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Variable Annuities

Variable annuities offer a very different annuity opportunity than their fixed annuity cousins. In addition to the highly desirable feature of tax-deferred growth, variable annuities permit a virtually unlimited number of investment combinations to achieve investment goals. Most work like brokerage accounts, and permit flexible purchase payments, small or large, that can be added whenever possible by the annuity owner.

Since their introduction in 1952, variable annuities have offered the attractive combination of annuity tax deferred growth and equity market investment return potential. At a time when mutual funds were gaining widespread popularity, these products gained attention and sales because of their

- Potential for upside market growth with minimized risk;
- Flexibility in investment choices;
- Professional management; and
- Tax advantages.

The introduction of living benefit riders added a new dimension to these products, and drove variable annuity sales to new heights. These riders offered protection of investments and guaranteed income streams, and became increasingly popular in 2001-2002, following a severe downturn in the U.S. equities market.

The market collapse of 2008 caused sales of variable annuity products to cool, as mutual fund subaccounts suffered substantial losses and market turbulence rattled investor confidence. Insurance companies also suffered huge investment losses, and were forced to reconsider the rich benefits and investment flexibility within their variable annuity products that added unmanageable risk and increased capital **exposure**. After an industry wide period of product analysis, a “de-risking” effort ensued, and a number of large insurance companies dropped out of the variable annuity business. Most other variable annuity issuers pulled back on the overly generous benefits and unsustainable guarantees that had been part of their product offerings during the variable annuity “arms race” preceding the crash.

Product innovation continued, however, and following the flight to safety in 2009, when fixed annuities flew off the shelves, variable annuity sales began to rebound. People started believing again in the market, and wanted to participate in the equity rebound. Sales of variable annuities started to bounce back substantially in the second half of 2010, with a great surge in the fourth quarter. Even though benefits had become less generous, and investment restrictions were added, sales of the product grew steadily, and living benefit riders proliferated. In 2010, more than 80% of all variable annuity products sold included an optional living benefit rider. Most

purchasers elected a guaranteed lifetime withdrawal benefit (GLWB) to lock in a retirement income benefit regardless of market performance.

The financial industry expects the popularity of variable annuity products to continue as pre-retirees prepare for long retirements, and as baby boomers move into the distribution phase of their financial lives. Financial advisors who serve this market must commit to a current understanding of these complex contracts and their riders and features to ensure suitability in serving their customers.

A. The Basics of Variable Annuities

Variable annuities combine the advantages of fixed annuity tax deferral with investment flexibility and access to a wide range of investment options. They offer multiple investment options including equity securities, debt securities, alternative securities, fixed account options, index funds and allocation funds under the umbrella of a single product. Variable annuities allow personalization of an investment strategy based on an investor's goals, time frame and risk tolerance. They provide access for small-scale investors with minimal dollar outlays to investment strategies normally accessible to only large institutional investors.

Like all other deferred annuity contracts, variable annuities have an accumulation phase and an annuity phase. During the accumulation phase, investors purchase units in subaccounts that are created by mutual funds especially for the insurer's variable annuity product. Each insurer contracts with different funds in order to provide a wide range of appealing investment options to potential purchasers. Fund choices range from conservative to aggressive, from domestic to international, from blue chip stocks and bonds to alternative investments like real estate, commodities and ETFs. The professional management offered through these fund choices is one of the many advantages of a variable annuity.

The cash value of an annuity depends on the performance of its subaccounts, and in theory, the annuity could fall to a zero balance or experience unlimited growth. If an annuity owner dies, the standard [death benefit](#) provision pays the beneficiaries a sum equal to the original investment, minus charges and withdrawals.

Purchase payments can be made in a lump sum or periodically as allowed by the contract.

Investors can choose to be as active or as passive as they want. They can personally choose and manage their allocations among the choices. Flexible [transfer](#) provisions allow contract owners to shift money as their investment strategies change or to take advantage of changes in the market.

1. Variable Annuity Investment Strategies

Variable annuities premiums are invested in securities, hopefully maintaining a constant purchasing power, as a protection against inflation. As a result, the investment risk is borne by the account holder. Premiums paid during the accumulation period are placed in the insurer's **separate account** that is usually invested in common stocks. This means that the investment will vary according to the fluctuation in stock prices. Separate accounts provide professional management and diversification.

In addition to the ability to customize variable annuity investment portfolios from the many individual fund options that are offered, most insurers offer both target allocation funds and pre-designed model portfolios.

Target Allocation Funds: Target Allocation Funds help simplify the investment decisions available to individual investors. There are choices designed to meet a range of investment objectives, from conservative, moderate to aggressive. To achieve their objectives, target allocation funds are actively managed by a management company that uses a fund of funds strategy. This means that the manager constructs a portfolio that invests in the other mutual funds. The fund manager monitors the allocation mix to maintain the targeted risk and return objectives of the fund. Target funds can be managed to achieve a stated investment strategy or to align with a projected retirement date in the future. For those that align with a future retirement date, a 2030 fund for example, the asset allocation strategy is geared to result in income available for retirement. The asset mix of the portfolio will change based on the years remaining to retirement. Asset allocations are generally more aggressive and equity-oriented for portfolios with a longer time to retirement.

As the retirement date nears, there is an increase in the percentage of the portfolio that is allocated to bonds and cash equivalents.

Target allocation funds can be excellent overall investment choices in variable annuities, eliminating the issue of deciding on a personal asset allocation strategy and which specific funds or investments to hold.

The foremost advantages that they offer are

- Broad diversification by asset class and fund manager;
- Active rebalancing as needed; and
- The ease of choosing a single fund that incorporates the risk tolerance and goals of investors.

As attractive as the target fund alternative can be, however, there are risks involved. In the financial crisis of 2008-2009, some shorter date target funds, which should have been invested conservatively, reported losses of 25-40%. Although there is no single reason, it was clear that there is substantial variability in fund strategies to meet the fund objectives. Some funds use alternative investments and/or complex investment techniques to meet targets that add to the portfolio risk. Target allocation funds may also carry higher expense ratios than other choices.

Model Portfolios: Model portfolios are predesigned portfolios that are constructed by investment professionals to meet a specific risk and return profile. They provide access to investment strategies that cannot easily be achieved by smaller investors with limited investment dollars. Model portfolio offerings can include institutional, retail and combination models. Institutional models offer access to funds and money managers that are not generally available to retail investors. Instead, these funds are offered to pension funds and other foundations that have large amounts of money to invest. The names of these funds are often not as widely recognized as the names of funds included in retail models. The retail models offer access to familiar brand name money managers subject to the insurer's choosing. *For example*, Vanguard, Fidelity, and American Funds are among funds that are included in retail models by some insurers.

Combination models are simply a blend of institutional and retail funds.

Model portfolios are typically offered based on the investment objective they are designed to achieve. *For example*, conservative, conservative moderate, moderate, moderate aggressive and aggressive, are frequent categorizations used to differentiate model investment objectives. Each model is constructed with a

combination of funds to help deliver the potential for optimal long-term performance. The fund managers are well known and follow a consistent and disciplined investment process, typically using both traditional and non-traditional asset classes in an effort to help boost investment performance while smoothing out investment volatility. Both traditional and non-traditional asset classes are used to achieve these goals. Traditional asset classes include both U.S. and international stocks and bonds from large-, mid- and small-capitalization companies, while nontraditional classes can include a modest [exposure](#) to real estate, commodity-linked and other nontraditional assets.

Although the models are carefully constructed to help deliver the potential for optimal long-term performance and follow the investment strategies of impressive investment managers, investing in a model portfolio neither guarantees a profit nor prevents the possibility of a loss.

Index Funds: For investors seeking a lower-cost strategy, investment options that seek to duplicate the performance of a financial market index could be a solution. Index funds do not employ an active investment strategy, so the costs of managing and rebalancing the investment options represented within the portfolio are minimized. Instead, these funds may invest in the purchase of exchange traded funds, or ETFs, that hold most or all of the same securities as the market index they track. The result is that investors in these funds have the potential to experience performance similar to the market index they track.

Restrictions on Investment Strategies: As a result of the financial crisis, companies that manufactured variable annuities were forced to re-evaluate the richness of the benefits they offered and “de-risk” many of their variable products. Some large companies chose to discontinue offering variable annuities because of the capital commitments required to support ongoing guarantees. In limiting risk [exposure](#), many companies now restrict the amount of equity exposure investors may choose to fund certain benefits, or may employ automated investment strategies that require automatic rebalancing to fixed account options under declining market [conditions](#). As potential buyers evaluate variable annuity contracts and their investment options, it is important that they consider these potential investment restrictions, and understand the circumstances under which they apply.

Dollar Cost Averaging Accounts: Many variable annuities offer dollar cost averaging (DCA) programs that allow for purchasers to make periodic subaccount investments over a defined period of time. Dollar cost averaging has historically proven to be a favorable method of purchasing shares at a lower cost per share than by investing a lump sum amount, although there is no guarantee of achieving a more favorable unit price or ensuring a profit or protection from loss. With a DCA program, when prices of variable subaccounts are high, fewer shares are purchased. When prices are low, more shares are purchased. Over time, average cost should be less than the average price. Dollar cost averaging involves continuous investing, regardless of fluctuating security prices.

Dollar cost averaging purchases can usually be set up to occur on a monthly, quarterly, semi-annual or annual basis, and [transfer](#) a specified dollar amount from a money market fund or funds that have been designated for this purpose into one or more subaccounts. There are typically minimum requirements on the amount to be transferred each period; a \$100 minimum is common. The DCA account is also usually required to maintain a minimum balance. Investors considering this purchase

arrangement should consider their financial ability to continue purchases through periods of low prices.

Subaccount Transfers and Portfolio Rebalancing

Variable annuity owners may choose to [transfer](#) all or part of their [contract](#) value among the subaccounts or the fixed account, subject to certain restrictions that may be imposed by the issuer. If imposed, restrictions are designed to prevent investment managers from engaging in disruptive trading practices. Some companies may charge administrative fees for transfers.

Examples of specialized transfer programs that may be available to contract holders are listed below:

- Dollar-cost averaging programs as previously described;
- Portfolio rebalancing program under which contract value is automatically transferred on a monthly, quarterly, semiannual or annual basis between and among the subaccounts to achieve a particular percentage allocation of variable contract value among the subaccounts. These automatic transfers may be
 - A specified dollar amount;
 - A specified number of accumulation units; or
 - A specified percent of variable contract value in a particular subaccount, in an amount equal to the excess of a specified amount of variable contract value in a particular subaccount;
- Voluntary programs: these requests may occur at the discretion and timing of the contract holder. Usually, written, faxed, internet or telephone requests can be accommodated, as long as the identity of the person making the request can be confirmed. Frequent, large, or short-term transfers among subaccounts, may be associated with "market timing" attempts. These may be limited because of their adverse effect on contract holders and the fund investments.

As previously stated, some contracts may require a specific allocation to a fixed account under defined market [conditions](#).

2. Registered Product Regulation

Variable annuities are investment products that subject investors to risk and potential loss of invested principal. Products that have these features are subject to regulation as a security, in addition to the state and federal insurance regulation that is also applicable. Individuals that sell registered products must be registered with the Financial Regulatory Authority (FINRA), and pass the Series 6 or Series 7 exam, in addition to state registration that is likely to require the passing of the Series 63 or Uniform Securities Act exam.

As securities, variable annuities and the representatives that sell them are subject to stringent [disclosure](#) requirements to ensure that potential investors are exposed to a balanced view of the features and benefits, risks and rewards of the product. In addition to sales materials that are prepared by the issuing company, all investors must receive a prospectus which is the final authority on all [contract](#) features. This often lengthy and detailed document includes detailed information on all investment options, contract fees and historical performance. Potential investors must be given a prospectus no later than at the time of sale, and should be encouraged to review it carefully to ensure they are informed of the features of the product they are purchasing.

B. Variable Annuity Share Classes

Variable annuity contracts generally offer different share categories, which allow investors a choice in payment of contract sales charges. These categories of shares differ not only in the charge at the time of the sale, or surrender, but in the amount of expenses charged against the contract value on an ongoing basis (called mortality and expense charges (M&E)). These purchase, surrender and ongoing charges determine the amount and timing of the up front and trail commissions that are paid to the sales representative.

B-Share Products: The most popular variable annuity contracts are B-share products. B-share contracts have no upfront sales charge, but incur a surrender charge during the early years of contract. Surrender charges are sometimes called contingent deferred sales charges, and are paid when money is withdrawn in the early years of the contract. The surrender charges typically range from 5-7% of the premium in the first policy year, and subsequently decline by 1% over a period of years until the charge is zero. The typical surrender charge period lasts 6-8 years. Some annuity contracts will impose surrender charges only on the original purchase payment, but others will associate a new surrender charge period with each subsequent purchase payment paid. Once the surrender charge period ends, the contract is out of surrender and no further surrender charges apply to withdrawals. However, withdrawals are still subject to income tax and, if taken prior to age 59½, a 10% IRS penalty tax. B-share products often have the lowest mortality and expense (M&E) charges of the share class options.

C-Share Products: C-share annuities provide more liquidity for investors by allowing cash surrenders without either front-end or back-end surrender charges. There are, however, ongoing M&E and administrative fees. As with all annuities, withdrawals of taxable amounts will be subject to ordinary income tax and, if taken prior to age 59½, may be subject to a 10% IRS penalty.

X-Shares: Annuities that offer X-shares credit an additional percentage or bonus to the contract value. The bonus is expressed as a percentage of the original purchase payment and may also apply to subsequent contract deposits. Throughout the industry, bonuses generally range from 1%-6%. Sometimes the bonus amount increases as the purchase amount gets larger. As an example, an individual that purchases an X-share annuity with a 4% bonus would receive a credit of \$4,000 on a \$100,000 purchase payment. Variable annuities with bonus credits often include higher ongoing expense charges and longer surrender charge periods than those that do not offer bonus credits. In addition, some include provisions that allow the insurer to recapture some or all of the bonus amount if the contract is surrendered within its early years.

A-Shares: These annuities shares are like A-share mutual funds, in that they have front-end loads, or up-front sales charges, instead of surrender charges. The sales charge is assessed as a percentage of each purchase payment. These annuities also offer breakpoint features, which mean that the upfront sales charges decrease as the purchase amount gets larger. Some companies also allow any new purchase payments to be aggregated with already deposited funds to determine the applicable sales load. *For example*, if \$1,000 is added to a contract that had been established with a \$100,000 purchase payment, the sales charge on the \$1,000 would be based on the percentage that would apply to a purchase of \$101,000. This could amount to a substantial sales charge reduction. Companies may also extend this breakpoint concept to include payments already made to other products that the company offers. A-shares often have lower ongoing M&E charges than annuity products that have surrender charges.

L-Shares: This annuity share class is the latest addition in share pricing options. While they are most similar to B shares because they have a contingent deferred sales charge, the surrender charge period is abbreviated. The standard L-share surrender charge averages about 3-4 years, and like the B-share surrender charge, declines annually. The cost for the shorter surrender charge period is typically covered through higher M&E and administrative charges than other share classes. These shares provide greater flexibility to those purchasers who may need to make withdrawals in a shorter time frame.

C. Other Considerations in the Purchase of Variable Annuities

The investment choices and cost of purchasing a variable annuity are two of the more critical considerations for potential purchasers. However, there are a number of other features that should not be overlooked in determining product suitability.

Death Benefits: Although variable annuity features vary by issuer, most contracts feature a guaranteed [death benefit](#). For many buyers, this benefit is one of the more attractive features, as it differentiates the variable annuity investment opportunity from straight investment, mutual funds and managed money products. If the contract holder dies during the accumulation phase of the contract, the issuing company will pay to the named beneficiary the amount of the original purchase less any withdrawals. The contractual payout of this benefit varies from contract to contract, but can be paid as a lump-sum payment or as a stream of periodic payments.

For example, a variable annuity offers a death benefit equal to the greater of account value or total purchase payments minus withdrawals. An annuity contract owner has made purchase payments totaling \$50,000, and has withdrawn \$5,000 from the account. Because of these withdrawals and investment losses, the account value is currently \$40,000. In this case, the designated beneficiary will receive \$45,000 (the \$50,000 in purchase payments minus \$5,000 in withdrawals). This benefit avoids the costs and delays of probate, although certain estate and income taxes may apply. Many annuities also provide optional death benefits that can provide enhanced coverage for beneficiaries for an additional cost. This death benefit and other option available through riders can be exceptionally attractive to buyers who are uninsurable, because there is no medical underwriting on annuity death benefits.

Withdrawal Provisions: Variable annuity withdrawal provisions are similar to those that apply to the fixed deferred annuities we have already discussed. Investors may withdraw a portion (typically 10% or 15%) of the initial purchase amount annually without surrender charges. Sometimes the free withdrawal amount may be based on gains in the contract instead. For example, the withdrawal may be as expressed as 10% or the gains in the contract whichever is greater. Applicable taxes are due on earnings upon withdrawal, and a 10% penalty may be incurred if withdrawals are made before the investor reaches age 59½.

Surrender charges are often waived for hardships, which can include the following:

- Confinement in a nursing facility or hospital, typically only after a contract waiting period is met, for example 30 consecutive days of confinement;
- Diagnosis of terminal illness;
- Unemployment as defined [conditions](#) that may include layoff, termination or other involuntary job loss; or
- Natural disaster.

Most contracts specify that withdrawals must meet minimum amounts, can be made only a certain number of times in a year, and that a minimum amount must remain in

the contract after the withdrawal. Proof may also be required when the withdrawals are made for hardship purposes. Withdrawals before an investor reaches the age of 59½ are generally subject to a 10% tax penalty. In addition, any amount of the withdrawal that is attributable to gain is taxed as ordinary income.

Variable Annuity Fees: Variable annuities have a reputation for charging many fees. The fees that are charged depend on features that are chosen and can add up to a substantial amount. It is very important that purchasers of variable annuities understand these fees, because they are charged against the contract's value.

In addition to the sales loads that are charged, variable annuity fees include

- **Mortality and Expense Risk Charge.** This charge is equal to a certain percentage of account value, typically in the range of 1% to 2.5% per year. It compensates the insurance company for the risk of guaranteeing payments under the annuity contract. Profit from the mortality and expense risk charge is sometimes used to pay the insurer's costs of selling the variable annuity, including commission paid to a financial professional for selling the variable annuity. *For example*, assume a variable annuity has a mortality and expense risk charge at an annual rate of 1.25% of account value. If the average account value during the year is \$20,000, \$250 in mortality and expense risk charges will be paid that year.
- **Administrative Fees.** The insurer may deduct charges to cover record-keeping and other administrative expenses. This may be charged as a flat account maintenance fee (perhaps \$25 or \$30 per year) or as a percentage of account value (typically in the range of 0.15% per year). *For example*, assume a variable annuity charges administrative fees at an annual rate of 0.15% of account value. If the average account value during the year is \$20,000, \$30 in administrative fees will be paid that year.
- **Underlying Fund Expenses.** Contract owners will also indirectly pay the fees and expenses imposed by the subaccounts that are the underlying investment options for the variable annuity. These subaccount charges vary, but can be as high as 1.5%.
- **Fees and Charges for Other Features.** Special features offered by some variable annuities, such as a stepped-up [death benefit](#), a guaranteed minimum income benefit, or long-term care insurance, often carry additional fees and charges.
- **Premium Tax.** Some states charge a premium tax on annuities. The insurance company pays this tax to the state. The company may subtract the amount of the tax as premiums are paid, when contract value is withdrawn, when an annuitant begins to receive income payments or when it pays a death benefit to a beneficiary.
- **Transfer Fees.** Some contracts charge for subaccount transfers that are made either on an unscheduled or a planned basis. Typically, these charges are flat-dollar, nominal amounts, such as \$10 per transaction, and they are often waived. However, the contract states that the company reserves the right to reinstate the charges at any time.

A complete description of the fees and charges that apply can be found in the variable annuity prospectus. It is important to remind buyers to evaluate contracts and subaccounts not on fees alone, but on performance. Comparing net (after fee) performance of similar funds like large cap to large cap, small cap value to small cap value, is a good practice for ensuring that the size of the fee is not the only [consideration](#) in the contract comparison process.

D. Variable Annuity Payout Phase

The payout phase of the annuity usually takes place when the annuitant is about to begin or is already in retirement. At this time, the [contract](#) holder can either choose a lump-sum payment, or **annuitize**. The choice to annuitize means the lump sum of the accumulated value will be converted into a series of payments.

The payout of the variable annuity is based on the number of units held by the annuitant. A calculation is performed to convert the accumulation units to annuity units at annuitization. The annuitant is credited with a fixed number of units, but the value of those units fluctuates, resulting in a variable payout. A fixed payout option may also be available, in which case the payment amount will be calculated based on the value of the units and will remain stable through the payment period.

Additional factors that impact the payment calculation are the current age of the annuitant (the longer the wait before taking an income, the greater payments will be), the expected future inflation-adjusted returns from the account's assets, and life expectancy (based on industry standard life expectancy tables). Finally, any spousal or survivor income provisions if included in the annuity contract are also factored into the equation.

Because the investment returns of the portfolio cannot be calculated in advance, assumptions must be made to calculate the value of the first payment. This is accomplished through the use of an **assumed interest rate** or **AIR**. After the initial payment has been calculated, the amount of each subsequent payment is adjusted up or down by comparing the actual performance of the investments in that period to the AIR. If the investments outperform the AIR, the payment increases over the prior period's payment. If the investments earn less than the AIR, the payment decreases from the prior period's payment. Finally, if the investment performance is equal to AIR, the payment remains the same as for the last period.

Although some variable annuity contracts specifically state the AIR, others allow the contract holder to choose an AIR from a range that is subject to state regulatory limits. The benefit of choosing a lower AIR is that payments are likely to increase faster with good investment performance. They will also decline slower than if a higher AIR was chosen. Although the selection of the lower AIR may seem advantageous, the initial income payment will be less than for a higher AIR.

If the owner chooses a stream of payments as the annuity option, there are a number of choices regarding how long the payments will last. The amount of each periodic payment will depend, in part, on the time period that is selected for receiving payments. It is important to note that once the choice of payment is made, it cannot be changed. Furthermore, some annuities do not allow withdrawals of additional money from the account once regular annuity payments have started.

The options for receiving annuity income payments are similar to those that are available for other types of annuities which have already been discussed:

- A life-only option provides income until the annuitant dies.
- A period-certain only option provides income for a fixed period of time, such as 10 or 20 years. If the annuitant dies during the specified period, payments continue to the **beneficiary**, or the beneficiary can choose to receive the value of the remaining payments in a single sum.
- A life annuity with period-certain option provides income until the annuitant dies. If the annuitant dies during the specified period certain, the insurer will continue income payments to the beneficiary for the remainder of the period certain.
- A joint and survivor annuity is an annuity on two lives, and provides income to the annuitant and joint annuitant until they both die.
- A joint and survivor with period certain provides the annuitant and the joint annuitant with a fixed income for a specified period, such as 10 or 20 years. If both joint annuitants die during the specified period, payments continue to the beneficiary or the beneficiary can choose to receive the value of the remaining payments in a single sum.

When payments are made from a variable annuity, the earnings are taxed at ordinary income tax rates. If the annuity contract is applied to provide a stream of periodic payments, each of those payments will be considered partly taxable as earned income at ordinary income rates, and partly excludable as a return of cost basis based on an IRS calculation called an exclusion ratio.

E. Riders and Living Benefits

Variable annuity benefit riders have become a very popular [contract](#) option and are added to more than 80% of contracts sold today. Some commonly offered riders are described below. Each rider carries a separate charge that will increase the cost of the annuity

1. Death Benefit Riders

As we have already reviewed, most variable annuities offer a standard [death benefit](#) during the accumulation period of the [contract](#). This standard death benefit is named the **guaranteed minimum death benefit, or GMDB**, and uniquely allows variable annuity contract owners the opportunity to invest in the stock market for growth while protecting their families from financial loss in the event of untimely death. Over the past 10 years, a number of enhanced death benefits have been offered by variable annuity manufacturers. These enhanced GMDB riders each include additional charges, usually in the range of .30% to .65% of the contract value annually.

Contract Anniversary or Ratchet. The additional benefit that this rider offers is the opportunity to receive a "stepped-up" death benefit. Under this rider, the guaranteed minimum death benefit may be based on the greater of the following three computations:

1. The contract value at death;
2. Total purchase payments minus withdrawals made to date; or
3. The contract value on a prior specified date, such as the contract anniversary or the date at the end of a 5-year contract period.

The purpose of a stepped-up death benefit is to lock in investment performance and prevent a later decline in the value of the account from eroding the amount that will be left to the heirs. The ratchet GMDB locks in the contract's gains on each of the dates specified (usually each contract anniversary).

Initial Purchase Payment with Interest or Rising Floor. This benefit adds to the standard GMDB an annual increase based on a specified rate of interest. For example, if this benefit were offered, the insurer might add an increase of 1% each year to the greater of the following:

- The [contract](#) value at death; or
- Total purchase payments minus withdrawals made to date.

Some contracts offer the choice of the ratchet benefit described previously or the rising floor; others actually combine the two.

Enhanced Earnings Benefit. This [death benefit](#) is appropriate in situations where the standard death benefit does not offer protection against falling markets. With this feature, known as the EEB, beneficiaries receive the base death benefit amount, plus some additional amount that is typically quoted as a percentage of the contract's earnings at death. This separate amount is intended to help offset federal income taxes payable on death based on the gains in the contract.

2. Guaranteed Minimum Living Benefit Riders

Living benefit riders add value to the variable annuity proposition by offering protection against investment risk, and by guaranteeing the level of a number of different benefits. It was the development and offering of these living benefits that led to the surge in popularity of variable annuity contracts. In addition to their availability at the time a new contract is purchased, some companies are permitting these riders to be added to existing contracts as a later date. There is an additional charge for these riders, typically expressed as an asset based charge against the contract value.

Our discussion will cover a number of these benefits that are currently available, but keep in mind that there is continued innovation in these benefits. Also, keep in mind that although these riders follow the same general benefit pattern and design, rider names and features vary from contract to contract. There are likely to be differences in provisions, benefits and costs from insurer to insurer.

Guaranteed Minimum Income Benefit (GMIB) riders guarantee a minimum return on the investments in subaccounts. Based on this return, the annuitant is guaranteed a minimum amount of lifetime income at retirement regardless of how the investments have performed. It typically applies to life, life with period certain, and joint life annuitization options. The minimum guaranteed amount is based on the amount that has been invested plus a credited interest rate that has recently been in the range of 4 – 5%. The benefit is available only at annuitization and usually requires a minimum holding period of 7 to 10 years before it can be exercised, and also may have age restrictions. For example, this rider might guarantee that a monthly payment will never be less than 75% of the first payment. If the first payment to the annuitant was \$1,200, this rider guarantees that monthly payments will never be less than \$900, regardless of how the investments in the subaccounts perform.

Guaranteed Minimum Withdrawal Benefit (GMWB) riders guarantee a return of all premiums paid, regardless of how the investments in the subaccounts perform. It also guarantees that a certain percentage of the amount invested can be withdrawn annually until the invested amount is exhausted. The withdrawal percentage is based on age, but is generally in the range of 5-7%. The annuitant must make annual withdrawals, because this rider does not return the premiums paid as a lump sum payment. For example, suppose the annuity owner has paid \$100,000 in premiums for a variable annuity and purchased a rider that guarantees a 6% withdrawal rate. The rider guarantees that \$6,000 can be withdrawn (or 6% of the \$100,000 paid in premiums) annually without penalty even if the investments in subaccounts have done so poorly that the annuity is only worth \$70,000. The total amount of withdrawals is limited to the premiums paid or \$100,000 in this example, so this benefit does not guarantee income for life.

Guaranteed Lifetime Withdrawal Benefit (GLWB) riders protect against investment losses in the subaccounts and guarantee income for life. They guarantee that the annuitant can withdraw a percentage of the original principal each year without penalty for life, regardless of how the investments in subaccounts perform. The amount that can be withdrawn typically depends on the age at which the withdrawals are started, and ranges from 2% to 8% in contracts that are currently available.

For example, suppose the annuity owner has paid \$100,000 in premiums for a variable annuity and purchased a rider that guarantees a 6% withdrawal rate. The rider guarantees that the annuitant can withdraw a minimum of \$6,000 annually for life (or 6% of the original \$100,000 investment), even if the annuity account value goes to

zero. The percentage that can be withdrawn is usually based on the annuitant's age and the annuity benefit base value. A recent addition to this rider is the availability of spousal continuation, which guarantees the payments for the lives of 2 individuals. These are usually the most costly of the income benefit riders and have an average annual cost in the range of .90% to 1.25% of contract value.

Guaranteed Minimum Accumulation Benefit (GMAB) riders guarantee that an annuity will be worth a minimum amount by a set date, even if the investments in the subaccounts do poorly. For example, this rider might guarantee that an annuity will earn at least 5% a year by the end of 10 years. If at the end of 10 years the annuity has only earned 3% a year, the insurer will add the difference. Many GMAB riders require that certain asset allocation strategies be followed for rider eligibility.

Standalone Lifetime Benefits (SALB) Riders are innovations that came to market in 2008. These riders basically offer the same features as guaranteed lifetime withdrawal benefit (GLWB), which allows the [contract](#) holder to withdraw a fixed percentage of the total annuity premiums each year regardless of market performance, and for life. The SALB has been stripped away and exists independently of a variable annuity. Instead, it can be added to a pool of money or assets that are professionally managed. The owner of a professionally managed private investment account who purchases a SALB would have all the features and protections of the GLWB.

For example, assume that a person with \$500,000 purchases a SALB that pays 5%. This person would be able to receive the 5% guaranteed income stream for life. The actual amount of the income stream would be \$25,000 (\$500,000 x 5%), and this amount would not be affected if the value of the \$500,000 portfolio decreases.

Some SALBs offer an annual step-up so that the income stream can increase if market [conditions](#) are favorable and the value of the portfolio increases. With a step-up feature, if the contract holder's portfolio value in our example increased to \$600,000, the income would increase to \$30,000 per year.

The SALB contract holder also has the ability to choose when to apply or remove the guarantee. SALBs also are available with spousal options, but there is little to no [death benefit](#) protection available. Many SALBs have minimum asset requirements.

The cost of an SALB is based on a number of factors, with equity market volatility being a substantial factor: the more equity in the portfolio, the higher the fee that is charged.

SALBs are not widely available yet, but with the decline of defined benefit plans and retirement income concerns, they offer an interesting option and are likely to gain more attention due to their lifetime income guarantee.

Long-Term Care (LTC) Protection Riders have been offered to help address the increasing concerns that Americans have about elder care. Some annuities allow the purchase of a rider, at an extra cost and with its own unique eligibility requirements and benefit periods, that increases the annuity's value and makes funds available to help pay for unexpected health expenses such as confinement in a **skilled nursing facility** or **hospice care**. These riders are relatively easy to qualify for and are affordable, especially compared to the purchase of a LTC policy. The charge for the rider is determined by the age of the owner at the time of issue.

Nursing Home Waiver vs. LTC, Hospice, or Skilled Nursing Facility Rider: Many annuities offer a surrender charge waiver if the annuitant is confined to a skilled nursing facility for a minimum period of time. While this is a good feature to have because it can mitigate the effect of surrender charges when someone is confined to a nursing home, it should be understood that this is a surrender charge waiver, not an LTC [rider](#). This surrender charge waiver does not provide any LTC coverage, and the [contract](#) benefits are "spent down" to pay for long-term care. Also, the surrender charge waiver usually requires confinement, whereas a qualified LTC rider will pay for additional health services including skilled nursing facilities, home health care, hospice care, respite care, etc.

Due to a provision in the Pension Protection Act of 2006, distributions from annuity assets and these types of LTC rider benefits receive tax-free status when used for qualified purposes. This has led to increasing interest in these contract provisions.

F. Variable Annuities and Suitable Sales

Before a variable annuity is purchased or recommended, it is important to learn as much as possible about how it works, the benefits it can provide, and the advantages and disadvantages to ownership.

1. Application

Meet Tina. At age 58, Tina is laying down plans for retirement, which she confidently says begins in 2 years' time. Her strategy centers on her 401(k) savings, her Roth IRA and she is thinking of adding a variable annuity to the mix. She likes the idea of access to professional money managers who can manage her savings to achieve a moderate growth objective. With the fears and losses of recent market volatility still fresh in her mind, she is interested in guarding her savings against a down market. Other key concerns include ensuring that she will not outlive her money, and maximizing her income without having to worry about day-to-day market fluctuations.

After working with her financial advisor, Tina decides to commit \$250,000 of her savings to a variable annuity. She has chosen to invest in a conservative model portfolio, and is confident in the track record of the money manager associated with this portfolio. She has also purchased a GLWB [rider](#). This rider alleviates her concerns for lifetime income, as it ensures that she will receive a paycheck for as long as she lives, regardless of how the market performs. The rider has a step-up feature that may add to the income she receives if the market achieves certain gains as stipulated in the [contract](#). Tina is feeling more confident than ever that she can achieve her retirement goals, and that she can face that future with confidence.

It seems like Tina has made an excellent decision in adding a variable annuity to her retirement portfolio. Her financial advisor seems to have placated her concerns and appropriately matched her investment objectives with a product that meets her needs. In helping her understand the product choice, its potential risks and rewards, Tina's financial advisor will have a satisfied client.

However, variable annuities are not appropriate for every retirement need, or every client. The following questions are helpful to discuss with potential customers in determining whether a variable annuity purchase is a suitable product choice:

- Will the variable annuity be used primarily to save for retirement or a similar long-term goal?
- Is the buyer willing to take the risk that account value may decrease if the underlying mutual fund investment options perform badly?

- Does the buyer understand the features of the variable annuity?
- Does the buyer understand all of the fees and expenses that the variable annuity charges?
- Does the buyer intend to remain in the variable annuity long enough to avoid paying any surrender charges if there is a need to withdraw money?
- Are there features of the variable annuity, such as long-term care insurance, that could be purchased more cheaply separately?
- Are all tax consequences of purchasing an annuity, including the effect of annuity payments on tax status in retirement, favorable to the buyer?

2. Seven Advantages of Variable Annuities

1) **Numerous Investment Options:** Variable annuities offer a broad spectrum of investment choices within one investment vehicle. The range of subaccount investment options and combinations that are available on the market today are virtually limitless. The value of the annuity owner's investment will vary depending on the performance of the investment options chosen, but there is flexibility within the [contract](#) to [transfer](#) funds among the investment options.

2) **Tax Deferral:** Variable annuities offer a tax deferred accumulation period with no maximum contribution limit. Tax-deferred growth allows annuity contracts to build cash value more quickly, which is a considerable advantage when saving for retirement. There are also no limits on the amount that can be invested in a variable annuity. Other tax-deferred vehicles like IRAs and 401(k) plans have annual limits.

3) **Flexibility in Investment Choices:** Chosen investment options can be adjusted to meet changing investment objectives. Variable annuities offer the opportunity to change investment allocations on a periodic basis or according to a predetermined schedule. Professional rebalancing can minimize questions about when to buy and sell.

4) **Alternative Fee Structures:** Purchasers of variable annuities can choose from different fee structures and share classes to align with investment objectives. There are five alternative share class and sales charge structures. Investors can choose the surrender charge that allows them to meet their liquidity needs and/or minimize the sales charges that are paid.

5) **Professional Management:** Well-known and accomplished professionals manage investments in variable annuities. The subaccounts and model portfolios that are available through variable annuities are often not accessible by small investors with limited investment dollars. The investment expertise enables person who are less confident in investing themselves to fully delegate the portfolio management process to professional money managers.

6) **Living Benefit Riders:** Customers can purchase living benefit riders that guarantee income for life. In spite of the investment volatility that may have an impact on variable annuity contract value, riders can be added to offset market risk. They can ensure that retirement income will not be outlived, regardless of market performance. They can also add death benefits that exceed those that are standard in the contract, and accumulation benefits that ensure that owners can participate in market upside by receiving benefit increases periodically based on contract performance.

7) **Death Benefits:** Contracts include death benefits that protect the original investment if the owner dies prior to annuitization. Variable annuities typically include a standard death benefit. In the event of death before payments begin, a [beneficiary](#) is guaranteed to receive a specified amount – typically at least the amount of the purchase payments. This benefit is especially valuable if at the time of death, the

account value is less than the guaranteed amount, and truly sets variable annuities apart from other investment choices.

3. Seven Disadvantages of Variable Annuities

1) **High Fees:** Variable annuities are notorious for charging high fees. There are a number of fees that are charged against the [contract](#) value, which can make ownership of these investments costly. The guarantees associated with variable annuities are often well worth the price, but the owner needs to understand the fees before purchasing the contract.

2) **Limited Liquidity:** Surrender charges reduce liquidity. Variable annuity buyers may be subject to surrender charges for up to 10 years. Investors that need liquidity in the short-term should probably not invest in variable annuities. Like all annuities, they should be considered long-term investment vehicles. There are different share class options that can offer full liquidity in a shorter time frame, but they may be more costly.

3) **Subject to Market Risk:** Variable annuity contract value is subject to market risk. The performance of the subaccounts within variable annuities is subject to market risk, unless the owner chooses fixed account options. Although additional riders can guarantee lifetime contract value, the value itself is subject to market risk.

4) **Complicated Features:** Variable annuity products are highly complex. The product complexity exceeds many investors' ability to truly understand its features. Investors do not always understand the features and restrictions of the contract, and may make choices that are not in their best interest as a result. Unless financial advisors take time to educate and reinforce contract features, investors may not fully understand how the contract fits their long-term needs.

5) **Too Many Choices:** Too many variations and choices make selection overwhelming. The incredible variety of investment choices and options available in variable annuities can also become a deterrent to their purchase. Overload of information and too many decisions associated with the purchase process can keep people from making an important and appropriate long-term move.

6) **Unfavorable Tax Treatment:** Certain IRS tax penalties and disadvantages may apply to withdrawals from variable annuities. The IRS will charge a 10% tax penalty for any income withdrawals before the age of 59 ½. In addition, while tax-deferred growth is of great benefit to accumulation, when the earnings are withdrawn, they are subject to taxation as ordinary income. They are not eligible for the more favorable capital gains treatment.

7) **Forced Investment Changes:** During adverse market [conditions](#), investments in variable annuities may be subject to restrictions. Insurers that issue these contracts must protect themselves from the risk of adverse market conditions that affect their ability to pay contract guarantees. As a result there are many variable annuity contracts that place limits on the equity [exposure](#) the can be chosen for certain contracts, and there are times when the insurance company may use automatic rebalancing to fixed accounts offset its risk. These restrictions may inhibit the ultimate investment potential of the contract. Agents should review the circumstances under which these investment restrictions apply with clients prior to purchase.

Chapter Complete

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