INSURANCE 101 | U.S.

The Nuts and Bolts of Fixed Indexed Annuities

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Fixed indexed annuities (FIAs) are used by financial advisors and insurance agents for income planning or to provide clients with market-based returns, while seeking to reduce risk by limiting potential losses. Much like traditional, declared-rate fixed annuities, FIAs offer a fixed rate of return, established by the insurance company, for any premium allocated to that option. However, FIAs also offer the policy owner the additional choice of a return tied to an underlying index. The owner can allocate funds to either of the return choices, or allocate some to both. As with all annuities, FIAs may allow unlimited funding, tax-deferred growth, the potential to create an income stream for life, and a death benefit that could avoid probate.

According to Cerulli and Associates' *Insurance 2012: Evaluating Growth Capacity, Flows and Product Trends*, clients request annuities more than any other unsolicited product. Within the FIA market, the S&P 500® is the leading index, offered in over 90% of all FIAs. The S&P MidCap 400®, the S&P GSCI, the Dow Jones Industrial Average®, and the Dow Jones U.S. Real Estate Index are also offered on many products. Since 2012, Risk Control, or volatility-targeting mechanisms applied to indices have become common for indexing choices within FIAs, with the S&P 500, the S&P 500 Low Volatility, the S&P 500 Dividend Aristocrats® and the Dow Jones U.S. Real Estate Index all being offered with a risk control framework.

The potential benefits of FIAs may include unlimited funding, tax-deferred growth, the potential to create an income stream for life, and a death benefit that could avoid probate.

Exhibit 1: Comparison of Annuities

Benefits	Declared-Rate Annuity	Fixed Indexed Annuity
Tax-Deferred Growth	✓	✓
Unlimited Funding	✓	✓
Income Stream For Life	✓	✓
Death Benefit Avoids Probate	✓	✓
Additional Optional Riders	✓	✓
Declared-Rate Account	✓	✓
Indexed-Linked Account		✓

Source: S&P Dow Jones Indices.

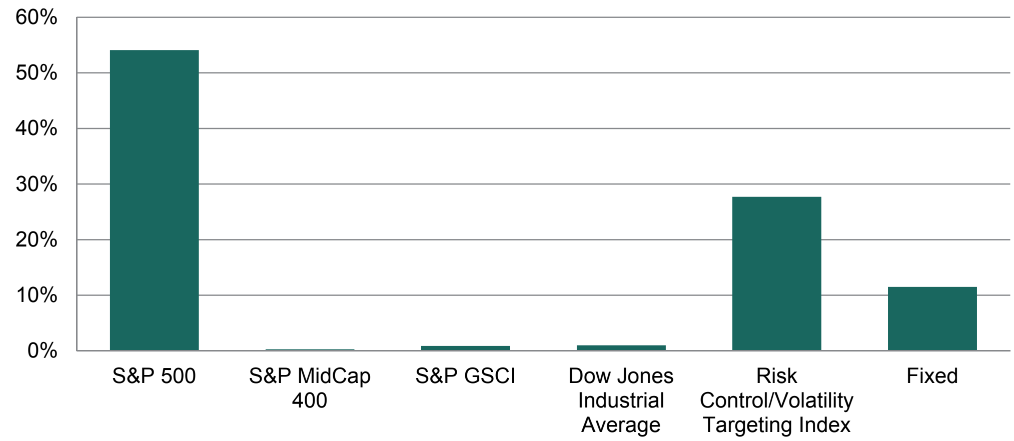
Breaking FIAs down into two primary components—accumulation and distribution—can provide a better understanding of how each part works in the whole.

The Accumulation Component

Like all traditional deferred annuities, FIAs are designed to accumulate funds over time. These funds can come as premium payments or through interest earned on the premiums paid into the policy. Most FIAs have single-premium policies, meaning they will only take one lump sum payment, but some offer flexible-premium policies, which will allow more than one payment into the policy. Once the funds are paid into the annuity account, the owner of the FIA has two basic options for earning interest within the account: a fixed rate of return based on a declared rate provided by the insurance carrier, or an index-linked rate of return based on the performance of an underlying index.

Typically, the client can place any percentage they choose in either account. Exhibit 2 shows how premiums are allocated, on average, to the indexed-linked account.

Exhibit 2: Industry-Wide Average Percentage of First-Year Premiums Allocated to Each Index



Source: Wink's Sales and Market Report. Data as of third quarter, 2014.

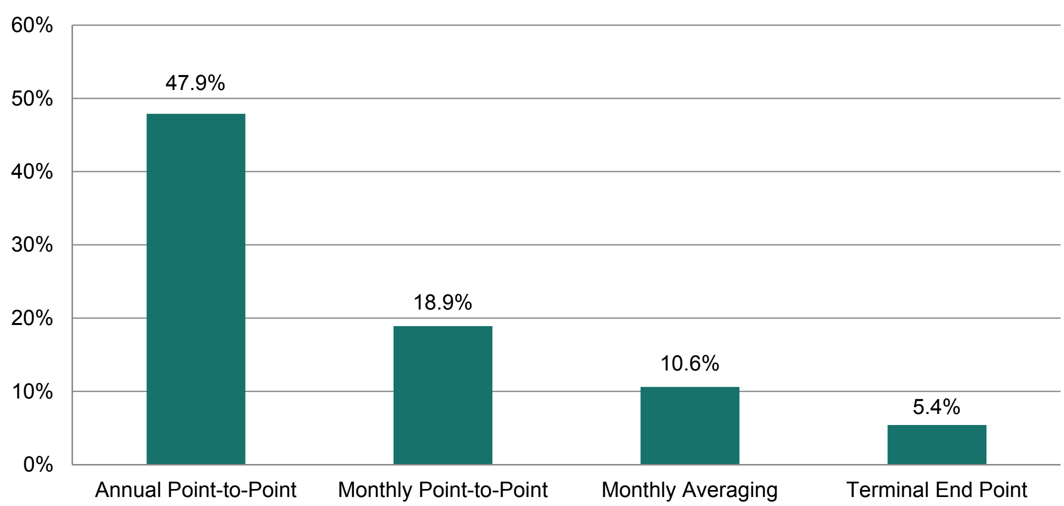
Getting Credit for Index Returns

FIAs have a minimum return of zero, which protects the owner of the product from ever having a negative return due to a negative year in the underlying index.

For the index-linked account, FIAs use a crediting method that measures the percent change in the underlying index over specified periods of time to determine the rate of return. The two most popular methods, annual and monthly point-to-point, measure the underlying index's percent change over those respective periods (see Exhibit 3). The percent of increase is subject to a cap, but because it is a fixed annuity, that account always has a minimum return of zero. This protects the owner of the product from ever having a return of less than zero due to a negative year in the underlying index.

The third most widely used method, monthly averaging, is the sum of the percent change of 12 consecutive beginning or ending index values (depending on the contract), divided by 12.

Exhibit 3: Percent of Premium Issued by Crediting Method



Source: Wink's Sales and Market Report. Data as of third quarter, 2014.

The Distribution Component

As with all annuity contracts, owners or beneficiaries have access to the accumulated funds. They can choose to receive the funds as a lump sum or over a period of time, including during the annuitant's lifetime. One of the major benefits of all annuity products is potentially creating an income stream that the beneficiary cannot outlive once the policy is annuitized. Annuitization occurs when the value within the policy is converted to an income stream.

Distribution Options

As with most traditional fixed deferred annuities, FIA contracts usually offer the following annuitization or distribution options.

- Certain Period: The annuity is paid out over a specified amount of time, such as five or ten years.
- Joint Life: The monthly payment is calculated on two lives and is paid until the last named annuitant dies.
- Joint Life with Certain Period: The monthly payment is calculated on the life of two annuitants, with a certain number of payments guaranteed.
- Life Only: The monthly payment is calculated only on the life of the annuitant. This option typically provides the highest payout, because the payments stop when the annuitant dies. The life-only option can be an effective hedge against an individual outliving their retirement income.
- Life with Certain Period: The monthly payment is calculated on the life of the annuitant with a number of the payments, such as 10 or 20 years, guaranteed regardless of the annuitant being alive for the entire period.
- Lump Sum: The accumulated value of the policy is paid out to the owner or beneficiary in one payment.

Safety of the principle is a major reason why FIAs have become popular with the pre-retiree and retiree markets over the past decade.

Penalties for Early Withdrawals

All annuities have a special tax-deferred treatment, so any distributions taken before the owner is 59 ½ years old may be subject to a 10% tax penalty.

Surrender Charges

Most annuity products are for long-term savings and because of this, insurance companies also base their investments on long-term investment horizons. To deter annuity owners from making withdrawals earlier than anticipated, insurance companies usually place surrender charges on the product contracts. These surrender charges can be severe and vary by company and product. Understanding surrender charges and how they apply to the FIA is critical before making a purchase.

Some Peace of Mind for Retirees

Safety of the principal is a major reason why FIAs have become popular with the pre-retiree and retiree markets over the past decade. FIAs offer purchasers a double layer of protection. The first layer is the financial strength and claims-paying ability provided by the insurance company. The second layer is that each state has a guarantee fund to provide protection if the insurance company becomes insolvent. The benefits of the state guarantee fund can vary dramatically, and each state's life and health insurance guarantee association is governed by state law, which determines the type and extent of coverage

Conclusion

Since their inception in 1995, retirees and pre-retirees have chosen FIAs as a viable, retirement savings option because of their potential for market-linked returns combined with zero minimum return features designed to limit potential losses. As more and more baby boomers move into position for retirement, this type of product is projected to continue as one of the fastest growing product types in the insurance industry.

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