

## A Brief History of Annuities

Annuities can be traced back to ancient Rome where contracts were known as “annual stipends” or, in Latin, annua. At that time, Roman soldiers would make a one-time payment in exchange for lifetime payments made once a year. These arrangements still exist today all over the globe and are now commonly called immediate or income annuities. These are one of many types of annuities, sold by insurance companies.

In America, after the Great Depression, the need to save for retirement became a focus of government and industry, and policies were established to allow workers to defer taking income from annuities and earn an interest rate during the deferral period. To encourage Americans to save, the income tax was also deferred. These are called deferred annuities both for the deferral of guaranteed payouts and the taxation.

### **An Indexed Annuity IS...**

1. A fixed annuity
2. An insurance product
3. A retirement savings vehicle

Indexed annuities and life insurance are like two sides of a coin. Life insurance protects you if you die too soon and an indexed annuity protects you if you live too long. Indexed annuities are used to save for retirement and for rainy day funds, fun money or a guaranteed lifetime paycheck. Annuities are an insured retirement solution.

## How Does Money Grow in an Indexed Annuity Contract?

Traditionally, insurance companies determined the amount of interest to credit an annuity based on the returns of the company's investment portfolio and its overhead expenses. Because annuities are insurance contracts with guaranteed and insured benefits, the company's investment portfolio is typically comprised of conservative investments such as corporate bonds and Treasuries. The indexed annuity was developed as an alternative to the traditional fixed annuity in the mid 1990s based on the concept that using an index

would allow the company to pay a bit more interest than in the non-indexed traditional annuity. The fixed indexed annuity incorporates all of the basic insurance elements of the traditional fixed annuity and simply adds the potential of additional, yet limited, interest based on the performance of an index, with the most common benchmark being a stock index. The annuity owner does not invest in the index, the company does. The annuity owner does not bear any market risk; the company does.

## Additional Benefits of Indexed Annuities

Indexed annuities offer many advantages to consumers looking to safely and reliably grow their retirement savings. Because the issuing insurance company protects indexed annuity owners against market downturns, indexed annuities offer safety. Because most often the interest crediting is based upon increases in a stock market index (however, some products credit interest when the index performance is negative), indexed annuities offer attractive interest crediting potential. Interest credited, and remaining in the annuity is granted the advantage of tax deferral under the income tax code. As a result, taxes are not payable on the annuity's value, until the owner withdraws money from the annuity. Annuity owners have the ability to take periodic or regularly scheduled withdrawals from their annuities. Annuity companies also provide options for annuity owners to turn their accumulated annuity values into a guaranteed lifetime stream of income, to supplement any similar streams of income the owner receives from Social Security or corporate pensions.

## Common Misconceptions about Indexed Annuities

- ▶ An Indexed Annuity is NOT an investment product. Unlike investments, the customer's indexed annuity value (premium paid plus interest earned, and premium bonus if applicable) will not go down when the stock market does. Because an indexed annuity is not an investment, it is not designed to perform like one. Indexed annuities are not intended to earn interest that is comparable to investments during the best bull markets. However, because an indexed annuity is insurance, and not an

investment, your annuity will not lose value when the market does.

- ▶ There is not one type of annuity - Many articles simply use the term “annuities” while the information in the article may be about variable, immediate, fixed indexed or non-indexed. This common practice is very confusing to the reader and does not help them understand their annuity choices. Although most public information on “annuities” refers to immediate annuities, deferred annuities account for a greater percentage of overall annuity sales.
- ▶ Indexed Annuities are NOT the same as or similar to Variable Annuities. An indexed annuity is a fixed annuity. Variable annuities were first introduced in 1952. Variable annuities are securities and they should be considered investments because they transfer market risk, along with the earnings and loss potential, directly to the annuity owner. Variable annuities experience both gains and losses, based on the performance of separate accounts inside of the annuity. The annuity owner chooses which, of the available accounts they wish to invest their monies in. Variable annuity owners typically have several types of accounts to choose from – such as accounts that own stocks, bonds, or other securities. In addition, variable annuity purchasers can often receive guarantees on death benefits, income, account values, and withdrawals, from the insurance company, in exchange for annual charges or fees
- ▶ Indexed Annuities are NOT immediate annuities. An immediate annuity begins payments almost at once, always within the first year, and there is no accumulation period or tax deferral benefit. Immediate annuities are most frequently the product of focus when people imagine that annuities result in the insurance company keeping their principal annuity payments, should they die the day after purchasing the annuity. It is important to understand that a “life only” immediate annuity payout is just one of several annuity payout options; the majority of which ensure that a specified amount of payments are distributed by the insurer. However, all indexed annuities available for sale today pay the full value of the annuity to the designated beneficiaries in the event of the annuitant’s death.

## How Indexed Annuities are Sold

Indexed annuities are insurance products, regulated by state insurance commissioners, and sold by licensed insurance agents (also called producers). Many times the insurance licensed agent is also licensed to sell securities, such as mutual funds or variable annuities. Consumers, who want to check on the licensing status of their agent or on any potential complaints against their agent, can contact their

state insurance department or visit [www.naic.org](http://www.naic.org) and select “States and Jurisdiction Map” then click on their state of residence.

When an insurance agent sells an indexed annuity to a consumer, 100% of the customer’s principal – which is also called the “premium” – is applied to the customer’s annuity. Agents are typically paid commissions by the issuing insurance company for the annuity sales they make; the commission is calculated based on the amount of premium paid. This agent compensation is a part of the company’s overall expenses and is built into the annuity’s benefits and limitations, similar to many other services and products that people routinely purchase (including other insurance products like life or homeowner’s insurance).

## How Insurance Agents are Paid

There are essentially three types of compensation structures in the financial services sector. The first type is paid to the agent at the time the annuity is sold, once the annuity premium has been paid. ***Fixed indexed annuities typically lower commissions for older aged purchasers, and often do not pay any commission at specified older ages. NAFA knows of no other financial product that reduces or eliminates the commission paid to the salesperson when sold to an older American.*** Since most annuities are purchased with a single premium, the agent is paid only one time; they are not paid again on that annuity. The insurance company pays the agent directly in this type of compensation structure. There is no need to pay continuous commission payments on an indexed annuity for the reasons discussed with the next type of compensation structure.

The second type of compensation is paid based on the assets under management. This type of compensation structure is used by most financial professionals who manage asset portfolios or sell securities investments, which can both increase and decline in value. In this structure, the financial professional is paid continually, often at a rate of 1% or more annually, on all of the assets that he or she manages for the client. This type of compensation arrangement provides incentive for the financial professional to manage the assets responsibly, and minimize any losses. The compensation paid to such financial professionals is paid directly from those assets. Because the financial professional is being paid to manage the assets, they are paid continually, regardless of the asset performance.

The third type of payment structure is often referred to as fee-based. A financial consultant charges a fee to review the customers’ financial objectives, design a plan to meet those objectives, and make recommendations on what products to purchase to achieve those objectives. When the plan is

executed, the customer may pay asset management fees, the insurance company might pay the agent for the sale of an annuity, or both payments may be made, depending on the plan and the products purchased.

## Limitations of Indexed Annuities

In order for insurance companies to create a financial product with all of the advantages of an indexed annuity, they need to have time. That is, they need a commitment from their customers that they will have use of the customer's money for a specified number of years. Annuities enforce this time commitment by imposing surrender charges, or penalties associated with excess early withdrawals.

Most indexed annuities will let you change your mind and will pay out all of the annuity's value (premium paid plus interest), without being subjected to surrender penalties, after three to five years; some as early as the second year. As a tradeoff however, the policyholder must take the annuity's value in a series of payments typically over a period of at least five years.

The most common surrender charge period on indexed annuities is 10 years, although there are indexed annuities with surrender charge durations ranging from four to 16 years. The longer periods are typically purchased by customers who want to leave the values in the annuity to their loved ones or to a charity. There are liquidity features in all indexed annuities, which give the purchaser access to the policy values. The most common liquidity option permits annuity purchasers to take withdrawals of a portion of their annuity's value during the surrender charge period, without being subjected to surrender penalties. Typically these withdrawals are at 10% of the annuity's value annually, after the first year. Most annuities also waive the surrender charges in the event of death, nursing home confinement, or diagnosis of terminal illness.

Some criticize that indexed annuities do not rise in value to the same level as the stock market index they use, when the market index is increasing. This criticism is misguided because one must take into account that when the index

is declining, the indexed annuity's values are not declining. Providing protection against unexpected declines in a market index is invaluable. This protection comes at a cost to the annuity owner in that the insurance company cannot provide credited interest on the full increase in the index. To summarize, the value proposition of an indexed annuity is that its interest crediting provides complete protection against index declines, and provides gains based on a portion of the index's growth.

## How Indexed Annuities are Protected

An indexed annuity is backed by the reserves, capital, and surplus of the issuing insurance company. The company is regulated by state insurance departments in the states where it conducts business. A key focus of each of these state insurance regulators is the solvency of the companies that operate in their state. In the unlikely event that the financial condition of a carrier becomes impaired, the state insurance department has the ability to take over the operations of the company in a process known as rehabilitation.

Additionally, each state has established a guaranty association to aid in ensuring that policyholder's benefits are paid. The guaranty fund association is funded by assessments made against all insurers that operate in the state. These assessments can be used to provide additional protections to annuity owners of a failed insurance company. Each state guaranty association has an amount of annuity cash values and death benefits that it guarantees. These amounts vary from \$100,000 to \$500,000, depending upon the state. To learn more about state guaranty associations, visit [www.nolhga.com](http://www.nolhga.com) or see our guide on Guaranty Associations at [www.fixedannuityfacts.org](http://www.fixedannuityfacts.org).

Even after the most recent financial crisis, no indexed annuity owner has ever lost a penny of their annuity's value, due to adverse market movement or carrier insolvency.

**Questions? We encourage you to contact our  
Executive Director, Chip Anderson, at 414-332-9306 or [Chip@nafa.com](mailto:Chip@nafa.com)**

