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Index Annuities

Equity index annuities emerged on the annuity scene in the 1990s, a product developed in response to difficult economic [conditions](#). The market in 1990 was struggling to rebound from the depressed period following Black Monday of October, 1987, when markets around the world crashed. In fact, there were many similarities between the conditions following the economic turmoil of 2008-2009 that closely resembled conditions in 1990: high unemployment rates, steep decreases in commercial property values, and decreasing GDP.

The insurance industry has historically shown great product innovation during times of financial challenge. It was during this recessive economic period that index annuities made their debut. In the early 1990s, with improvements in the offerings of the stock options markets, the more innovative insurance companies found a new way to ensure that they could pay more interest than could be paid on traditional fixed annuities. They learned to hedge with short call options on market indices to enable annuity [contract](#) owners to participate in market gains, if they occurred, but avoid loss of principal. Actuaries were also able to prove that there was enough interest left over after the purchase of the year's stock index options to offer the annuity owner a minimum guaranteed rate of return, even if the market was flat or down for the entire duration of the annuity contract. With this unique new protection strategy to offer protection and income, the fixed index annuity grew into a "win-win" product combination for consumers and insurers.

After a fairly unremarkable start, the index annuity's popularity soon took off at the turn of the millennium, with sales in the billions. With greater competition, insurers started differentiating their contracts with an abundance of features, fees and charges, limitations on accumulation, complex calculations of index values, and other rules and restrictions. The contracts earned the reputation of having little transparency and great complexity, and were often the target of criticism by financial writers and commentators. Undeniably, there were abusive sales practices as well. Unscrupulous sales representatives sold index annuities inappropriately to investors who did not understand their features, and earned high sales commissions without regard for suitability. Senior citizens, in particular, were targets of abusive sales.

In 2008, the Securities Exchange Commission (SEC) became involved in the investigation of the abusive sales practices associated with index annuity promotions. An inquiry at a national seniors summit revealed that index annuities were fraudulently sold to seniors. As a result of its investigation, the SEC tried to gain regulatory authority over index annuities and require their registration. Ultimately, this did not come to pass; however, many broker-dealers and insurance agencies began to apply

more rigorous FINRA standards to their index annuity supervision and sales practice oversight.

Insurers and index annuity product sales results were not deterred by the negative publicity. Increasing emphasis on transparent product design, ethical sales practices and appropriate recommendations have strengthened product sales and design. In fact, 2010 resulted in a record sales year for index annuities. Due to product innovation, along with the increase in distribution channels, sales of index annuities continue to grow and attract many who desire rates of return potentially higher than traditional fixed but are not willing to accept risk of principal. The time is simply right for these products.

A. The Basics of Index Annuities

An index annuity is a fixed annuity product's alternative that ties the product's returns to the performance of a particular stock market index or indices. Originally called *equity indexed annuities*, or equity linked annuities, these products can fill an important gap for investors who like the safety of fixed annuities, but desire the upside performance potential of index mutual funds. They have characteristics of both fixed and variable annuities, and are sometimes described as a hybrid annuity product. *Their return varies more than a fixed annuity, but not as much as a variable annuity.* Unlike variable annuities, index annuities do not subject contract owners to risk of loss of principal as a tradeoff for market participation.

Growth potential for index annuities can be strong in times of sustained high performing markets, with earnings that have ranged as high as an average of 10-15% before 2008's downturn. Even in down years their earnings have ranged between 1-3%, which has been a particularly strong selling point to those who suffered losses of 30-40% in retirement plans invested in mutual funds in the recent market crash. Individuals who purchase them are not investing directly in the market, and they are not buying shares of stock or any ownership interest in a market index. They offer an attractive alternative for persons who prefer a passive style of saving and a downside guarantee.

Available as either immediate or deferred annuities, our discussion will focus on non-registered index annuities. Although registered versions of index annuities have been introduced to the market, they are not the common variety.

Index annuities differ from other fixed annuities because of the way interest is credited to the annuity contract value. They share many of the other standard characteristics of fixed annuity products which will be reviewed as we proceed through this section.

B. Interest Crediting Strategies

Index annuities credit interest using a formula based on changes in the index or indices to which the fixed index annuity is linked. The formula decides how interest, if any, is calculated and credited. How much interest the insurer credits to an index annuity contract depends on the features of the insurer's product, and there are numerous varieties and combinations in the market today.

A market index measures the performance of a particular sector of the stock market. The most widely recognized index, the S&P 500 Composite Stock Price Index, includes 500 stocks that are considered representative of the performance of the broad market. There are also more narrow indices such as technology indices, foreign

equity indices, and other sector specific indices that measure performance of nearly any market sector. Some index annuities allow the purchaser to choose one or more index to which performance of the contract is tied, while other more straightforward products are typically linked to the S&P 500's performance. Synthetic indices have even been designed and offered as a means of product differentiation. The index on which the product is based acts as a performance benchmark only. While the contract value is not invested directly in the stock market, the contract benefits when the index is up and is protected when the index is down.

Besides the determination of which index is used to benchmark performance, the most common features that impact the return on index annuities are the participation rates, the index crediting strategy, the spread, margin and asset fee, and interest rate caps.

1. Participation Rate

Participation rates determine the amount of gain in the index that will be credited to the annuity. This rate is established by the insurance company and commonly varies from 70% to 100%. *For example*, if an insurance company sets the participation rate at 80%, the annuity would be credited 80% of the index gain. If the participation rate of a particular [contract](#) is 80% and the increase in the S&P 500 is 5%, the gain credited is equal to 80% of the 5% S&P 500 gain, or 4%.

This participation rate is an important feature to consider in evaluating the competitiveness of an index annuity contract. While some advisors recommend that only participation rates of 100% should be considered, there are other important features that impact the value of the participation rate.

The participation rate may or may not be guaranteed for the duration of the index period. Issuing insurance companies also reserve the right to change the amount of the participation rate as needed.

2. Spread, Margin or Administrative Fee

Some index annuities base the amount of interest credited to the [contract](#) on a spread, margin or administrative fee that is charged either in conjunction with or instead of a participation rate. This **spread** is typically expressed as a percentage to be subtracted from any gain in the index linked to the annuity. *For example*, if the index gained 6% and the spread/margin/administrative fee is 2%, then the interest gain that is credited to the annuity is 4%.

This spread is the amount of money that the insurance company subtracts from the index gain during interest crediting. If applicable, the annual spread typically ranges from 1.5% to as much as 5%, and is spelled out in the annuity contract and disclosed in annual statements.

If the spread amount exceeds the earnings from which it is to be subtracted, it is sometimes not applied or limited. This adjustment never results in a negative performance. *For example*, if a contract specified a 2% spread, but index earnings for the period were only 1%, the contract would have 0% earning credited for the period, not (-1)% as indicated by the calculation.

3. Interest Rate Caps

Some insurers place an upper limit or maximum percentage on the amount of earnings that can be credited to an indexed account. These are often called **rate caps** or cap rates. *For example*, if the annual rate cap is 7%, this will be the maximum

amount of interest that is credited, even if the index performance provides for a higher percentage. Any amount of return above the rate cap percentage is profit for the insurer.

- If the S&P 500 goes up, the **contract** is credited the percentage increase, up to the rate cap, on the contract anniversary. That interest is locked in, and the account value is then eligible for index interest the following year, which allows for interest compounding.
- If the S&P 500 goes down, the account value is guaranteed not to decrease because of poor performance. Although the S&P performance may be negative, there is no reduction in the contract's value.

The following table illustrates the impact of rate caps when interest is credited based on a participation rate of 100% of S&P index performance and an initial purchase payment of \$100,000.

Rate caps are typically used as an alternative to a spread approach. If the index performs exceptionally well, they allow for more upside for the insurance company. When rate caps are used, they are usually declared on the contract anniversary, and guaranteed for one year. A key differentiator for contracts that use rate caps is their rate cap renewal history. Some companies are committed to maintaining the rate caps declared at the time the contract was issued, while other companies change the rate cap to manage their spreads. When comparing index annuity company performance and selecting an appropriate product, a review of rate renewal cap history helps understand how different insurance company products respond to changing market cycles.

S&P Performance	Assumed Rate Cap	Index Interest Credited	Contract Value
21%	7%	7%	\$107,000
5%	7%	5%	\$112,350
-10%	7%	0%	\$112,350
4%	7%	4%	\$116,844

C. Methods of Calculating Index Returns

One of the challenges of understanding index annuity performance is the method of calculating the performance of the index. There are 3 typical methods, as well as a number of averaging methods that are commonly in use.

Point-to-Point Method. The point-to-point method uses only two points during the term of the index annuity to determine performance. The most common points are the one at the start of the term and the one at the end of the term. If the index to which the annuity is tied is higher at the end of the term than it was at the beginning, that difference is used to calculate the addition of interest to **contract** value.

Because it measures only one point in time, this index crediting method can be risky when there is a market downturn that coincides with the last day of the term. Even if the index to which the annuity is linked goes up throughout the term of the investment, if its value declines dramatically on the last day of the term, then part or all of the earlier gains can be lost.

In addition, because interest is not credited until the end of the term, investors who wish to surrender or withdraw funds from their annuities should time these events carefully. No index-linked gain may be payable if either event takes place prior to the end of term when interest is credited.

An advantage of the point-to-point crediting method is that it is very simple to calculate and understand.

The High-Water or Low-Water Mark Method. A second method of calculating interest, the “water mark” methods, evaluates index performance at various points during the term. The insurance company “looks back” at the index value at different times during the term, usually the annual anniversaries of the date the annuity is issued. Using the high-water mark method, if the current rate is higher than the starting point, the index performance is up. The net amount of the credit is determined by taking the difference between the starting point and the highest index value during the index term.

Using the low-water mark method, the interest credit is based on the difference between the index value at the end of the term and the lowest overall index value during the index period. This indexing method may credit higher interest than some other methods if the index reaches a low point early or in the middle of the term and then rises at the end of the term.

The Annual Reset Method. The annual reset method simply uses the change in the percentage of the index from the start of the first contract year to the end of that contract year. The next year, the change is computed from the end of the prior year, and so on for the remainder of the contract term. If the index is higher at the end of the term, the percentage of the increase is credited and “locked in” for that year. The index value is reset at the end of each year; therefore, after a year of negative performance, the index starting point for the next year is reset to the depressed index level. This allows the annuitants to be well positioned for future gains, and improves the chances of index annuities out-performing other fixed annuity returns over the longer term. It also supports the idea that a buy and hold strategy is quite effective with index annuities, because over the longer term the index annuities using this crediting method have competitive performance results.

Index annuities using the annual reset method may credit more interest than annuities using other methods when the index fluctuates up and down often during the term of the contract. This index crediting method is also more likely than others to result in credits of index-linked interest before the term of the annuity ends. Any declines in the index value are ignored. In years of negative index performance, the interest credit is 0.

Average Methods. Another form of interest crediting is the daily average method, which is an average of every single day’s index value during the [contract](#) year. There are other methods of averaging, such as monthly and quarterly, that are used. Different methods and calculations yield different advantages, but two points to recognize as general rules of thumb are

- Averaging at the beginning of a term protects from purchase at a high point which may reduce the amount of index-linked interest potentially earned.
- Averaging at the end of the term protects against severe declines in the index and losing index-linked interest as a result.
- Overall, averaging may reduce the amount of index-linked earned when the index rises either near the start or at the end of the term.

As you can see, there are a number of index crediting methods, each with their own advantages and disadvantages. On their own, these methods may seem fairly straightforward, but in currently available index annuity contracts they are combined with other features like participation rates, spreads, and rate caps to arrive at the final crediting calculation. An important [consideration](#) in selling index annuity contracts is ensuring that people understand how these strategies impact the contract choices they make. With the many moving parts available as choices in index annuities, this isn't always easy to do.

D. Index Annuity Contract Features

After determining that an index annuity may be an appropriate vehicle for retirement planning, there are basic considerations that must be discussed as part of the [application](#) process.

Issue Ages. These vary somewhat by [contract](#), but are usually in the range of age 0 to 85. The typical purchasers of index annuities are people that are age 50 and above, and they generally use the index annuity as a means of accumulating funds for retirement. They are also used by persons already in retirement as a savings vehicle for funds currently not used to generate income.

Term. The index term is the time period over which index-linked interest is calculated. Terms are generally from 1 to 10 years, with 6 or 7 years most common. Some insurance companies offer a selection of terms, with longer terms offering potentially higher index interest crediting than shorter terms. Surrender charge periods between the longer and shorter terms also vary.

Insurance companies may offer annuities with single terms, but others are available with multiple, consecutive terms. Annuities with multiple terms typically include a window, often 30 days in length, during which money may be withdrawn without penalty.

Vesting. A vesting provision, if applicable, limits that amount of interest credited before the end of the index annuity term. *For example*, if all contract value is withdrawn before the end of the term, some annuities will credit no or only part of the index-linked interest. The percentage that is vested generally increases as the term nears the end and is always 100 percent at the end of the term.

Minimum Purchase Amounts. This also varies by contract, but most issuers have one contract with a minimum purchase of \$10,000 or \$25,000.

Maximum Purchase Amounts. Companies may state a maximum purchase payment of \$1-\$5 million, but often require home office permission before applications for contracts of more than \$1 million are accepted. For any multi-million dollar investment, financial advisors should consider recommending diversification between different company products. Although the risk of financial failure by insurance companies may be slight based on historical performance, it is a sound practice to divide large purchases among different high quality insurers.

Contract Administration Charges. Although many companies charge no administration fees either initially or annually, some companies charge a policy administration fee in the range of 1-3%. If charged, this fee is deducted from the account value each year, prior to the crediting of interest and regardless of market performance. Other insurers often collect this charge through their spread. One way or another, administration charges are paid by the contract holder. Depending on the

contract, it might be preferable to pay a fixed annual fee in return for a higher participation rate or other more attractive features.

Banding. Some insurance companies may encourage larger purchase payment deposits by offering higher rate caps or other incentives for larger deposit amounts. Other companies offset the smaller purchase payments by an administrative charge as just described above. Investing larger amounts for higher periods allows more efficiency for insurance companies.

Tax Deferral. Indexed annuities, like all annuities, grow tax-deferred even when they are not included in a retirement savings account. This favorable concept adds more dollars for compounding until the annuity contract value is withdrawn or annuitized.

Death Benefits. An important feature of any annuity, index annuity death benefits depend on the phase the contract is in. If death occurs in the accumulation phase, most contracts pay the contract value directly to the named beneficiary. Some companies wave surrender charges on distribution at death. Although the beneficiary's payment may be subject to taxation, these payments avoid the costs and delays of probate. If death occurs after annuitization has started, the benefit that is paid is dependent on the payout option chosen.

Payout Options. Numerous flexible annuity income payment options are available for owners to choose from when and if annuitization is chosen. An important part of determining suitability in the sales process is to determine the payout option that best fits the needs of the annuitant. The options that an insurer makes available for annuitization are often the same options that are available for annuitization of other annuity contracts that insurer issues, and include single and joint, life and installment options, with or without beneficiary protection and possible inflation adjustments.

Minimum Guarantee. At issue and upon any renewal, purchasers of index annuities are guaranteed a minimum rate of return for the full index period. The contract's minimum guarantee may be subject to certain state law variations, but in general the range is 1% to 3%. This minimum guarantee ensures that index annuity contract values will always increase, even if the index performance over the term is negative or flat, and is one of the main attractions of index annuities.

The minimum guarantee amount is calculated at the end of the term for the entire period. The amount of that calculation, less any withdrawals, is compared to the amount of the contract value including the interest credits already made due to index performance during the term. The larger of the two values is the contract value at the end of the term.

Surrender Charges. The surrender period on an index annuity is typically longer than other annuity surrender periods. It often ranges from about 7 to 14 years, although there are shorter periods of even 4 to 5 years available. Commonly, the contracts with longer surrender charge periods will offer the potential for higher returns, but not always.

There is a current regulatory trend that limits surrender charge periods in a number of states called the **10/10 Rule**. For states that have adopted this rule, there is a limit on surrender charges to 10 years and 10% in the first year of the annuity. Each state has its own twist on 10/10, so there is no standard in the way the rule is applied.

For example, with regard to the maximum 10% sales charge in the first year, some states will permit a first-year surrender penalty of 15% if there is a guaranteed up-

front bonus of 5% on the contract. Some states add an age component to the rule, such as Florida, which applies the rule only to purchasers that are 65 or older, unless they fall into an elite high net worth group classified as accredited investors. Other states add in a restriction on market value adjustments if a 10 year surrender charge limit applies.

Many broker-dealers have made the 10/10 Rule a criterion for approving index annuity selling agreements. Regardless of whether the rule is adopted, these broker-dealers may restrict the sale of index products with surrender periods of more than 10 years for brokers they sponsor. This practice helps simplify the process of managing state variations for producers that are licensed in multiple states.

Whether or not a state has adopted the 10/10 Rule, it is important to note that contracts with longer surrender charges are not always unsuitable. They may be appropriate for younger individuals who have limited liquidity needs that can be covered by other liquid assets, and no intention of moving the money. They may yield better returns because they spread the costs associated with the contract over a longer period, and also permit a longer period for the insurer to generate investment returns. However, when working with the over-65 population, it is important to remember that longer surrender charge periods may not be appropriate.

Liquidity Options and Free Withdrawals. Most index annuity contracts offer some form of liquidity option. The most common liquidity provision is a 10% free withdrawal. This feature allows contract holders to make one or more withdrawals without charge each year subject to the 10% limit. Sometimes there is no free withdrawal allowed in the first year, or the amount may be reduced (5% first year free is a relatively common provision in contracts that offer free withdrawals in the first year).

The size of the free withdrawal is usually limited to the set percentage of the annuity's guaranteed or accumulated value. Larger withdrawals that exceed the free amount are subject to surrender charges and potential withdrawal fees. With index annuities in particular, the timing of the withdrawal may be very important. If withdrawals are made before interest is credited for the policy year, that portion of the contract may receive no index-linked interest.

Some contracts offer waivers on withdrawal charges in certain situation such as death, confinement in a nursing home, or terminal illness. The eligibility qualifications for these provisions differ from contract to contract.

Market Value Adjustment. Some insurers impose market value adjustments on early withdrawals from index annuity contracts. In addition to surrender charges that may apply, a market value adjustment can have either a negative impact (if interest rates have increased) or a positive impact (if interest rates have decreased). Insurers sometime waive the MVA for early withdrawals due to death, nursing home confinement, natural disaster and terminal illness.

The market value adjustment is used by insurers to recoup their losses or pass gains to contract holders in the event of the early termination of investments that back the annuity contracts.

Premium Bonuses. Some index annuity issuers offer premium bonuses to boost the potential earnings of the contract. Usually bonuses are a percentage of the initial purchase amount, and may or may not apply on subsequent purchase payments. Contracts that offer premium bonuses may often have higher and longer surrender charges than those do not. In addition, if contracts with bonus payments are

surrendered in the early years of the contract, some or all of the bonus credit may be recaptured by the insurance company. The most common bonus paid on an annuity credits a higher rate for the first contract year.

1. Other Optional Riders and Benefits

GLBs. Insurers continue to offer innovative new benefits to index annuity contracts in their efforts to respond with changing needs of consumers and changing market conditions. A feature that has become more prominent in the index annuity marketplace over the last several years is the guaranteed living benefit rider (GLB). These riders earned immense popularity as variable annuity benefits, and are gaining traction with index annuities as well.

First introduced in 2006, GLBs on index annuities offer the lifetime income without the loss of control of the accumulated value of the contract. There is usually an annual fee with these riders added to base index annuity contracts. Recent studies have shown that contracts that include these riders have lower surrender rates than indexed annuities without the features. Approximately 60% of all index annuity contracts currently sold include these riders.

Other forms of traditional variable annuity riders such as the guaranteed minimum death benefit riders (GMDB) are also offered as index annuity contract options by some issuers.

Fixed Account Option. In order to offer greater contract flexibility, some index annuities offer fixed account options. These fixed account options are like having a traditional fixed annuity subaccount within the index annuity, and provide a conservative rate of return on the funds allocated to the account. Contracts that include this option usually permit the contract owner to allocate purchase payments between an index account which is credited interest based on the performance of the index, and the fixed account which credits interest based on a rate declared by the company. Periodic changes to the account allocations are allowed to reflect the contract owner's changing strategies and market attitudes.

A benefit of fixed accounts within index annuity contracts is that there is visible growth in the portion of the purchase payments allocated to this account each year of the contract, even when there is no index interest credited because of flat or negative market performance.

E. Index Annuities and Suitable Sales

As confirmed by recent years' sales results, index annuities have proven an attractive alternative savings plan for conservative individuals. They marry the benefits of potential upside of greater returns with the guarantees against loss that only annuities can provide. In strong markets they deliver some of the upward movement of the index, subject to caps, participation limits, and spreads imposed by the issuer. In times of flat or negative index movement, they benefit from the minimum interest rate guarantee. A quote from a writer in The Dow Theory Letter sums it up well: "He who loses least ... wins!"

Index annuities also offer attractive annuitization options for those who wish to create an income stream to support them in retirement.

As with any other annuity product, careful consideration must be given to the personal situation, objectives and other suitability concerns of the investor. The following list of

questions helps focus on important points that should be weighed when a person is considering the purchase of an index annuity:

- What is the guaranteed minimum interest rate?
- What charges, if any, are deducted from purchase payments?
- What charges, if any, are deducted from the [contract](#) value?
- What is the death benefit?
- How long is the term? What options are available at the end of the term?
- What is the participation rate? For how long is it guaranteed? Is there a minimum?
- Does the contract apply rate caps to determine the amount of interest credited? What is the company's history of rate cap renewal?
- What rate crediting strategy or indexing method is used to determine the amount of index credited?
- What index is used as the performance benchmark?
- Is there a margin, spread, or administrative fee? Is that in addition to or instead of a participation rate?
- What surrender charges or penalties apply to full surrender or periodic contract withdrawals?
- Does the contract have vesting provisions? What are the terms that apply?
- Are any surrender or withdrawal charges waived for confinement to a nursing home or other reasons?
- What annuity income payment options are available?

1. Application

Meet Jim and Sharon. They are in their late fifties. They have recently taken serious interest in preparing a retirement plan, and want to be sure they are on track to retire in 7-10 years. They hope to live the retirement dream, and want to have money in excess of their basic needs to travel and live leisurely without worry. Both have substantial 401(k) plan balances that are invested in mutual funds, and have now finally regained losses suffered in the 2008-2009 downturn. They have become quite conservative in their fund allocations as a result, but feel they need some market [exposure](#) to keep up with inflation.

Jim's financial advisor has spoken to them about the advantages of an index annuity. Both Jim and Sharon think this is a great alternative, and like the balance of upside potential with no risk to principal. Jim opts to take an in-service withdrawal from his 401(k) plan and invests \$200,000 in an index annuity with a 7-year term. He likes the idea that it offers a 1% bonus and options for renewal or termination at the end of the period. He is not concerned about the 10% surrender charge of the [contract](#) because the couple has no intention of withdrawing funds, since they have already established a liquid emergency fund. Jim and Sharon feel they are one step closer to realizing their retirement dream with an index annuity.

It seems that in this situation, an index annuity meets the needs for a portion of Jim and Sharon's retirement savings. Like many others, they find that the blend of upside potential and downside protection fits well into their retirement plan.

2. Seven Advantages of Index Annuities

1) **Best of both worlds.** Index annuity contracts offer a highly attractive blend that fits well with the financial objectives of nearly any individual. Who can argue that the concept of strong upside potential with no loss of principal is not an attractive [consideration](#) for most individuals?

2) **Minimum Guarantees.** Even if markets fall by record amounts, purchase payments to index annuities benefit from minimum interest rate guarantees that are generally no less than 1% for each year in the term of the contract. Although 1% does not sound

great, it is tremendously attractive when compared to several years of market loss of any amount.

3) **So many choices.** With the multitude of crediting methods and features available, clients have many options to consider. New [rider](#) developments also offer even more options for customization.

4) **Death Benefits.** When premature death occurs, the contract beneficiaries receive all or most of their purchase payments. Some contracts may apply a surrender charge adjustment or market value adjustment, depending when death occurs. Regardless, there is certainty of the [death benefit](#) that cannot be achieved with other vehicles linked to market performance.

5) **Keep pace with inflation.** Index annuities can offer an attractive balance for persons who typically prefer conservative choices. Their upside potential can help inflation proof retirement savings, but without the risk of traditional equity investments.

6) **Protection from Market Volatility.** Although the performance of the market index is a key feature of index annuity performance, the contract owner is not subject to the worries and impact of day-to-day market volatility. The upside benefit: competitive growth within the annuity and protection from account value fluctuation can be important to those with a conservative temperament.

7) **Guaranteed Income for Life Options.** Index annuities offer the opportunity to annuitize the accumulated value of the contract. Contract owners can establish guarantees that ensure their retirement savings will not be outlived, and can choose guarantees on single or joint lives. A multitude of beneficiary protection, inflation protection, and fixed period options are also available.

3. Seven Disadvantages of Index Annuities

1) **Complexity.** Although the overall concept of equity linked performance seems simple, the number of moving parts in the [contract](#), combined with fees, charges, restrictions and definitions, makes these contracts very hard to understand for less sophisticated individuals. Unless financial advisers take time to educate and reinforce contract features, individuals may not fully understand how the contract fits their long-term needs.

2) **Lack of Transparency.** Certain fees and charges against contract performance and also sales commissions are not always easy to discern from statements or contract information. When they are “bundled” into a spread charge, it is difficult for an annuity owner to understand the impact of charges.

3) **So many choices.** The plethora of contract options available is a double-edged sword! The process of determining what contract is appropriate for an individual becomes a monumental task if agents are committed to comparison of all the combinations and options available.

4) **Surrender charge periods are typically longer.** Index annuity surrender charge periods are usually slightly longer than surrender charge periods found in other types of annuities. This may affect their appropriateness for individuals who are uncertain about future liquidity needs.

5) **Early withdrawals may result in loss of purchase payments.** If an annuity owner withdraws money in the early years of the contract, the combination of surrender

charges plus possible market value adjustments may result in return of less than the original purchase payments.

6) **Interest credit timing.** Depending on the crediting method used, one day of decline could wipe out an entire year of interest credit. In addition, withdrawals or surrenders that are made mid-year may not receive interest credits if credits are applied to the contract value at the end of the contract year.

7) **Insurers maintain the right to change key contract features annually.** Although index annuities impose a multi-year surrender charge, the insurer can change certain key contract features on an annual basis. Examples of these features that may be subject to annual change are rate caps, contract fees, participations rates, all of which may vary from contract to contract.

Chapter Complete

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