty, unless the distribution is made after age 59½, or if death, disability or annuitization occurs. Distributions include policy loans, cash dividends, withdrawals and surrenders.

If a policy becomes a MEC, it is “tainted” for as long as it exists and carries over to any policy that is issued in exchange for a MEC. A Sec. 1035 exchange (see below) is a material change for MEC purposes and is retested. Cash values that are transferred from the existing policy will not count as premium. If the policy fails the material change test, it will be classified as a MEC. Transfer Provisions Sec. 1035 policy exchanges: When a policyowner exchanges an existing life insurance policy in accordance with IRC Sec. 1035, no gain is attributed on the exchange. The adjusted basis of the old policy is carried over to the new one. Only the newly added premium will be measured for MEC status. A Sec. 1035 exchange is allowed only when transferring cash values from an annuity to an annuity, life insurance to life insurance, or life insurance to an annuity contract.

The actual amount payable at death may be decreased by loans or withdrawals, or increased by additional insurance benefits. The insurance contract will specify how to determine the benefit.

TAX CONSEQUENCES OF LOANS AND WITHDRAWALS

Also, if withdrawals are taken between interest crediting dates the amount of the withdrawal will not be available for interest calculation. The tax treatment of withdrawals for FIULs is no different the any other life insurance product.

Fixed rate loans are loans that are charged a specified rate as long as the loan is outstanding. Variable rate loans change the rate on the loan charge at specified intervals and based on some tangible measurement. Often the Treasury Bill plus or minus a percentage is used.

Policy loans are normally not taxable. If a policy is surrendered with a loan outstanding, and if that loan, with other cash value, is greater than the cost basis, there is a taxable gain. Loans like withdrawals may reduce the death benefit and the loan amount is not eligible for interest crediting if taken prior to the interest crediting date.

Riders

Accelerated or Terminal Illness Benefit Rider

There may be an administrative fee charged for exercising this benefit in some policies. This benefit allows insureds that are diagnosed with a terminal illness to receive up to one half of their policy face amount (usually up to a stated maximum and often $250,000).

Waiver of Surrender Charges

Upon confinement this rider allows an annual withdrawal from the cash values without incurring a surrender charge if the base insured is confined to a hospital or inpatient nursing facility for at least 30 consecutive days. Confinement may have to occur after a specified time, often the first contract year. Exercising this option may result in a withdrawal fee.

Other Riders

Other riders can be a life protection rider that prevents a contract from lapsing due to loan indebtedness when certain conditions are met by automatically converting it to a paid up coverage. Conditions include a minimum attained age, minimum percent of indebtedness, and minimum number of years the contract must be in force. There is often a fee for exercising the rider benefit. Most of the riders available for traditional universal life contracts like term insurance, waiver of premium, accidental death are often available as well on FIUL policies.

Illustrations

The agent’s responsibilities can be outlined as follows.

Understanding that 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 of this regulation are to ensure that illustrations do not mislead purchasers of life insurance and to make illustrations more understandable. 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. According to the NAIC Illustration Regulation applies to all group and individual life insurance policies and certificates except:

- Variable life insurance;
- Individual and group annuity contracts;
- Credit life insurance; or
- Life insurance policies with no illustrated death benefits on any individual exceeding $10,000.

When using an illustration in the sale of a life insurance policy, an insurer or its producers or other **authorized representatives shall not**:

- Represent the policy as anything other than a life insurance policy;
- Use or describe non-guaranteed elements in a manner that is misleading or has the capacity or tendency to mislead;
- State or imply that the payment or amount of non-guaranteed elements is guaranteed;
- Use an illustration that does not comply with the requirements of this regulation;
- Use an illustration that at any policy duration depicts policy performance more favorable to the policyowner than that produced by the illustrated scale of the insurer whose policy is being illustrated;
- Provide an applicant with an incomplete illustration;
- 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;
- 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;
- Except for policies that can never develop nonforfeiture values, use an illustration that is "lapse-supported;" or
- Use an illustration that is not "self-supporting."

For illustrative purposes, a weighted average assumed rate for all fixed term and index strategies available. The weighted average assumed rate is determined for each year illustrated. The weighted average used to determine each year's assumed rate is based on the premium direction selected for the rest of the strategies. The

weighted average assumed rate for this illustration is shown for each year of the illustration.

Historical performance of any Index should not be considered a representation of past or future performance of any indexed strategy under this life insurance policy. Future performance of an indexed strategy under this life insurance policy may be greater or less than the yields shown in an illustration. The illustration will show the guaranteed cash value and death benefit, the non-guaranteed mid point and the non-guaranteed assumed.

Guaranteed is the guaranteed amount available to the contract owner upon surrender/death. The stated percentage typically between two percent and three percent (2%-3%) is shown in the illustration for the non-indexed interest crediting strategies. There is also a minimum interest rate guaranteed for each indexed strategy available and again is typically between two percent and three percent and is guaranteed for the earlier of policy termination or end of Indexed Strategy Term.

Non-Guaranteed Midpoint shows hypothetical value/death benefit based on non-guaranteed elements approximately midway between the guaranteed values and the current values.

Non-Guaranteed Assumed shows the value/death benefit is not guaranteed and is subject to change. The weighted average assumed rate is determined for each year illustrated. The weighted average used to determine each year's assumed rate is based on the premium direction selected for the rest of the strategies.

ANNUAL REPORT — NOTICE TO POLICYOWNERS

The NAIC Illustration Regulation requires that the insurer shall provide each policyowner with an annual report on the status of the policy that shall contain at least the following information: (1) 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

(g) 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 could 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

(h) For flexible premium policies: If, assuming guaranteed interest, mortality and expense loads, the policy's net cash surrender value will not maintain insurance in force until the end of the next reporting period unless further premium payments are made, a notice to this effect shall be included in the report.

All insurance plans require supervision and review as your clients needs may change, the non-guarantee elements may have different outcomes than first illustrated, or both. You should review the cash value accumulation to date and projections based on the guaranteed and non-guaranteed elements of the contract, expense charges, mortality charges to see if they are still in line with your original proposal. This is also a good time to review any riders and consider any new ones that might be important to your client at this later date. You should be sure to have a policy review at least annually with your client and when there are significant life changes such as divorce, death, new job, new child, inheritance, etc. Obtaining an in force illustration from the home office a close to your meeting as possible will help you analyze the insurance plan with the most up-to-date information, illustrative values and death benefit projections. With Indexed UL policies annual statements are released after the indexed interest is credited on the anniversary of the index crediting strategy, usually annually but may be every two years with certain index strategies. You should review all non-guaranteed performance and expenses as well as the guaranteed and assess whether the policy continues to meet the objectives that were outlined at the time of purchase. You may consider changing the premium structure, the death benefit or both if your client's needs have changed.

The death benefit is assumed at issue is shown above. The actual amount payable at death may be decreased by loans or withdrawals, or increased by additional insurance benefits. The insurance contract will specify how to determine the benefit.

Explain the liquidity features in the policy such as loans and withdrawals, their cost and tax implications. Also discuss the impact of partial surrenders on the death benefit and cash value as well as keeping the policy in force.

The purpose of this regulation is to set forth minimum standards and procedures for insurers and insurance producers who make recommendations to insurance consumers—initially for those aged sixty-five (65) years or older but has since been expanded to include all ages—on transactions involving annuity products so that the insurance needs and financial objectives of consumers are appropriately addressed and product recommendation meets the insurance needs and financial objectives of the consumer.

SUITABILITY AND MARKETING PRACTICES — NAIC SUITABILITY IN TRANSACTIONS MODEL ACT

Recommendation Standards

(1) Prior to recommending a transaction involving an annuity to a consumer, an insurer and an insurance producer shall make every effort to obtain relevant information from the senior consumer.

(2) An insurer and an insurance producer shall make recommendations only of transactions that are appropriate to assist the senior consumer to meet the particular senior consumer's insurance needs and financial objectives.

(3) An insurer and an insurance producer shall not make a recommendation unless the insurer and the insurance producer comply with the standards, guidelines, procedures and data collection processes established by the insurer under Subsection B(2)(a) to (c) of this section.

Important Information

(1) Occupation and occupational status;
(2) Marital status;
(3) Age;
(4) Number and type of dependents;
(5) Sources of income;
(6) Yearly income;
(7) The consumer's existing insurance;
(8) The consumer's insurance needs and objectives;
(9) The cost to the consumer and the consumer's ability to pay for the proposed transaction or transactions;

(10) Source of funds to pay premiums;
(11) Investment savings;
(12) Liquid net worth;
(13) Tax status;

Additional information and discussion:

- Risk tolerance
- Use of benefit – income or wealth transfer
- Time horizon for the benefit need to help you determine the surrender period appropriate
- Other benefit sources – Social Security, Retirement plans, Other Assets
- Health
- Liquidity of product solution
- Required Minimum distributions
- Free Withdrawals
- Withdrawal in excess of free amount
- Full surrender – penalties and impact on premiums
- Review tax ramifications of liquidity decisions

CONTRACT DISCLOSURE

Discuss the need for full contract disclosure is to ensure that consumers are protected from unsuitable sales and to and foster consumer education. Full disclosure ensures that consumers are not mislead into the purchase and to make sure they fully understand the product and how it can be expected to perform, how to access features, as well as the consequences of surrender, stopping premium payments or withdrawing money.

RECORDKEEPING

It is important to maintain records of the relevant information and the recommendations that were the basis for insurance transactions for a minimum number of years. This is useful not to ensure the suitability of the sale at a later date but for review with the client annual to update the information, goals, objectives as they change or are modified by the client. It is highly recommended that the producer keep the records until the end of the contract whether at death or surrender.

In practical terms, when planning for the senior, you are often working for the entire family. The plan that is created may have implications that carry on for generations. The classic ethical issue when planning for seniors is "who is the client?" In an ideal case, everyone is "on the same page" and agrees what should be done. In the real world, it is far more likely that there will be disagreements and hard choices will need to be made. For example, sometimes, older-generation member realizes greater tax benefits from a lifetime gift but the potential donee prefers an inheritance. There can be many interests and many options involved in creating a plan. The financial plan must make clear who is the client and owner and who's interests must be protected in case of a conflict. When members of a family have seriously conflicting interests it is wise to recommend separate individuals to represent each of the separate interests. The health, psychology, education, and intelligence of the client must all be measured and considered with working with the client.

Marketers and producers should, through the IMOs and insurers, inquire into the state insurance and securities regulations to ensure that you have the licenses appropriate for the business. Insurance agents, producers, financial planners and investment advisors should seek the licensing and education that is required based upon their sales and related activities. Agents should regularly inquire of state and federal authorities as to the obligations of any new licensing or registration being sought. If after review, an agent chooses not to hold any licenses outside their insurance licenses, NAFA, through the NAFA member carriers and marketing companies, offers some general guidelines to help safeguard the practice and the customer.

Advise clients (and document that advice) about using insurance products for money that requires **safety, guarantees, and limited liquidity**.

Meet the clients' needs by diversifying funds into multiple products from a variety of carriers. Present clearly and document completely the **insurance benefits and features** in addition to the **safety** and guarantees of fixed annuity products. Recommend and provide advice only on those products that meet the client's needs and for which you are **appropriately licensed**.

Limit the sales activities to those that you are appropriately licensed to do.

In addition to supporting these state and federal educational requirements for licensing and license renewals, NAFA believes that any program that qualifies an individual to give financial and retirement planning advice must contain the following.

(1) A published Code of Ethics and Professional Duties or Responsibilities that provide standards defining conduct to which the designee must adhere in

his or her business practice plus rules which relate to each standard detailing the specific application and behavior pertinent to each standard.

(2) An established Board of Standards, Market Conduct, or Compliance that reviews and resolves complaints lodged against a designee or certified individual for alleged violations of the group's code.

(3) Posting of individuals on whom disciplinary action or revocation has been taken that is easily accessible and available to the general public.

(4) Ongoing and robust re-certification requirements of education annually or, at a minimum, every two years. Education curriculum should not only include specific training in all aspects of the designee's practice, but it must also include re-certification of the knowledge and understanding of the Code of Ethics and Standards or Duties.

(5) The designation or certification company must publicly endorse, support, and assist state and federal insurance and securities regulators to ensure that all designees follow the applicable state insurance laws or securities regulations and conduct themselves in accordance with the Standards.

(6) Written and enforced standards and rules regarding the use of designation and certification labels, marks, insignias, and logos which prohibit the holder from:

(7) Referencing nonexistent or self-conferred degrees or designations or referencing legitimate degrees or designations in a misleading manner.

(8) Performing or offering to perform professional services that are outside the scope of the designee's professional practice, license, or education

(9) Implying in advertising or other communication an ability to legitimately perform professional services which are outside the scope of the designee's professional practice, license, or education

(10) Implying endorsement of a company, product, or plan or suggesting competence or training

The following practice standards should be used consistently and completely:

- Establishing and defining the relationship with the client;
- Gathering all the client information and needs that are necessary to ensure that their financial goals and objectives are met and that the product recommendation is suitable to meet those objectives and goals;
- Analyzing and evaluating the client's financial status;
- Developing and presenting the recommendation's in compliance with state marketing, illustration, and sales laws;

- Implementing the recommendation(s) and completing all of the forms and paperwork required by state insurance laws and to document the information gathered, relevant discussions and decision making that led to the final product(s) selection;
- Monitoring, reviewing and servicing the client and the product at least annually and updating or changing depending on the client's current financial and insurance situation.

CHAPTER 4 REVIEW QUESTIONS

Which of the following answers each sentence the best?

(Answers are in the back of the text.)

1. The ______________ is the percentage of increase in the index that will be used to determine the amount to be credited to the cash value.

   a) Participation Rate
   b) Spread
   c) Asset Fee
   d) Cap

2. The ______________ is a stated percentage that is deducted from positive increases in the index.

   a) Participation Rate
   b) Spread or Asset Fee
   c) Cap
   d) Indice

3. The ______________ is the maximum annual increase to be credited to the cash value.

   a) Participation Rate
   b) Spread
   c) Asset Fee
   d) Cap

4. When it comes to life insurance policy charges, the ____________ is commonly referred to as the “front-end load.”

   a) Cost of Insurance
   b) Expense Charge
   c) Premium Load
   d) Net Cash Value

5. What is the purpose of the seven-pay test?

   a) It establishes limits to the amount of premiums that can be paid within a seven-year period.
   b) It means the contract must be fully funded within seven years.
   c) It means taxes are only paid on the first seven years of the contract.
   d) It means the contract may not be surrendered for at least seven years.

CHAPTER 5

SPECIAL ISSUES FOR SENIOR CONSUMERS

Seniors need many of the same services and products that everyone else does. According to Senior Marketing Magazine, seniors do more and better research than most. They tend to be more careful about whom they do business with, and they want to know more about the individual with whom they are doing business.

Also, according to the Boomer Project founder, John Martin, tomorrow's seniors will be a more varied group than any other age group of people. This niche covers all races, socio-economic channels, political and religious persuasions, and of course genders.

Also, because of age, health plays a larger role in the buying process. Eyesight, hearing and engagement in discussion are first line indicators of the individual's competency to understanding the insurance advantages and disadvantages. Also, other health issues should be considered because of what they can do to the senior's outlook, emotional state and financial considerations. Adult children and grandchildren of seniors are also important considerations in the decision making process and should be address with the senior customer early on. Because seniors are more than likely not to have a full time job, income you can't outlive is a larger consideration. However, asset liquidity for income is equally of concern. Balancing these two income needs is critical for their retirement security.

Diversity and complexity of financial products can benefit the public. Unfortunately, however, diversity and flexibility can also lend themselves to abusive sales practices including fraud. All financial products are vulnerable to the contemptible tactics of the unscrupulous. The United States Securities and Exchange Commission—SEC for short—held its first Senior Summit on how regulators and others can better coordinate efforts to protect older Americans on July 17, 2006. The SEC announced that the purpose of the Seniors Summit was "to examine investment fraud and abusive sales practices." (www.sec.gov/news/press/2006/2006-109.htm.)

The Seniors Summit released a new NASD Investor Education Foundation Fraud Study (http://www.nasd.com). Some of the study's key findings are the opposite of what one would expect. The study finds that "…investment fraud victims are more financially literate than non-victims." The study also finds that fraud victims,

compared to the general population, are more educated, have high levels of income, and are more often married. The study further finds that fraud victims, compared to non-victims, are more optimistic, tend to have a personality that is more self-reliant and self-deterministic, and are more likely to rely on their own experience and knowledge to make financial decisions. The study concludes—contrary to common perception—that “traditional financial literacy education alone will not inoculate investors from being defrauded.”

The study demonstrates an important need to rethink how we can teach investors to protect themselves against abusive sales practices and fraud. The study makes clear that factors other than the diversity and complexity of financial products contribute significantly to investment fraud. So, it’s not enough simply to educate the public as to the characteristics and operation of financial products. Education must also address what the study calls the “psychological profile” of investors – the demographic and personality indicators.

This, however, is easier said than done. As the study recognizes, attempts to understand these psychological factors are still “early,” and “social workers, researchers and law enforcement personnel” must do further work in order for us to have a fuller picture.

SUMMARY AND THE FUTURE

Indexed insurance products are increasingly popular with the public. As with all cash value insurance products, fixed indexed insurance products offer a combination of insurance and investment features.

Fixed indexed insurance products are a natural evolution of the traditional fixed insurance product, which offers one method of crediting interest. Fixed indexed insurance products are nothing more than a traditional fixed insurance product that offers owners an opportunity, often on an optional basis, to receive interest based on positive changes in a financial markets index coupled with insurance guarantees of purchase payments and minimum rates of interest. In other words, fixed indexed insurance products offer guaranteed preservation of purchase payments coupled with guaranteed growth in value, even when indexed-based interest is small or non-existent.

Since indexed products are relatively young, new features will be added and products enhanced and/or changed. More crediting strategies will likely evolve and more indices will be used. One of the newer products is the **deferred income annuity** (DIA) — a single premium deferred annuity that is available for nonqualified, IRA, and Roth IRA plans. Deferred income annuities offer a guaranteed lifetime income benefit, providing a lifetime annual income while maintaining access to the money. The following provides examples of the features a DIA might include.

- **GUARANTEED LIFETIME INCOME BENEFIT**
  - Activate at any time after age 59½ (and after the first contract year).
  - Provides a guaranteed annual income you can systematically withdraw for as long as you live, even if the Contract Value falls to zero.
  - Contract Value continues to receive positive indexed interest gains even after electing to begin the Guaranteed Lifetime Income Benefit.
- **GUARANTEED LIFETIME INCOME ACCOUNT VALUE**
  - Includes a 10% bonus applied to the initial premium received.
  - Guaranteed to be at least 110% of the premium, less prior withdrawals, accumulated at five percent interest on the date the benefit is exercised.
  - Opportunity to receive annual indexed interest gains based on change in the S&P 500 Index®.

- 100% participation with no annual caps and no annual fees, all guaranteed for ten years.

- **GUARANTEED LIFETIME ANNUAL INCOME**
  - Equal to five percent of the Guaranteed Lifetime Income Account Value on the day you activate the benefit.
  - Should the Contract Value exceed the value of the Guaranteed Lifetime Income Account, a 10% Step Up Benefit will provide at least 10% additional guaranteed income for life.

- **EXPANSION OF INDEX CREDITING**
  - Indexing interest crediting is now being used on immediate annuities with choice of index, crediting strategies and fixed account guarantees.

CHAPTER 5 REVIEW QUESTIONS

Which of the following answers each sentence the best?

(Answers are in the back of the text.)

1. It has been determined that financial literacy education will inoculate investors from being defrauded.

   a) TRUE
   b) FALSE

2. ________________ are first line indicators of an individual's competency to understand the insurance advantages and disadvantages.

   a) Eyesight
   b) Hearing
   c) Engagement in discussion
   d) All of the above.

ANSWERS TO CHAPTER REVIEW QUESTIONS

Following are the correct answers to the chapter review questions – listed by chapter, question number, the correct answer, and the section where the answers can be found within the course material.

CHAPTER 1

Question #	Correct Answer	Reference
1	c	Definition and Types of Annuities
2	a	Definition and Types of Annuities
3	b	Definition and Types of Annuities
4	d	Definition and Types of Annuities

CHAPTER 2

Question #	Correct Answer	Reference
1	d	Renewal Rates
2	b	Minimum Guaranteed Rates
3	a	Unemployment Waiver
4	b	Contract Administration Charges and Fees
5	a	Indexed Value Percentage Change
6	b	Indexed Value Percentage Change

CHAPTER 3

Question #	Correct Answer	Reference
1	d	Advantages and Disadvantages of Annuities
2	a	Life Annuity with Period Certain
3	c	Life Annuity Without Refund

CHAPTER 4

Question #	Correct Answer	Reference
1	a	Mechanics – How Interest is Credited
2	b	Mechanics – How Interest is Credited
3	d	Mechanics – How Interest is Credited
4	c	Premium Load
5	a	

CHAPTER 5

Question #	Correct Answer	Reference
1	b	Special Issues for Senior Consumers
2	d	Special Issues for Senior Consumers