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The Importance of Sustainable Retirement Savings

A. Retirement Income Planning & Concerns

1. Retirement Planning Options

We've all heard the statistics: Our nation has reached a retirement demographic milestone. The first of the baby boomers reached the age of 65 on January 1, 2011, and 7,000 more are turning that age each day. An estimated 79 million individuals will participate in this retirement boom between now and 2029. Many individuals who are grouped within this "silver tsunami" are approaching retirement with fears and worries that did not exist in previous generations. The well-publicized concerns of this group center on not having sufficient financial assets to live successfully in retirement.

Probably the greatest impact on retirees today is the blessing and possible curse of living longer than ever. Life expectancies have increased dramatically. Today, the average 65-year-old male is expected to live 17.2 years to age 82; the average female for 19.9 years to nearly 85. Moreover, for married couples, where each spouse has reached the age of 65, there is a 57% chance that one spouse will live to age 90, and an 11% chance that one spouse will live to age 100. When approaching retirement, many people do not fully realize that the assets they have accumulated, and other outside retirement income sources, may need to last for 30 or more years. These extended retirements also increase the strain on government programs, which are already on shaky ground. In fact, it is a sign of these times that, according to a recent survey, the number one concern of those nearing or living in retirement is whether their money will last – 96% of retirees say it is their biggest worry. Other trends also influence traditional approaches to retirement income planning.

Pension Plans

Pension plans were once a primary source of retirement income for many Americans. Today, traditional defined benefit and defined contribution pension plans have become the exception rather than the rule. Consider that in 1985 there were more than 114,000 private pension plans maintained by corporations for their employees. Today, this number has fallen to 38,000. Although 401(k), 403(b), and 457 plan participation has grown rapidly, these plans do not guarantee a lifetime of income, and many of their balances are far below the amount needed to support life in retirement. Government employees are one of the few employee groups that continue to enjoy this type of pension benefit.

Social Security

Retiring workers rely heavily on Social Security benefits. However, the newspapers and airwaves have relayed countless stories about the uncertain future of this system.

Yes, Social Security has money problems, and after continuing benefit payments at current rates, the program's trust fund could be depleted by the year 2037. At that time, Social Security will be able to pay only about 78¢ on the dollar. It is no wonder we have come to this point when you think of the origin of Social Security in 1935. Consider that in 1930, the life expectancy at birth for men was age 58, and for women it was age 62. The Social Security designated retirement age was 65! Because life expectancies increased greatly since then, many people of this era have lived long years in retirement.

There is substantial emphasis on improving the future of the Social Security system. Increasingly, individuals are advised to delay the receipt of benefits to age 70 to increase their payout amounts, and to continue working longer. Establishing delays in the retirement age (currently 67) are another method of addressing this issue, and other options, such as limiting payments and increasing taxation on those in higher income brackets, are continually evaluated. In any case, it is clear that Social Security is important to many for a comfortable retirement, but that there will be changes to the benefits it delivers in the future.

Cost of Health Care and Inflation

Two other concerns rank very high on the list of those living in or nearing retirement. As you might guess, they are the cost of health care and inflation. Healthcare costs continue to grow, and it is estimated that on average, a healthy 65-year-old couple will need \$260,000 just to pay for healthcare and long-term care costs for the remainder of their lives. Medicare provides substantial coverage for most over the age of 65, but it is not complete, and the cost for Medicare and other medical and long-term care coverages continue to grow at a rapid rate.

Since the financial turmoil of 2008-2009, inflation has had less impact than in years past. However, it is certain to reappear with a growing economy, and it is recommended that retirement plans should factor in an average inflation of rate of 3%. The detrimental effect of inflation can take a healthy retirement balance and reduce its value and buying power dramatically over a long retirement.

Every one of the issues just described places significant stress on funds available for retirement income. However, with a good planning process and continued commitment to preparation for the future, the risks can be mitigated.

2. Annuities in Retirement Planning

How do annuities fit into this rather bleak retirement picture of the future? Annuities and the features they provide are a strong and worthy financial choice for the mitigation of these retirement risks, and should be considered for a portion of the retirement assets of nearly every retiree today.

Annuities offer unique value propositions that are unavailable in other financial product alternatives. Their guarantees can erase the fear of running out of money no matter how long an individual or a spouse may live. They offer tax-deferred growth that can help assets accumulate faster. They pay death benefits to beneficiaries that ensure that no less than the principal invested is paid from the contract.

There are other less advantageous considerations with these products. For example, they are known to have high fees, limited liquidity, and may require that control of funds be given to the insurance company for a defined period. They also pay high commissions compared to certain other financial products. In spite of all the good they can provide, annuity products are not appropriate for all situations. In addition,

annuities have been sold improperly by financial representatives who have not kept the best interest of customers in mind.

NAIC Suitability in Annuity Transaction Model Act

The protection of the financial assets that individuals have accumulated for retirement is a primary concern of financial regulators. They are committed to protecting against bad retirement planning advice and sales motivated by greed alone. As such, there is continued evolution in regulatory requirements that apply to representatives who provide retirement advice, and in particular those who work with seniors. A critical focus over recent years has been on suitability of annuity sales, and **the NAIC 2010 Suitability in Annuity Transactions Model Act** is especially centered on this important topic.

As stated in an executive summary prepared by participating commissioners, the National Association of Insurance Commissioners (NAIC) adopted the Model Regulation *“to set standards and procedures for suitable annuity recommendations and to require insurers to establish a system to supervise recommendations so that the insurance needs and financial objectives of consumers are appropriately addressed.”*

Three primary objectives of the Model Annuity Suitability Act include

1. The establishment of a regulatory framework that holds insurers responsible for ensuring that annuity transactions are suitable;
2. The requirement that producers be trained on the provisions of annuities in general, and the specific products they are selling; and
3. The intention of creating consistency with suitability standards imposed on registered financial products by Financial Industry Regulatory Authority (FINRA) whenever possible.

Industry Regulation

Individuals within the financial industry today recognize the vast opportunity this retirement need presents. With this incredible opportunity comes the responsibility to ensure that the products and services that are recommended are appropriate for the needs of these individuals. Bad financial decisions can steal "golden years" away from persons that have worked all of their life to attain their retirement dream.

Unscrupulous practitioners can urge trusting and vulnerable seniors into inappropriate investments that are solely motivated by greed. With the plethora of financial products in the market today, many people rely heavily, sometimes with blind trust, on advice from others in making critical life decisions. It is because of these concerns that financial industry regulators have focused on the protection of consumers who are considering the purchase of these products.

B. Guaranty Associations

Guaranty Associations are formed to protect policyowners, insureds, beneficiaries, and anyone entitled to payment under an [insurance policy](#) from the incompetence and insolvency of insurers. The association will pay covered claims up to certain limits set by state law. The Association is usually funded by its members (through assessment). All authorized insurers, which are required to be the members of the Association, contribute to a fund to provide for the payment of claims for insolvent insurers.

The Guaranty Association, under the direct supervision of the state department of insurance, usually is required to maintain **separate accounts** for each type of products: life insurance, annuities, and health insurance. The liability of the Association may not

exceed the lesser of the contractual obligations for which the insurance company is liable or a specified dollar amount (which varies by state and type of coverage).

1. California Life and Health Insurance Guarantee Association (CIC 1067-1067.19)

The California Life and Health Insurance Guarantee Association is designed to protect consumers against the failure of insurance companies to fulfill contractual obligations under life and annuity contracts due to financial impairment or insolvency.

To provide this protection, an association of insurers has been created to pay benefits and continue coverage. **All admitted insurers in California are required to be members of this association**, and are assessed membership fees in proportion to the amount of premiums written, to provide funds to carry out the purposes of the association.

The association performs its functions under an approved plan of operation and exercises its powers through a board of directors.

Protection is afforded to California life, health, and annuity policyowners, contractholders, and their beneficiaries, assignees, and payees. The association provides coverage for direct, nongroup life, health, or annuity policies or contracts, and supplemental contracts to any of these, and for certificates under direct group policies.

Annuity contracts and certificates under group annuity contracts include allocated funding agreements, structured settlement annuities, and any immediate or deferred annuity contracts.

The benefits for which the association may become liable for life insurance and annuity policies in no event may exceed the **lesser** of the following:

- 80% of the contractual obligations for each policy or contract for which the insurer is liable or would have been liable if it were not impaired or insolvent;
- With respect to any one life, regardless of the number of policies or contracts:
 - \$300,000 in life insurance death benefits, but not more than \$100,000 in net cash surrender and net cash withdrawal values for life insurance;
 - \$250,000 in the present value of annuity benefits, including net cash surrender and net cash withdrawal values;
- With respect to each payee of a structured settlement annuity, or beneficiaries of the payee if deceased, \$250,000 in present value annuity benefits including net cash surrender and net cash withdrawal values.

When a member insurer becomes impaired, the association may:

- Guarantee, assume, or reinsure, or cause to be guaranteed, assumed, or reinsured, any or all of the policies or contracts of the impaired insurer;
- Provide moneys, pledges, loans, notes, guarantees, or other means and assure payment of the contractual obligations of the impaired insurer; and
- Provide notice of termination of benefits and make efforts to provide annuitants with replacement or substitute coverage.

The commissioner oversees the Guarantee Association and has the following rights and duties:

- When an impairment is declared and the amount of the impairment is determined, serve a demand upon the impaired insurer to make good the impairment within a reasonable time;
- In any **liquidation** or rehabilitation proceeding involving a domestic insurer, be appointed as the liquidator or rehabilitator;

- Suspend or revoke, after notice and hearing, the [certificate of authority](#) to transact insurance in this state of any member insurer which fails to pay an assessment when due or fails to comply with the plan of operation.

To aid in the detection and prevention of insurer insolvencies or impairments, the Commissioner must notify the commissioners of other states when a member insurer has its license revoked or suspended, or when the Commissioner formally orders a member company to restrict its premium writing, obtain additional contributions to surplus, withdraw from the state, reinsure all or any part of its business, or increase capital, surplus, or any other account for the security of policy owners or creditors.

The Commissioner must report to the board of directors when he or she has reasonable cause to believe from any examination that a member company may be an impaired or insolvent insurer.

According to the California Insurance Code (CIC) 1067.17, agents may not publish or make any claims, written or oral, which use the existence of the California Life and Health Insurance Guarantee Association for the purposes of inducing the purchase of an insurance or annuity [contract](#) or to imply that insurance or annuity contracts are in any way financially backed or "guaranteed" by the Association.

Insurers must provide a standard document prepared by the Guarantee Association describing the general purposes and limitations of the Association coverage to the [policyowner](#) or contractholder at the time of delivery of the policy or contract. The document must be available upon request of the policyowner or contractholder, and must not be used to imply that the policy or contract would be covered in the event of an insurer impairment or insolvency. The disclaimer must include the following:

- The name and address of the Life and Health Insurance Guarantee Association and insurance department;
- A warning that the California Life and Health Insurance Guarantee Association may not cover the policy or, if coverage is available, it will be subject to substantial limitations and [exclusions](#) and conditioned on continued residence in the state;
- That the insurer and its agents are prohibited by law from using the existence of the California Life and Health Insurance Guarantee Association for the purpose of sales, solicitation, or inducement to purchase any form of insurance; and
- That the policyowner or contract owner should not rely on coverage under the California Life and Health Insurance Guarantee Association when selecting an insurer.

C. California Annuity Training Requirement (CIC 10509.915)

Even before the NAIC acted on annuity suitability, California required producers selling individual annuity products to receive detailed training on sales and suitability practices. These rules have been in effect since 2004.

An insurance producer may not solicit the sale of an annuity unless the producer has adequate knowledge to recommend the annuity purchase and is in compliance with the insurer's standards for product training.

An insurance producer may rely on insurer-provided product-specific training standards and materials to comply with this requirement.

A licensed life producer must complete a **one-time 8-hour annuity training** course provided by an approved education provider, before transacting annuity business.

In addition, every producer who engages in annuity sales in California must complete **4 CE credits** of annuity training prior to license renewal **every 2 years**.

The required training must include all of the following topics:

- The types of annuities and various classifications of annuities;
- Identification of the parties to an annuity;
- How fixed, variable, and indexed annuity [contract](#) provisions affect consumers;
- The [application](#) of income taxation of qualified and nonqualified annuities;
- The primary uses of annuities; and
- Prohibited sales practices, the recognition of indicators that a prospective insured may lack the short-term memory or judgment to knowingly purchase an insurance product, and fraudulent and unfair trade practices, as well as California replacement and [disclosure](#) requirements.

Courses must cover all topics listed in the prescribed outline and not present any marketing information, sales training or specific information about a particular insurer's products. Additional topics may be offered in conjunction with and in addition to the required outline.

Annuity course providers must register as a California CE provider and must comply with CE course rules and guidelines, including certification and reporting requirements. Courses may be completed by classroom or self-study.

An insurer is required to verify that an insurance producer has completed the annuity training before allowing the producer to sell an annuity product for that insurer. An insurer may satisfy its responsibility under this paragraph by obtaining certificates of completion of the training course or obtaining reports provided by commissioner-sponsored database systems or vendors or from a commercial database vendor that has a reporting arrangement with approved education providers.

D. Importance of Reviewing Sample Contracts

It is important for the consumer to know whether an annuity fits their situation before entering into a [contract](#). A best practice is for the agent to review sample contracts with the prospective insured so they are fully informed about the contract's features and benefits.

Individual needs change with time and what may have benefited them in the past may not be in their best interest now. Clients must consider their long-term goals, including whether they:

- Might need access to the money for unexpected family emergencies;
- Might need access to the money for long-term care or health care;
- Can afford to lock up these funds for a period of several years.

Some annuity products carry high surrender charges during the initial years the contract is in force. Always discuss the drawbacks as well as the benefits. California requires individual annuity contracts for seniors to contain a [disclosure](#) regarding the surrender charge period unless the contract does not contain surrender charges.

E. About this Course

This course is designed to meet California's 8-hour annuity suitability training requirements, as created by the following:

- SB 620 (Chapter 547, Statutes of 2003), Annuities: life insurance: required disclosures and prohibited sales practices and how annuities affect Medi-Cal as stated in SB 483 (Chapter 379, Statutes of 2008). Medi-Cal: home and facility care; and
- AB 689 (Chapter 295, Statutes of 2011) Insurance: annuity transactions.

It is designed to help you improve your understanding of annuity products and features so that you confidently and appropriately recommend suitable solutions for your customers. Through studying and contrasting various types of annuities and reviewing customer situations, it will heighten your awareness of how and when certain products and features may fit well with a client's needs. It will explain both the benefits and the risks associated with each product type to help you give fair and balanced product presentations to your customers.

The course will explore the following topics with an emphasis on how knowledge of these topics impacts the sales process and the determination of suitability:

- Annuity basics and terminology;
- Parties to annuity contracts;
- Product overview, including fixed, immediate, index and variable annuities;
- Annuity Taxation;
- Annuity Replacements and Exchanges; and
- The Producer's Role in Suitable Sales.

The retirement planning field presents a phenomenal opportunity for financial practitioners today. Your commitment to continued education, professionalism, and just doing the right thing for your customers will help ensure that your career in this field is long and prosperous.

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Annuity Basics and Terminology

At its most basic level, an annuity is simply a [contract](#) with an insurer that guarantees to provide payments to an owner. An annuity contract typically helps individuals accumulate money for retirement, and then provides an income stream to supplement other retirement income sources. Like life insurance, annuity contracts include guarantees that only insurance companies can provide. They are unique compared to other investment opportunities because of these guarantees.

A number of features make annuities attractive and well suited for retirement savings:

- Money is tax-deferred until withdrawn, allowing for potentially greater accumulation of contract value;
- Contracts include guaranteed death benefits payable to beneficiaries that ensure, at a minimum, that no less than original purchase payments are distributed;
- Contract owners can choose from payout choices that include a lump sum, periodic payments or a monthly income guaranteed for life;
- The Federal Tax Code includes a provision that permits the [transfer](#) of annuity contract values between annuities. This is helpful if financial objectives change.

A. Annuity Categories

The process of making suitable recommendations to customers and ensuring their understanding of and satisfaction with an annuity purchase, is heavily dependent on education. Persons who are unfamiliar with annuities sometimes view them as complicated, with features and terminology that are obscure and hard to understand. To ensure that you can provide a simple explanation of how an annuity can benefit your customer, and why it is a suitable solution, you need a solid understanding of basic annuity terminology.

At a high level, the insurance industry categorizes annuities in two ways:

1. How purchase payments are made; or
2. When payments from the annuity begin.

Purchase payments can take the form of a single lump sum, or **single premium**. In other words, the purchase payment is a one-time only deposit that accumulates earnings until a defined date. Other contracts can receive payments on a predetermined, scheduled basis, such as annually, quarterly, or monthly, while still others are open for contributions at any time that the owner wishes to make them. Contracts that receive more than a single payment are **periodic payment** annuities.

At the time of annuity purchase, the owner makes the determination of when payments from the annuity will begin. If the owner has the need for income in the very

near future, and wants the income stream that the annuity generates to begin anywhere from 30 days to 12 months from the date of purchase, the owner must purchase an **immediate** annuity.

A **deferred annuity** is an annuity that either is purchased with a single lump sum (single premium-deferred annuities) or is purchased through periodic payments (flexible premium-deferred annuities). Deferred annuities are unique in that they grow tax deferred. **Deferred annuities are often used to accumulate funds for retirement.** In a deferred annuity the owner will receive the **current interest rate** or the **guaranteed interest rate**, whichever is higher. **Payments from a deferred annuity** begin later in the future sometime after one year from the date of purchase (10 years, 20 years, at age 65, etc.). This time is often consistent with retirement, but varies with the owner's situation and preference. If an annuity is tax-qualified, the annuitant is required to begin minimum required distributions by age 70 ½. Failure to take the required minimum distribution by age 70 ½ will result in a tax penalty. If the annuity is nonqualified, there is no requirement to withdraw the funds at any age except as required by the contract itself.

From these differences in the way annuities are purchased and how made payments are made, three basic annuity categories results. Purchasers of annuities may choose from

- Single premium immediate annuities;
- Single premium deferred annuities; and
- Flexible premium deferred annuities.

When individuals purchase annuities, the insurance company invests the purchase payments to generate earnings that add to the income contract owners ultimately receive. The method of investment and the amount of risk **exposure** that buyers assume further categorizes annuities as either fixed or variable. In fixed annuity contracts, the insurer assumes the investment risk, and promises the annuity owner a conservative rate of return based on a conservative investment portfolio. There is no risk of loss to the annuity owner, and they know exactly what their contracts are worth at all times. Variable annuity contracts offer a greater reward potential to investors, but with the tradeoff of assuming investment risk or potential loss of principal. The insurance company does not guarantee an amount of investment earnings, and they vary directly with market performance.

In combination with the previous categories we identified, we further subdivide annuities by the investment risk the purchaser assumes for 4 general categories:

1. Fixed immediate annuities;
2. Variable immediate annuities;
3. Fixed deferred annuities; and
4. Variable deferred annuities.

Next, we will discuss each category individually, with the objective of demonstrating situations in which they are suitable and customer needs that they serve.

Before we begin the deeper dive into these more specific descriptions, let's review general annuity terminology that applies overall.

B. Annuity Definitions

Several groupings of annuity definitions follow to help you associate these terms appropriately within the annuity lifecycle. These terms will appear within the context

of our product discussions as we proceed through the course. Most annuity contracts include an explanation of some of these key terms to help the owner understand contract nuances specific to that insurer.

1. Contract Terminology

Accumulation Phase – the time during which an annuity owner can add money to the [contract](#). Also referred to as the growth period, it is the time between purchase of the annuity and the beginning of benefit payouts. Principal and earnings accumulate tax deferred during this period.

Annuitization Phase – the time when the insurer makes periodic payments to an annuitant, also known as the distribution period or payout period. Payments can cover a specified period or may be guaranteed for life. During this period, payments may be fixed or variable, and include earnings that are taxable to the annuitant.

Annuitize – the time at which the contract owner trades the accumulation value of the annuity for a stream of payments paid for a defined period of time or over the life of one or more annuitants.

Annuitant – the person whose life expectancy is used to calculate the income payment amount on the annuity. That is why the annuitant must be a natural person. The annuitant and the contract owner are usually the same individual.

Annuity Owner – the person(s) who have contract authority. The owner selects from investment options, designates beneficiaries, and may withdraw, surrender or change annuity benefits. The annuity owner often is the recipient of payments from the annuity in the annuitization phase.

Joint Annuitant – an individual in addition to and together with the annuitant, whose age and life expectancy determine the amount of the annuity payments.

Joint Owner – an individual who shares ownership of an annuity contract and possesses the same rights as the contract owner to approve any contract decisions.

Maturity Date – the latest date at which an annuity must be converted to income payments (or annuitized).

Contract Anniversary – the same day and month as the contract issue date for each year the contract remains in force.

Contract Issue Date – the [effective date](#) of the contract, which determines future contract years and contract anniversaries.

Contract Year – a 12-month period beginning any contract anniversary date.

Free-Look Period – An annuity contract provision that provides a period after contract issue for the owner to examine the annuity contract with the option of returning it to the insurer for a full refund (usually 10 to 30 days).

Surrender – the act of termination of an annuity contract by the owner. All accumulated interest is usually be taxable to the owner at time of surrender, and the IRS 10% tax penalty will apply if the owner is not yet 59½ years of age, unless an IRS exception applies.

Surrender Value – the amount of contract value available for withdrawals or for early termination. This value is reduced by applicable fees if the contract value is accessed in the early years of the contract.

Surrender Charges – charges imposed by the insurance company for withdrawal of contract value before the end of the surrender charge period. Surrender charges typically are a percentage of the total premium deposited, and decrease to zero over a period of years defined in the contract (often 5 – 10 years). Many companies allow an annual free withdrawal amount, such as 10% of contract value, annually during this period. A new surrender charge period may apply to each subsequent contribution.

Premature Distributions – also known as early or partial withdrawals, these occur prior during the accumulation phase of the annuity. Owners must report withdrawals as income and are subject to ordinary income tax treatment. If withdrawals are made prior to age 59½, they may be subject to an additional 10% federal income tax penalty. Insurer imposed surrender charges may also apply.

Minimum Guaranteed Surrender Value (MGSV) – the minimum value paid to the annuitant in the event of death, surrender, or low performing investments. The National Association of Insurance Commissioners (NAIC) has mandated that MGSVs on annuities cannot credit anything less than 1% interest on 87.5% of the premiums paid on the annuity. However, as much as 3% interest can be credited on 100% of the premiums paid on the annuity. There is a direct inverse correlation between the richness of the annuity's MGSV and the potential for gains on the contract; in other words, the higher the guaranteed minimum, the lower the potential investment gains credited to the contract.

Rider – an optional benefit, also called an [endorsement](#), that is added to a base annuity contract and changes the annuity's terms, features, or conditions.

Settlement Options – the methods by which the insurer may pay annuity proceeds to the annuitant, contract owner, policy owner or [beneficiary](#). The options are many and may include payout periods that guarantee income for life to one or two annuitants, beneficiary protection, or specified periods.

Term certain option – an annuity payout option, also known as a period certain or fixed period, that distributes income payments over a set number of years.

Systematic Withdrawals – payout strategy that allows withdrawals from the accumulated annuity contract value on a regular schedule. Flexible withdrawals are also permitted.

Collateral Assignments – the [transfer](#) of the ownership rights in the contract to another person to serve as collateral for debt. When this provision is invoked, there is typically another provision that reverts the ownership rights back to the original owner upon debt repayment. This is considered a taxable event to the owner of the contract.

Proof of Death – proof that may be required for payment of contract benefits, particularly death benefits. Acceptable proof may consist of a certified copy of the death record, a certified copy of a court decree reciting a finding of death or any other proof defined as satisfactory to the insurer.

A.M. Best Rating – an independent analysis of an insurer's financial strength and ability to meet its ongoing [insurance policy](#) and contract obligations, as provided by the firm A.M. Best.

2. Annuity Contributions and Interest Rate Terms

General Account – The insurance company portfolio used for the investment of purchase payments from fixed contracts. This portfolio is usually invested in safe,

conservative, guaranteed investments, such as government securities, real estate and mortgages.

Separate Account – The insurance company investment portfolio that supports variable annuities. It is kept separate from the insurance company's regular investment accounts and is invested more aggressively than the general account.

Subaccounts – The various investment portfolio options in which variable annuity payments are invested. The annuity owner chooses which subaccounts to invest in and how much to allocate to each.

Simple Interest – The interest crediting method in which interest is only credited on the principal payment, not on the interest accrued.

Compound Interest – The interest crediting method in which interest is credited on the principal payment, in addition to on the interest itself.

Current Interest Rate – The interest rate that an annuity is paying, including the sum of the base rate and the bonus rate, if any. The current rate is set by the insurance company at the time of contract issue and is guaranteed for specific length of time.

Floor – The minimum amount of interest credited to an annuity each year.

Guarantee Period – The period of years that an interest rate is guaranteed on a multi-year guaranteed annuity.

3. Annuity Features and Fees

Death Benefits - Payments made to beneficiaries or the annuity owner's estate if death occurs before the annuity matures. The benefit that is payable varies with the [contract](#), but is an important feature that differentiates annuities from other retirement savings alternatives.

Surrender Charge Waiver - A feature that permits the annuitant to withdraw a portion of the annuity value without the imposition of surrender charges in the event of certain triggers. These triggers vary by contract and can include death, disability, nursing home confinement, terminal illness, unemployment, and natural disaster.

Return-of-Premium (ROP) Option – This annuity feature guarantees a return of the full premiums paid in the [contract](#) to the annuity purchaser, at any time.

Bailout Option – This annuity contract provision allows the contract owner to surrender the contract without a surrender charge applying, if renewal interest rates or index cap rates fall below a pre-determined level. It is designed to alleviate concern of locking money away and giving up control.

Administrative Fee – An optional charge that covers the cost of issuing and maintaining the contract. These fees often apply to small contracts that are below an established purchase payment amount, and may be applied at the time of issue or on an annual basis.

Mortality and expense risk charge (M&E) – This fee covers the insurance guarantees included in an annuity contract, including the [death benefit](#), the choice of guaranteed lifetime payout options, and the guarantee that insurance charges will not increase.

Recapture Charge – A feature that applies to annuity contracts with premium bonuses, which causes a forfeit of all or a portion of the premium bonus in the event of withdrawal in excess of the penalty-free amount, during a specified period.

Premium Tax – a tax on annuity premium payments that some states impose on insurance companies.

Market Value Adjustment (MVA) – This feature is usually applicable to fixed deferred annuities, and is triggered when certain withdrawals are taken. If it is applicable, the MVA causes an increase or decrease to the withdrawal amount or the contract value of the annuity if more than the penalty-free amount is withdrawn or if the contract is surrendered during the surrender charge period.

Exclusion Ratio – This ratio applies to nonqualified contracts only, and determines which portion of an annuity distribution is considered earnings and which portion is a return of the original investment. The portion consisting of earnings is taxable as ordinary income to the annuitant. The portion that is considered a return of principal is not taxable.

C. Parties to Annuity Contracts

An annuity [contract](#) involves interaction between four distinct parties. These parties are

- The owner;
- The annuitant;
- The beneficiary; and
- The issuing insurance company.

1. The Insurance Company

Several hundred U.S. insurance companies offer and issue annuity contracts to the public. In return for purchase payments, they assume a number of financial obligations to the other parties of the contract, the owner, the annuitant, and the [beneficiary](#). The insurance company that issues an annuity contract promises to invest the owner's purchase payments responsibly, credit interest to the contract value of the annuity, pay the settlement option selected by the contract owner, and pay death benefits to the beneficiary or beneficiaries at death.

It is a very important [consideration](#) in ensuring suitable annuity sales that the insurer that issues and backs the contract is financially strong. Many consumers rely on the ratings provided by independent organizations like A.M. Best, Standard & Poor's, and Moody's. These organizations issue ratings and opinions regarding the financial strength of the issuer after performing comprehensive quantitative and qualitative evaluations.

Even the most well-known insurance companies can be financially vulnerable – regardless of high ratings. Although the number of insurance company financial failures is very low, the fact that they have happened at all can be frightening to consumers. Similar to the FDIC in banking, insurance guaranty associations exist to protect state residents who own contracts or are beneficiaries of contracts issued by insurance companies that can no longer conduct business. All insurance companies licensed to write life and health insurance or annuities in a state are required to be members of the state's life and health insurance guaranty association. If there is a shortfall of funds needed to meet the obligations to policyholders, state guaranty associations cover legitimate claims from assessments collected from insurers doing business in that state. The amount insurers are assessed is based on the amount of premiums that they collect in that state. Like the FDIC, state guaranty associations have maximum benefit limits that vary from state to state, but virtually all states offer

at least \$100,000 to \$300,000 of coverage for individual annuities. Some states, including Washington and New York, have extended coverage amounts to \$500,000.

2. The Owner

The annuity **contract** owner is usually the person who purchases the annuity. As the term "owner" implies, the owner of an annuity contract holds certain rights under the contract, such as the right to make purchase payments, to withdraw part or all of the contract value, to terminate the contract, or change the parties to the contract, like the annuitant or **beneficiary**. The owner is usually a **natural person**, like an individual or couple, but can also be a non-natural person such as a trust or a partnership. Note that special tax rules apply to annuities owned by non-natural persons.

3. The Annuitant

The annuitant is the individual whose life expectancy determines the payments made from the **contract**. The annuitant **must be a natural person**, not a corporation or business entity. Insurers permit joint annuitants, which means that the payment calculation is based on two lives, and will continue until the second person is deceased. Most commonly, the annuity owner and the annuitant are the same person(s), although this arrangement is not required. Annuitants cannot make additional deposits, withdraw money or terminate the contract unless they are the owner.

4. The Beneficiary

All annuities have a **beneficiary** designation and frequently, insurance companies will not issue the **contract** until the beneficiary section of the **application** is completed. Insurers permit multiple beneficiaries as long as the total percentage of all beneficiaries equals 100%. The individual(s) or entity that is designated as beneficiary receives any death benefits that become payable under the annuity contract when another party to the annuity contract dies. Note that if an annuitant dies before annuitization, the beneficiary will receive either the amount paid into the plan or the cash value of the plan, whichever is greater.

The beneficiary has no rights under the annuity contract, other than the right to receive payment of the death benefit. The beneficiary cannot change the payout settlement option, alter the start date for benefit payments, and cannot make any withdrawals or partial surrenders against the contract. Annuity owners can also restrict the beneficiaries, meaning they can determine how benefits are paid at death. Some owners do not wish the beneficiaries to receive the account value in one lump sum and prefer to structure payouts over a period of time.

Unlike the party named as the annuitant there is no requirement that the beneficiary be a flesh-and-blood individual. Named beneficiaries often include trusts or other entities such as a charitable organization.



D. Owner-driven vs. Annuitant-driven Annuity Contracts

Insurance companies choose to issue annuity contracts with certain features and specifications. One choice made by the insurer is whether to issue the annuity as an owner-driven or annuitant driven contract. What is the difference, and why is this important?

Annuitant-driven annuities are those that contractually pay a [death benefit](#) when the annuitant dies. At the death of the annuitant, the contract terminates and the insurer pays any death benefit to the contract's designated beneficiary. If the owner of an annuitant-driven contract dies, the annuitant receives the contract value and not the death benefit (unless the contract specifies otherwise). At the time of the owner's death, the account value may be less than the expected death benefit. In addition, the death of the owner can trigger tax consequences that may be undesirable, including the need to distribute all contract proceeds within 5 years.

If the owner and the annuitant are the same person, this distinction is generally not a material factor in planning. Increasingly, though, customers that purchase annuities prefer to name an annuitant other than themselves. In ensuring suitable sales, it becomes the agent's responsibility to explain the general difference between these types of contracts, and then help the client choose which type best suits the client's objectives. It is also important to direct the client to seek professional tax advice if necessary.

Annuitant-driven contracts are currently more common than owner-driven contracts; however, there are more and more owner-driven annuities. The subtle differences we have described can result in vastly different outcomes in contract execution and taxation.

Owner-driven annuities, on the other hand, pay a death benefit only when the owner of the contract dies. When the annuitant dies, the owner simply designates a new annuitant and the contract continues without interruption.

Chapter Complete

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Study Chapter

Fixed Annuities

Now that we have examined basic [contract](#) terminology that applies to all annuity contracts, we will turn our attention to examining each of the four main types of annuity contracts one by one. Each of these contracts has a unique [application](#) in retirement accumulation and distribution planning, and as we progress through our study of these contracts, you will see both great commonality and great contrast in their features. We will begin with fixed annuities which were the first of all annuities, and remain a foundation product for many retirement plans.

A. Timeline

Fixed annuities have long had a reputation for financial security. In fact, their power for providing payment for life goes back for more than two thousand years. First sold in ancient Rome under the name *annua*, they worked fundamentally as they do today. A Roman annuity buyer made a lump-sum payment, and in return received a [contract](#) that promised a fixed payment every year for his natural life. Eventually they were modified to provide payments for a specified period, or a term. As you can see, the same fundamental principles apply to today's fixed annuities.

The use of annuities continued in Europe through the Dark Ages, Middle Ages and more recent times. The idea traveled to America, where the first evidence of their use was as early as 1759, when the first known American annuity producers began as the Corporation for the Relief of Poor and Distressed Presbyterian Ministers and Distressed Widows and Children of Ministers. The company provided fixed annuity payouts for the survivors of deceased ministers.

The annuity concept was relatively slow to catch on, but all the while, their sale continued. During the Great Depression, the ideas of stability, asset safety and security were strongly promoted, as President Franklin D. Roosevelt, urged Americans to "save for a rainy day." The annuity emerged as a savings tool well suited for that time, especially as banks began to collapse at a catastrophic rate. One Depression era story significantly helped in promoting the fixed annuity concept. Supposedly, at the suggestion of his business mentor, baseball legend Babe Ruth survived the stock market crash of 1929 by putting all of his savings in annuities. The insurance companies came through on their promise and Babe Ruth lived well.

Annuities in the late 1930s and early 1940s were comparatively simple, offering a fixed return during accumulation periods, and guaranteed safety and return on principal. The addition of tax-deferral and compound accumulation made them all the more attractive. Even with few of the features available today, the fundamental fixed annuity constant of lifetime income or payments over a set number of years gained momentum.

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continue to attract the simplest alternative option amidst annuity and index annuity products.

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Because of their safety and the guarantees they offer, the sales of fixed annuities strengthen at times when the stock market becomes volatile or when equity markets are in turmoil. It seems that financial crisis promotes risk aversion. So, the recent market turmoil of 2008-2009, and the resulting “flight to safety” drove record sales of fixed annuities for many companies, and near record results for the industry overall.

Then came the increasing demand for the safety of U.S. Treasury securities. As more and more dollars poured into Treasuries, interest rates continued to fall. Traditional fixed product rates lost their relative competitiveness and sales in 2010 began to shrink, falling a total of 31% from their 2009 results.

Historically low Treasury rates continued to present a challenging interest rate environment for fixed annuities in 2011. However, when compared to other conservative choices like CDs and money market funds, the features of tax deferred growth and guarantees continue to drive fixed annuity sales. *Who is buying them?* Mostly people age 50 and above. This aging U.S. population is also likely to drive future sales of fixed annuities. People that are nearing or living in retirement tend to allocate assets much more conservatively than when they were young.

The segment to watch for fixed annuity sales is Gen Y, also known as the Millennials. This demographic group, born anywhere between 1980 and 2000, has a fairly strong aversion to risk. They lost faith in the financial markets and became highly conservative in response to the financial crisis of 2008. When surveyed, many of this group claim to have become market skeptics, and prefer to steer clear of equity market investments.

Stay tuned for new developments in the fixed annuity market. Their guarantees will continue to play a significant role in retirement planning as long as people are risk averse, and desire stability and retirement security, as they have for the past 2,000 years.

B. The Basics of Fixed Annuities

Fixed annuities have been a mainstay in the retirement planning industry for decades. Their underlying premise of safety of principal, stability of payments, and guaranteed growth have made them an important component of many retirement plans. Quite simply, a fixed annuity is a contract with an insurance company in which purchasers invest purchase payments to receive a fixed rate of return that is guaranteed by the insurer. Fixed annuities are usually purchased by conservative individuals or groups who are concerned about accumulating savings for retirement. As stated previously, persons that buy fixed annuities are usually age 50 and above.

A fixed annuity can be purchased with a single payment or a series of deposits. The money that is accumulated in the annuity is guaranteed to earn the contract’s guaranteed fixed rate of return throughout the annuity’s accumulation phase. The purchase payments that are made to fixed annuity contracts are invested in the insurance company’s general account. To deliver on the promised interest guarantees,

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available in the market today, the purchase payments grow at the fixed interest rate that is guaranteed by the insurer. The funds grow **tax-deferred** until the annuity owner decides to receive payment from the annuity. The tax savings from the tax deferral allow for accumulation of savings at a faster rate than taxable investments earning similar rates of return. The annuity has the potential for faster growth because interest is earned on

- The **principal amount** that is contributed;
- The interest that is credited on the account; and
- The money that would otherwise have been used to pay the taxes owed.

1. Fixed Annuities Compared to Certificates of Deposit (CDs)

A fixed annuity can be thought of as an insurance company's version of a CD. Both are primarily viewed as savings vehicles, and they serve conservative individuals or groups who wish to ensure growth of their principal but have no tolerance for principal risk. However, they differ in several fundamental areas that are noted below:

Financial Backing. Because CDs are typically issued by banks, they are covered by the FDIC deposit insurance. Fixed annuities are issued by insurance companies, and it is their financial strength that stands behind the interest payments that are made during the accumulation period, and potentially, the income payments that are made during the payout period after the term of the annuity ends. In the rare event of insurance company default, state guaranty associations protect annuity account values with coverage that ranges from \$100,000 to \$300,000, or more in some states.

Interest Rates. Except in rare circumstances, fixed annuities offer higher interest rates than CDs. There have been exceptions in recent times of historic low interest rates, especially when depository institutions like banks and credit unions run CD specials to attract deposits.

Taxation. Tax deferral is certainly one of the most important benefits of deferred annuities compared to CDs. CD interest income is taxed annually (unless held within a qualified retirement plan such as an IRA); while a deferred annuity balance earns interest on a tax deferred basis, even if funded with nonqualified money. This means that no income tax is paid until the money is withdrawn. This benefit is really magnified over time, so it is to the advantage of a fixed annuity owner to opt for a longer accumulation period term to take advantage of the account's potential growth. Reinvesting money that would otherwise be taxed makes a large difference if left to grow for 10, 20 or 30 years. Slowly but surely, because of the benefit of tax deferral, money contributed to fixed annuities can outperform not only CDs, but also other fixed income alternatives like Treasuries and high quality corporate bonds.

Early Withdrawals. CDs typically do not permit withdrawals without penalty until the end of their term. If early withdrawals are necessary, substantial interest penalties apply. Most fixed annuities today permit withdrawals of a specified amount of interest or a percentage of premium each year without penalty. However, if the withdrawal is made prior to the age of 59½, the IRS 10% penalty applies.

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Income Option ☒ Quiz

lifetime income option and other payout options available through the insurance company. CDs do not offer structured payout options. They are an accumulation vehicle, while annuities both accumulate and distribute income with guarantees that are unavailable through other savings alternatives.

Investment Alternatives

PRODUCT	ADVANTAGES	DISADVANTAGES
Annuities	- Contract guarantees - Lifetime income option - Tax-deferred growth - Death benefits	- Higher contract fees & commissions Surrender charges - Lack of liquidity - Withdrawals prior to age 59 and a half taxed at 10%
Money Market	- No risk to principal - Complete liquidity (no withdrawal limits or penalties) - Flexibility to invest	- Lower interest rates - No tax-deferred growth - No payout/income options - No death benefit
CDs	- FDIC backing - No risk to principal	- Lower interest rates - Taxed annually - Penalties for early withdrawal - Limited liquidity - No death benefit
Savings Accounts	- FDIC backing - No risk to principal - Complete liquidity - Flexibility to invest	- Lower interest rates - Earnings taxed annually - No death benefit
Mutual Funds	- High growth potential - Risk selection - conservative to aggressive	- Income fully taxable - High front-end load sales charges - Higher market risk - No death benefit
Stocks, Bonds, Commodities, Options	- High growth potential - Dividends - Participation (voting rights)	- Product complexity - Higher market risk - Values fluctuate with risk to principal - Sensitive to changes in interest rates - Dividends and capital gains are taxable - Taxed at fair market value upon death - Limited liquidity

Select Chapter ▼



Promissory Note ① Practice Question

☒ Quiz

		Default consequences difficult to enforce
Real Estate Investment Trust (REIT)	• High growth potential • High dividend payout ratios • Special tax treatment • Liquidity	• Sensitive to fluctuations in interest rates and the real estate market • Dividend payouts and capital gains are taxable
Viatical Settlements	• High growth potential	• Mortality risk difficult to predict • Unknown rate of return • Limited liquidity • Investment return is taxable

2. Fixed Annuities Compared to Money Market Accounts

Money market accounts are also conservative savings alternatives chosen by investors who do not have tolerance for principal risk. Like their CD counterparts they offer FDIC insurance protection. They differ, however, substantially in these two areas:

- **Complete liquidity:** money market accounts have no withdrawal limits or penalty fees. There may be limits on the number of times each month that a withdrawal can be made, and minimum withdrawal amounts may apply.
- **Greater flexibility:** Investments can be made into money market accounts with any frequency. The accounts are open until the owner closes the account; there is no [expiration](#) or term.

The tradeoffs for the flexibility and liquidity of money market accounts, as compared to features available in fixed annuities are listed below:

- Lower interest rates;
- No tax deferred growth; and
- No option for guaranteed lifetime income and other forms of payout.

Like CDs, money market accounts, and certain other fixed income investments, fixed annuities fully protect against loss of principal. *Unlike* CDs and money market accounts, fixed annuities typically offer higher rates and tax deferral. This does not remove every risk possibility for a fixed annuity investment, but it does eliminate some of the more important concerns of retirees.

3. Types of Fixed Annuities

When choosing to invest in fixed annuities, an investor can select between CD-type annuities or a book value annuities. Their features are contrasted below.

Multi-year Guarantee or CD-Type Annuities

A “CD-type” annuity is a term used to describe a fixed annuity that offers an interest rate guarantee for the same length of time as its surrender charge period. *For example*, an annuity with a stated interest rate guaranteed for 5 years that has a schedule of surrender charges ending after 5 years is a CD-type annuity. This term

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year guarantee in high regard | Practice Question

MYG fixed annuity | Quiz

guarantee” annuities. These annuities offer a guaranteed interest rate for the first year of the **contract** only, and then a rate for the subsequent years that can vary based on current market rates. The first year rate is usually called the base rate of the annuity, and the subsequent year rates are called renewal rates. To help attract investors to this type of contract, and also to offset the risk of the change to the rates in subsequent year, an attractive and highly competitive bonus interest rate is typically paid in the first year of the contract. *For example*, a 5-year banded rate annuity might offer a rate of 5% the first year, and then a renewal rate that is a minimum of 2% from years 2-5.

When considering a recommendation of a single year guarantee annuity, it makes good financial sense to check on the issuer’s history of renewal rates, to see whether the insurer has a history of raising, lowering, or maintaining the base interest rates of its single-year guarantee contracts after the first year.

GRA and MVA Fixed Annuities

A second classification of fixed annuities is either Guaranteed Return Annuities (GRA) or Market Value Adjustment annuities (MVA). This important classification differentiates the way an insurer treats early **contract** withdrawals or surrenders. The GRA guarantees that at full surrender or early termination of the contract, the annuitant will never receive less than 100% of the purchase payment. In other words, no penalties or interest rate fluctuations can impact principal when a contract is surrendered. A synonymous common industry term for a GRA annuity is a “book value” annuity.

The type of fixed annuity in which there is no guarantee of full return of principal at the time of surrender is called the Market Value Adjustment annuity (MVA). When an MVA provision applies, the insurer can adjust the contract value for interest rate movement at the time of a premature withdrawal that exceeds any free amount. In this way, it returns some of the interest rate risk to the annuity contract owner. The adjustment calculation equation is specified within the annuity contract. The way the adjustment is calculated can vary substantially between contracts.

MVA adjustments usually seem counter-intuitive when first considered, because when interest rates go up, a negative adjustment, or additional charge applies to offset the bond’s loss in value. When interest rates go down, the contract value receives a positive adjustment from the insurer.

Although MVA contracts may sound like something to avoid because of the possible charge, some financial advisors suggest only MVA contracts. The reason for this is that the MVA option enables the insurer to take on less risk. With less risk to plan for, the insurer can afford to pay slightly higher interest rates to outstanding contract values.

C. Fixed Annuity Contract Features

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by older individuals who are already living in retirement to earn a conservative return on funds that are not needed to support retirement lifestyle.

Term. The fixed annuity term is the time period over which guaranteed interest will be credited to the contract. Terms are generally from 3 to 10 years, with 5 to 7 year terms most common. Usually, the longer the term, the higher the guaranteed rates paid. Insurance companies may offer a renewal option at the end of the term. This feature allows a window of time, usually 30 days, to choose another contract term with new guaranteed rates, withdraw the funds without penalty, or choose an option for income payouts.

Bail-out Provisions. Some fixed annuities come with a protection against major interest rate fluctuations that allows the [contract](#) owner the right to cash out of the annuity contract, penalty-free.

A couple of *examples*: The provision may state that if the insurance company drops the interest rate by more than 1% of the original guaranteed rate, the owner can request the full contract value without surrender charge. If a fixed annuity with a five-year term guaranteed a rate of 5% for the first year and dropped the rate to 3% the following year, the bail-out provision would apply. This option protects the right of the annuity owner to keep the funds invested as competitively as possible. Keep in mind that there is a cost for a bail-out provision. Often commissions paid for the sale of these annuities are lower than those paid for annuities without a bail-out provision.

The bail-out provision is closely related to a return of premium option (ROP). The ROP feature also allows the contract owner to cancel the contract prior to the end of the term and for full return of purchase payments.

Interest Rate Crediting Methods - Portfolio and New Money Rates. With the *Portfolio Rate*, all annuity premium deposits enter a single portfolio, and the total return establishes the interest rate for all contractholders in that particular annuity block. The *New Money Rate* method places annuity premium deposits into a "bucket" during a discrete interest rate cycle. Cycles may change frequently so there may be a large number of buckets. Each is separately evaluated to establish the renewal rate, taking into [consideration](#) cash flows, underlying investments, market value, and other factors.

Minimum Purchase Amounts. This also varies by contract, but most insurers offer contracts with a minimum purchase of \$5,000-\$10,000.

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 companies. 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 annuities.

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less than 100% of the purchase payments to the named beneficiary, but this may vary. Some companies waive surrender charges on distribution at death. Although the beneficiary's payment may be subject to taxation, these death benefit 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 fixed annuity contracts are guaranteed a minimum rate of return for the full term. This guaranteed rate is most important for banded or single year guarantee contracts. While a substantially higher rate may be paid in the first year of a contract, the following years' rates can be no less than the minimum guarantee. The contract's minimum guarantee may be subject to certain state law variations, but in general the range is 1.0% to 3.0%.

Surrender Charges. The surrender period is typically equal to the term of the annuity. It often ranges from 5-7 years. Contracts with longer surrender charge periods may offer the potential for higher returns, but this is not always true.

Liquidity Options and Free Withdrawals. Most fixed annuity contracts offer some form of liquidity option. Common liquidity provisions include a 10% free withdrawal or a withdrawal of contract earnings. Some contracts permit more than one withdrawal per year, as long as the withdrawals do not exceed the overall withdrawal maximum.

Many contracts offer "*crisis waivers*" on withdrawal charges in certain situation such as death, confinement in a nursing home, or terminal illness. Some annuity contracts allow the contract holder to take a loan from the annuity, much like a life insurance policy loan. Interest is charged and there are caps on the amount that may be borrowed. The eligibility qualifications for these provisions differ from contract to contract.

Market Value Adjustment. We have discussed the market value adjustment feature which may impact contract value when excess withdrawals are taken prior to the end of the surrender charge period. It may be important to clarify whether the MVA applies to early withdrawals for hardships, such as nursing home confinement, natural disaster and terminal illness, and or death.

Premium Bonuses. Some fixed 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 have lower renewal rates than other contracts. In addition, if contracts with bonus payments are surrendered in the early

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changing consumer needs, several features that are appearing more frequently on fixed annuity contracts are those that have become popular on other annuity contracts, particularly variable annuities.

Guaranteed Lifetime Withdrawal Benefits (GLWBs): These riders have played a large part in driving interest in variable annuity contracts over the years. For an annual charge, they can guarantee that a certain benefit is paid for life, and may allow for step-ups in other benefits. They ensure that income cannot be outlived, without loss of control over the index annuity's accumulation value.

Long-Term Care/Confinement Benefits: Many insurers are thought to be considering an introduction of these combination contracts. Although a number are available today, the sales of these contracts have been insignificant. With concern for the potential cost of long-term care, these riders or built-in long-term care policy features usually result in a more cost-effective solution than a standalone long-term care policy. If long-term care is needed, the costs are first deducted from the contract's accumulation value, and then covered with insurance based on a multiple of the contract's value. A main attraction is that if the long-term care benefits are not used, the accumulation value remains as an asset.

Split Annuity: A split annuity combines a fixed period immediate annuity and a single premium deferred annuity. This retirement strategy is used to create an immediate monthly income stream for a guaranteed period of time (via the immediate annuity) and the restoration of original principal (via the deferred annuity).

Two-Tier Annuity: Most annuities guarantee a specific rate of interest regardless of whether the annuity is withdrawn as a lump sum at the end of the contract or whether the payments are annuitized. With a two-tier annuity, a higher rate of interest is applied if the payout is annuitized; however, a much lower rate of interest will apply to lump-sum payouts. In fact, if money is taken out of a two-tier annuity in a different way than specified in the annuity agreement, the contract penalties could even result in a negative rate of return.

D. Fixed Annuities and Suitable Sales

Particularly after recent years of market turbulence, fixed annuities have regained respect as a proven component for secure and stable retirement savings. For those who truly believe that "slow and steady wins the race," a fixed annuity can fill the bill. With so many fixed annuity alternatives to choose from, it is important that personal objectives and preferences are carefully considered along with the overall financial situation of the buyer, and that a fair and balanced overview of the product's advantages and disadvantages are clearly presented.

The following list of questions helps focus on important points of [consideration](#) in the fixed annuity purchase process:

- What are the interest guarantees and for how long do they apply? Are there any bonus provisions?
- What charges, if any, are deducted from the purchase payments?
- What charges, if any, are deducted from the [contract](#) value on an ongoing basis?

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1. Application

Meet Bob and Ellen. Throughout their working years, Bob, age 60, and Ellen, age 59, have tried diligently to set aside savings for their retirement. Each year they tried to maximize contributions to their respective savings plans: Ellen's 403(b) as a teacher, and Bob's 401(k) as a production supervisor for a manufacturing company. Because Bob is suffering from some health [conditions](#), he has decided to take advantage of an early retirement package that his company is offering. In addition to the severance money of \$100,000 included with the plan, he has another \$300,000 in 401(k) savings that will be distributed upon his termination.

Bob and Ellen have become more risk averse over the years, and want to take no chances with this \$400,000 of retirement savings. Bob is worried about needing the money for unforeseen expenses, and thinks they should just invest the entire lump sum in a money market account so that it is there when they need it. Ellen isn't so sure, and after talking to a financial advisor, proposes an alternate plan. The financial advisor agrees that an emergency fund is absolutely essential in their plan, and that they should set aside about 6 months' worth of their monthly expenses in the money market fund that Bob had chosen. However, he feels they should consider a fixed annuity for at least a portion of the lump sum, and recommends, that they invest at least \$200,000 in a 5-year multi-year guarantee (MYG) fixed annuity. He explains that the 401(k) funds can be transferred directly to the annuity so that the tax deferred growth can continue without interruption. He explains that the annuity has a 10% annual withdrawal feature, and also can be accessed free of withdrawal charges in the event of nursing confinement or terminal illness, both of which have been a concern of Bob's. The financial advisor also reminds Bob and Ellen that the interest rate is substantially more than the money market or even a CD will pay.

After learning more about fixed annuities, and completing their own research, Bob and Ellen agree that the MYG fixed annuity [contract](#) meets their needs for part of Bob's retirement distribution. They really appreciate the guaranteed rate of interest it will pay for the next 5 years, and like the idea that they don't have to worry about market volatility. They feel the 10% withdrawal option is important, and reasonable, and that it fits well overall into their vision of managing their financial future in retirement. The 5-year term of the annuity aligns well with Ellen's plan to consider retirement at about that time. They also will consider the guaranteed lifetime income opportunities that the annuity can provide down the road, as the idea of a worry-free retirement income paycheck fits nicely in their retirement income plan.

2. Seven Advantages of Fixed Annuities

1) **Safety of principal.** For the financially conservative who want no financial risk to the principal of their investment, fixed annuity contracts are hard to beat. Their minimum guaranteed requirements ensure that investors will receive their principal plus the accumulated interest at the end of the annuity term.

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3) **Tax-deferred growth.** Growth that is uninterrupted by taxation is a strong attraction for fixed annuities. As people save for longer periods of retirement and increasing life expenses, the maximization of retirement savings is increasingly important. Tax-deferred growth, especially over a lengthy period of time, can make a remarkable difference.

4) **Stability and protection from market volatility.** Some people don't respond well to market volatility – particularly where their hard earned savings are concerned. The recent market turbulence has driven many people out of the market, simply because they cannot tolerate the drastic ups and downs. Fixed annuities deliver steady and consistent growth, regardless of market and economic volatility that impacts other investment alternatives.

5) **The option of guaranteed income for life.** This annuity differentiator is one of the most unique and valuable provisions that annuities provide. At the end of their terms, annuity owners can choose from a wide variety of payout options that can be tailored to their retirement needs. With longevity concerns at top of mind for most retirees and persons approaching retirement, the security and peace of mind provided by a retirement income paycheck that is guaranteed for life cannot be underestimated.

6) **Penalty-free withdrawals.** Although not designed as liquid savings vehicles, annuity contracts today allow reasonable withdrawals to accommodate uncertainties in life. Most permit a withdrawal of up to 10% of the contract's value each year that is free of surrender charges. There are also many contracts that permit free access to accumulated funds when hardships occur. The restriction on the withdrawal can be a benefit: it helps people from dipping into their long-term savings for less important spending.

7) **Assets avoid probate.** Fixed annuity contract owners can plan to deliver a valuable legacy to their beneficiaries without the expense or delay often associated with other bequests made through their will(s). Death benefits from insurance contracts that are paid directly to a named [beneficiary](#) are not subject to the probate process.

3. Seven Disadvantages of Fixed Annuities

1) **Lack of liquidity.** Although there are limited withdrawal provisions, fixed annuities are not designed as a ready source of cash for emergency needs. Surrender charges and possible market value adjustments can amount to a large penalty if funds are withdrawn. A fixed annuity investment is probably not a good idea for persons who do not have any other investments or savings accounts that supply liquidity for emergencies.

2) **Low interest rates.** When compared to other available products in the market place, the returns offered by fixed annuities are comparatively low. Although tax deferral helps to accelerate growth, the lower rates that fixed annuities pay may not be appealing when compared with other alternatives.

3) **Surrender charges.** Long periods of high surrender charges are commonly identified as disadvantages of annuity contracts. In addition to the impact of a

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earnings are fully taxable as ordinary income, and if funded fully with qualified purchase payments, both principal and earnings are fully taxed as ordinary income.

5) Inflation impact. A challenge with any fixed income product is its ability to keep pace with the rate of inflation. Even if inflation averages only 2-3% per year, the relatively low interest rates paid by fixed annuities make it challenging to keep up. The erosion of purchasing power can be a substantial retirement planning challenge as retirees plan for retirements that can be 20-30 years or more in length.

6) Too many charges and fees. With surrender charges, possible market value adjustments, commissions to financial representatives, mortality risk fees, and miscellaneous contract charges and administrative fees, fixed annuity returns are subject to a substantial haircut. It can also be challenging for annuity owners to understand the impact of the charges on the contracts.

- Under what circumstances do the charges apply?
- How are they calculated?
- What is the impact of these charges on annuity return?
- How do mortality credits apply to my contract?

The fee structure and contract charges can overwhelm many persons looking for ways to save for retirement.

7) Locking in low rates. With interest rates at record lows, making a decision to lock money away for multiple years may not be to an investor's advantage. Although tax deferral and interest compounding help offset the low rates, they don't make up for the time during which a higher rate of return is lost.

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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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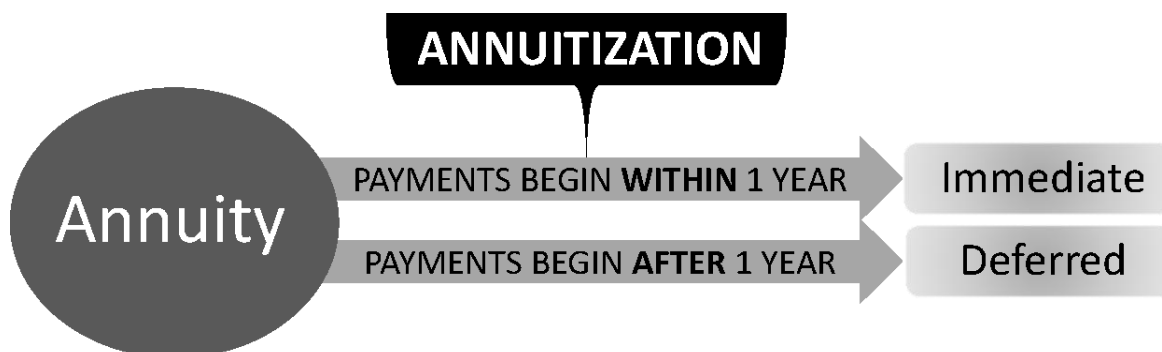


Study Chapter ? Practice Question



Immediate Annuities

A. Introduction to Single Premium Immediate Annuities



Single Premium Immediate Annuities, or SPIAs as they are commonly known, are an annuity product designed for the person who needs income now, or at least within 13 months of purchase. This product, once much maligned by the financial press and many financial practitioners, is gaining popularity as demonstrated through its increasing sales results over the last several years. In fact, there are predictions that SPIA will one day emerge as a fundamental part of the income portfolio for every retiree.

Of all types of annuities sold today, SPIA accounts for the smallest sales totals. In fact, in 2010, fixed immediate annuities represented only about 3.4% of total annuity sales. However, there is definite opportunity for the use of SPIA in helping people eliminate the risk of outliving their retirement savings.

Although SPIA may be appropriate for delivering secure retirement income for retirees of all financial demographics, a significant and underserved market may exist among middle-income seniors. Statistics indicate that many middle-income retirees, those with incomes between \$25,000 and \$75,000, tend to have a gap between their guaranteed income and their basic living expenses. These less wealthy retirees may not have access to rich pension plans or large saving balances. They also often have lower tolerance for risk, and tend to contribute primarily to conservative financial products such as CDs and cash equivalents. In recent times of low interest rates, the declining income generated from these investments is not always enough to keep up with retirement living expenses.

Often persons in this demographic are not approached with solutions to manage their income risk. Traditional brokers typically seek to serve the more affluent, or are selling investment products rather than protection against the longevity risk. In fact, 51% of pre-retirees and retirees with incomes between \$25,000 and \$75,000 have not been

contacted by any kind of retirement professional in the past 12 months. These persons, who may be particularly at risk for not being able to maintain their standard of living during retirement, are often unaware of products like SPIA that may offer them the retirement security they need.

It is important to recognize that the objectives of accumulating income for retirement and distributing it when retirement occurs are very different. Persons who have reached retirement are generally trying to maximize their income while maintaining a desired cushion or safety net of assets. Their risks differ from the risks that face those saving for retirement as well.

1. Types of Risk

The most apparent of these risks is **longevity risk**, or the risk of outliving one's resources. We have discussed the uncertainty factor around two other retirement "annuities" that retirees today rely on heavily: defined benefit plans and Social Security benefits. We have also focused on the strength of annuities in eliminating longevity risk with their lifetime guarantees.

Two other risks that are equally important to protect against in retirement are withdrawal risk and sequence of return risk.

Withdrawal risk is the risk that the retiree draw too much from their investments to be sustainable throughout life. This risk can lead to wiping out the value of the portfolio too early. Many financial advisors have used a "4% rule of thumb." They have advised that most people will not outlive their savings by following the rule of taking no more than 4% from their savings each year. However, with market performance of recent years, and interest rates at record lows, this rule may no longer apply.

Sequence of returns risk is another acute challenge for those drawing income from investments. This risk centers on the order, or sequence, of market fluctuation, and how it affects portfolio growth. This sequence becomes highly critical in retirement when retirees are "drawing down" from their portfolio to provide regular income. If a retiree's portfolio suffers negative returns early in retirement, the growth of the nest egg will not keep pace with the annual withdrawals. Unless the portfolio funds are increased, continued withdrawals can have a drastic impact on the amount of income that can be withdrawn. The only "fix" for the sequence of returns risk is to reduce the income taken from the portfolio, or improve the market performance.

These risks combined can greatly jeopardize the probability of maintaining the regular and targeted amount of income needed to ensure a secure and comfortable retirement. SPIA can be an ideal solution for mitigation of these risks, and bears [consideration](#) in the distribution planning for nearly every retiree.

B. The Basics of SPIA

The SPIA is a straightforward, uncomplicated product concept. Individuals purchase these annuities when they want to begin receiving a stream of income within a short period of time. Quite simply, purchase payments go to an insurer, and the insurer converts those payments into a stream of income. While other annuity products are important for the accumulation of savings for retirement, SPIA is designed solely for the distribution of income. Unlike other annuity products, there is no accumulation phase. Instead, purchase payments are converted to income within 30 days to 13 months of [contract](#) purchase.

Any lump-sum purchase payment of cash can be converted into an income stream for the preferred duration, which could be for the lifetime of one or more individuals, or for the period specified by the annuity purchaser for the designated annuitant to receive payments. Annuitants can receive their payouts on a monthly, quarterly, semi-annual, or annual basis based on their income needs and lifestyle.

People typically purchase SPIAs at the time of their retirement to ensure that their basic income needs are met, or when already in retirement to boost the income they are already receiving from other sources. SPIAs are often marketed as a "personal pension plan" or a "retirement income paycheck" that can be guaranteed for life. They bring peace of mind to retirement because the income they provide is stable and secure, and cannot be outlived.

SPIAs can be purchased at other times during life, as well. Persons that receive lump sums of cash from inheritances, legal settlements, lottery winnings or the sale of a large asset, like a business or home, have also used SPIAs to dependably deliver a constant paycheck that could potentially last for life.

C. How Income from SPIA is Determined

SPIA is one of the most efficient retirement income products available to retirees. It maximizes the cash flow that is available per dollar of retirement saving. This is possible because of the pooling of the risk of outliving assets among large groups of contract holders. The pooling of mortality risk among insureds is one of the basic concepts that enables insurers to offer the unique guarantees which differentiate their products from any others in the financial marketplace. In pools of hundreds of people, statisticians know that at least some persons will die before their life expectancies, while others will live well beyond what actuarial tables predict. These staggered results allow insurers to maintain guarantees for life from the investment of these purchase payments.

SPIA payments are also maximized due to the fact that the purchase payment principal is liquidated as the payouts are made. This concept is easiest to understand when compared to a CD. Retirees who depend on CD income receive only the interest that the CD principal generates. The interest amount is locked in for the term of the CD, but when the CD matures, the retiree faces reinvestment risk. In other words, if interest rates are lower, the retiree must accept a lower rate of return when investing in a new CD at that time. Between the years of 2005 and 2010, for example, the average rates of CDs with a one-year term have dropped from near 5.25% APR to 1% APR or less. An investor with a \$100,000 CD would have seen annual income drop from \$5,250 to \$1,000. This lack of certainty can cause great concern for retirees that rely on CD income for a significant portion of their retirement income.

Because immediate annuity payments include both liquidated principal and earnings, the payout rates that can be guaranteed generally compare very favorably to other fixed rate investments. Depending on the age of the annuitant, payout rates for income for life option can range from 5% – 10% or more. As you can imagine, this type of income boost can be very important for those persons that truly need additional income to live in retirement. Furthermore, there is no uncertainty about the amount of payment that will be received in the future. The payment is locked in for the term of the payout, with no uncertainty regardless of changes in the economic and interest rate environment. Unless the individual is willing to take more risk, and has little concern for payment stability, most individual investment plans are hard pressed to match the guaranteed income an immediate annuity can provide.

The amount of income that SPIA delivers is determined by these **4 elements**:

1. Interest Rate;
2. Size of the Initial Investment;
3. Pay Period; and
4. Length of the Contract.

The highest monthly payments are realized from larger investments with shorter payout periods.

The trade-off for the income boost that SPIA provides is the loss of control of the purchase payment. At the death of the annuitant, there may be no principal to pass on to heirs as there is with a CD. For this reason, and others yet to be discussed, it is usually important to recommend that immediate annuities are purchased only with a portion of retirement savings. Many financial practitioners have used a “rule of thumb” to recommend that no more than 25% to 40% of savings be allocated to SPIAs. By investing only a portion of retirement savings into an immediate annuity, a liquid fund remains for emergencies, and the remainder of the savings can be invested for long-term growth.

When SPIA is used as a portion of an overall retirement income portfolio strategy, it can take pressure off of the performance of the rest of the portfolio. *For example*, if based on the assets a retiree has accumulated, it is determined that a retiree needs income of 5% annually, the use of SPIA in the mix can allow for the rest of the portfolio to return less in down years and still meet the income needs of the retiree. If the retiree’s goal is to have 5% income from the retirement nest egg and 40% is allocated to SPIA (at 6.5%), then the rest of the portfolio only needs to produce 4% income. This, in turn, can allow for the remainder of the portfolio to be invested more aggressively for growth as well as income. The amount of the savings that are not invested in the SPIA can also be used to pass an inheritance to heirs.

This portfolio strategy helps offset the discomfort that some people have with giving up control of the SPIA purchase payment amount. In the long run, the investment growth of the assets that weren’t used to generate income can offset the liquidated SPIA assets, and grow to a generous legacy over a long retirement.

D. Immediate Annuity Contract Features

At the time of the purchase of a single premium immediate annuity, there are basic considerations that are part of the [application](#) process. Features may vary between insurance companies that issue the product. In addition to these contrasts in features, it is certainly important to consider the financial strength of the insurance company that stands behind the product guarantees. These insurers could be responsible for ensuring retirement security for as long as 20 to 30 years or more. Their financial ability to deliver on this promise should not be underestimated.

Issue Ages: Issue ages vary greatly, and can range anywhere from age 0 to 90 or 95. Although typically purchased at retirement, immediate income annuities can serve other purposes, such as for the payment of legal settlements and lottery winnings, which is why they are available to a broad age range. Younger purchase ages result in smaller payments when spread over a life expectancy. However, if a period-certain payout option is selected, there is no difference in the payout amount regardless of age.

Minimum Purchase Amounts: Although this varies, usually the minimum purchase is \$10,000 or more. At younger ages, the lifetime income generated by a relatively small

contribution may seem insignificant, but at age 80, it can be substantial. Many companies also stipulate a minimum payment amount, such as \$50. *For example*, if a relatively small purchase amount generated income of \$40 on a monthly basis, the insurer would not allow a monthly payment frequency because of the administration expense. Instead, a quarterly or annual frequency may be required.

Maximum Purchase Amounts: Many companies will state a maximum purchase payment of \$1 million-\$5 million, but often require home office permission before accepting applications for contracts of more than \$1 million. Financial advisors should also recommend diversification between companies for extremely large purchases. 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.

Contract Administration Charges: Although many companies charge no administration fees either initially or annually, some companies may charge a one-time only set-up fee particularly when the purchase amount is relatively small. An example of this type of fee is a \$100 charge for contracts of less than \$100,000. The fee is subtracted off the top, and the net amount that remains is used to purchase the income benefit.

Banding: Some companies may encourage larger purchase payment deposits by offering higher payout rates for larger deposit amounts. Other companies offset the smaller purchase payments by an administrative charge as just described above.

Rate Locks: Often the purchase process of SPIAs involves a [transfer](#) of funds from another source. Perhaps this process may involve waiting for a CD to mature to avoid an interest penalty, or an administrative process concerning a mutual fund or pension plan that takes several weeks. Insurers that issue SPIA contracts periodically revise their payout rates to reflect changing market [conditions](#) and affordability.

What if an illustration using a certain payout rate was presented to a customer, and then there is a subsequent payout rate change while waiting for funds to arrive from other sources? The concept of rate lock defines how long the quoted payout rate that was presented at the time the sale took place will be maintained.

For example, if an insurer establishes a 60-day rate lock, this usually means that the payout rate quoted will prevail for 60 days from the date of application. If payout rates for other new contracts were to fall during that period, the additional funds to complete the contract under rate lock would qualify for the higher payout rate. What happens if payout rates for new contracts increase during the rate lock period? Some insurers extend the new higher payout rate, while others may hold the original payout quote. Provisions like the length of rate lock and impact of rate changes on fund transfers vary from insurer to insurer, and are important to understand when money for funding the contract is coming from other sources.

Potential Tax Benefits: Immediate annuities that are funded with nonqualified assets can provide some significant tax benefits to annuitants. Because a nonqualified [contract](#) is funded with assets that have already been taxed, each payment is considered part a return of principal, which is not taxed, and part earnings. Only the portion of the payment attributable to earnings is taxable, which can present a significant tax advantage over other investment earnings. Our course will address taxation of annuity benefits in greater detail within a later section.

Note that if funds for the immediate annuity purchase payments come from IRAs, 457 plans, 401(k) plans or other qualified plan rollovers or transfers, this special tax treatment does not apply. Payments based on funds from these qualified sources are fully taxable to the annuitant because they include no cost basis of already taxed earnings. However, taxation is at least partially postponed since it is spread out over the entire length of the annuity distribution instead of applied to a lump-sum distribution.

Contract Type: While the majority of SPIAs that are sold are fixed benefit contracts, variable immediate annuity benefits are also available. A fixed immediate annuity contract offers the consistency and stability that many retirees find important. Once determined, the amount of income that is payable for each period is a specified amount. Variable immediate annuities may guarantee a minimum benefit that is payable for life, but the amount of the regular payments benefit will vary with the performance of the insurance company's investment portfolio.

Payout Options: Insurers that issue SPIAs offer great flexibility in income payment options that annuity owners may choose from. 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 immediate annuitization are often the same options that are available for annuitization of other annuity contracts that insurer issues. In other words, when annuity contract holders are ready to annuitize other fixed, index or variable annuities of that issuer, they typically have access to the same payout options available to purchases of SPIAs.

As you might expect, both the length and the strength of the guarantee affect the payout option. Those payout options that offer more guarantees will result in lower income for the same purchase payment. Insurers usually offer a choice in payment frequency, and typical choices include monthly, quarterly, semi-annual or annual payment modes.

1. Annuity Payout Options

The standard payout options that are available in immediate and deferred annuities are described below.

Fixed Period

Fixed Period: Also called fixed installment or period-certain payout options, a fixed period guarantees the time for which annuity payments will be made. Common periods include 5, 10, 15 or 20 years. If the annuitant dies during the payment period, the remaining benefit is paid according to the terms of the [contract](#). If the annuitant lives beyond the fixed period, a benefit is no longer paid.

This choice is often useful for retirement distribution planning when it makes sense to defer receipt of other benefits for a period of time. *For example*, many retirees choose to defer receipt of Social Security payments to take advantage of the increase in benefit payments that results from deferral. By waiting until age 70, the Social Security payment amount can increase nearly 70% over the benefit available at the early retirement age of 62. The use of a period-certain annuity payout can maximize income during the waiting period. It can take the place of Social Security until the payments begin on the delayed date retirement. The net result of this strategy can be a higher stream of income for all of retirement.

When considering this strategy, it is important to consider the impact of low interest rates on period certain payout options. The shorter the payment period, the less time

the insurer has to achieve profitable investment returns to offset contract charges. There may be situations when the total payouts of a short installment period do not equal the total purchase payments. *For example*, if a 5-year period certain is elected during a time of low interest rates, and 60 monthly payments are to be made, after the contract charges (administration, sales commissions, premium taxes, spread, etc.), the total of the 60 monthly payouts could be less than the lump sum invested. Many insurers will not allow the election of period certain options in this circumstance.

Fixed Amount

Fixed amount: A [contract](#) owner can determine the amount to be paid in each payment. With this choice, the term for which payments are made is defined at the time of annuitization, and varies based on the amount to be paid in each installment. There is no lifetime guarantee associated with this option. If death occurs before the full purchase payment amount has been distributed, the amount that remains is paid to beneficiaries according to the terms of the contract.

Life Options

Life only: A life only payout option ensures lifetime income to a single annuitant for the remainder of life. The risk with this option is that if death occurs before payout of the full value of the investment, there is no provision for payment to a [beneficiary](#). This option generally results in the largest payment amount, because the potential of the premature death of the annuitant is not protected.

Life with period certain: This option is one method of providing beneficiary protection to a lifetime income option. If chosen, this option guarantees payments made throughout the lifetime of the annuitant. However, if the annuitant dies before the [expiration](#) of the period certain selected (often 5, 10, 15 or 20 years), the named beneficiary receives payments for the remainder of the period. If death occurs after the expiration of the period certain, no benefit is payable to a beneficiary. A longer period certain creates a longer guarantee period, so the longer the guarantee period chosen, the greater the reduction in payout amount.

Life with refund: Under this option, the annuitant receives income guaranteed for life. However, if death occurs before the full amount of the purchase payment has been paid, the remainder is paid to a named beneficiary. If death occurs after full purchase payment amount has been paid, no benefit is payable to a beneficiary.

Life with refund can involve either a cash refund option or an installment refund option. When a cash refund option is chosen, the remaining benefit is payable to the beneficiary as a lump sum. If an installment refund option is chosen, benefits are paid to the beneficiary according to a scheduled frequency selected by the [contract](#) owner, and may be subject to certain IRS rules that require full distribution within 5 years of death. We'll cover this tax concept in more detail in a later section of this course.

Joint and Survivorship

Joint and survivorship options: Annuity payout options may guarantee benefits for 2 lives. With this option, the [contract](#) owner may also need to choose the amount of the benefit payable to the [beneficiary](#). The most common of these options are joint life with 100% to survivor, and joint life with 50% to the survivor, although there are others available. Under the 100% option, the payment after death of the first annuitant that continues for the life of the second annuitant is the same as the original amount. Under the 50% option, the payment is cut in half after the death of the first annuitant.

Inflation adjusted lifetime income: When surveyed, a large number of retirees identify inflation as one of their biggest concerns in retirement, as well it should be. Even if inflation averages a modest 3% over the next 20 years, the purchasing power of a fixed, never-changing payment declines by almost 50% over that 20-year period. Many insurers offer inflation protection as an annuitization option to address this concern. Both single and joint life payout options often offer inflation protection.

An inflation adjusted income payment comes with a price. It results in a lower initial payment when compared to non-inflation adjusted options. As inflation adjustments are made over time, the benefit can increase well beyond the amount paid by a non-inflation adjusted options.

As you can see, immediate annuity payments can be structured in numerous ways to meet the specific needs of your client, and to fill an important role within the overall retirement distribution plan.

2. Recent Innovations in SPIA Products

Insurance companies continually respond to the changing needs of the market and release new and improved features. When compared to other annuity products, the SPIA is much more “plain vanilla,” but [contract](#) innovations are popping up that address prior product restrictions and offer new planning [application](#).

Liquidity Features

One of the biggest considerations in the purchase of a SPIA is the loss of liquidity. Life happens, and often there are needs for access to funds that could not have been anticipated. A recent LIMRA survey found that the loss of control of the assets used to purchase the income annuity and the lack of liquidity are the two greatest objections to income annuity purchases. Having some element of liquidity allows for the benefit of an income stream for life, while mitigating the objection to loss of control of assets.

The types of liquidity benefits available are many and varied. In general, they can fall into several categories:

- Acceleration of benefits;
- Withdrawal of [contract](#) value; or
- Cash refund of the premium not yet received.

The acceleration benefit typically allows the contract owner to elect an advance payment of benefits to be paid in a future period. *For example*, an acceleration of the next 12 months' worth of benefits might be payable if this benefit is exercised. There are typically a maximum of 1-2 elections of this benefit for the duration of the contract.

The withdrawal option is sometimes expressed as the option to take up to a certain percentage of the original purchase payment or current commuted value of the contract. Typically, there is a maximum percentage that ranges from 10% to as much as 30%. Usually there is a waiting period before this benefit can be utilized; a common waiting period is 3 years.

A cash refund feature may also be available, and could allow for cashing in a certain portion of the remaining contract value, up to the full contract value. The commuted value that remains after reduction by prior payouts, is then paid to the annuity owner. There may also be a waiting period before this benefit is available.

Regardless of the type of liquidity options, there are fees that must be paid when they are elected. The chance that any one of these benefits may be selected impacts the investment strategy of the insurer. To have flexibility to meet these benefits has a cost that the insurer passes on to the contract owner. These fees may be imposed in a variety of ways, including

- An upfront calculation that would reduce the subsequent monthly payment after the benefit has been received;
- Flat or percentage base fees that are imposed at the time the liquidity feature is exercised;
- An interest rate adjustment that is used to reduce the commutated value of the contract; or
- A flat percentage applied against the commutation value that reduces the amount available for future payouts.

Deferral Features

Delayed or deferred income options (DIOs) are a relatively new development that can be sold separately or added to existing products. Also known as longevity insurance, these contracts begin providing payments after the traditional window of up to 13 months that is defined by immediate annuities. Payments under DIOs are often deferred to a future established age, such as to begin at 85, so that retirees do not outlive their assets. The cost for these benefits is relatively low because of the payment delay. These contracts or riders can have great value in reducing the fear of outliving benefits. They can allow for maximization of other income streams from retirement assets since the risk of living beyond a certain age can be mitigated.

Medically Underwritten Immediate Annuities

Persons with known medical [conditions](#) may find that the normal lifetime expectancies that are factored into standard lifetime payouts are a disadvantage. Some companies have chosen to offer medically underwritten immediate annuities. The advantage of these contracts is that payouts are made based on a shortened life expectancy that reflects the medical condition, resulting in higher payments. Buyers that get the greatest value from a SPIA contract are those that live longer than the actuarial average lifetime calculations, so persons with known life-threatening medical conditions may not find nonmedically underwritten SPIA payouts with single lifetime guarantees to be of good value.

E. SPIAs and Suitable Sales

The benefit of immediate annuities — an income stream guaranteed for life — is a tremendous value as individuals become increasingly self-reliant in creating their post-retirement finances. They can be an advantage in most any retirement portfolio and warrant careful [consideration](#) along with the other portfolio components that will create the desired income stream.

Obviously, the sales process will require careful suitability determination, and the questions below are a start in determining when an immediate annuity is appropriate or if a different annuity or alternative investment is a better fit.

- What is the purpose of the income stream? Is it needed to cover basic expenses or for discretionary purposes?
- How much additional income do you need on a monthly or yearly basis?
- How long will you need this income stream?
- Are you more concerned with supplementing your income now or growing your assets for later use?

- Are you concerned with leaving a legacy? Do you have children or other family members who have special needs that you wish to support after your death?
- Do you have other assets that can be invested now for later use?
- Do you want to build in cost of living increases?

1. Application

Meet Mary. Mary is retiring in 6 months and is worried about what to do when she does not have a regular paycheck coming in each month. She has seen many ups and downs in the market, and doesn't want to worry about market volatility. The idea of a steady, worry-free retirement income is appealing. She will begin to draw Social Security in 6 months, and will also benefit from a defined-benefit pension plan payment of about \$500 per month. Although she thinks these sources will meet most of her basic needs, she likes the idea of an extra \$1,500 per month that she can use to travel and enjoy without guilt. She has \$300,000 of retirement savings in a 401(k) plan, and is willing to use some of this money to meet her retirement objectives. She also would like to leave an inheritance for her grandchildren to help with their college education in the event of her death.

After reviewing the options with her financial adviser, Mary selects a single life, fixed immediate annuity with the cash refund option. At her death, if the total of payments received is less than her net purchase payment, the difference will be paid in a lump sum to her grandchildren. She likes the comfort that the extra retirement paycheck provides, and is especially pleased that she doesn't need to worry about fluctuations in her monthly income. She feels that giving up control is worth the income security, and is confident that her retirement income choice will suit her needs.

Given Mary's objectives, risk tolerance, and other retirement assets, the SPIA option works extremely well in helping Mary ensure a comfortable retirement lifestyle.

Although it is clear that immediate annuities can deliver tremendous advantages in retirement income planning, they are not without risk and disadvantages. In ensuring suitability, producers and insurers must take a fair and balanced approach to every product recommendation. Understanding the advantages and disadvantages of this product can help you, as a producer, make appropriate recommendations for appropriate retirement solutions for your clients.

2. Seven Advantages of Immediate Annuities

1) **Predictable Income Stream for Life:** A steady retirement income paycheck is one of the greatest benefits that SPIA provides. With 96% of retirees worried about outliving their income, this is a critical risk management benefit.

2) **Income Your Way:** The income payout options that SPIA delivers are numerous. Whether for one or two lives, for a period certain, with or without [beneficiary](#) protection or with or without inflation protection, the SPIA owner can tailor payments to meet the needs of nearly any retirement income plan.

3) **Simplicity:** Sometimes the simplicity of this benefit is its greatest advantage. The idea of a steady stream of income that never changes, regardless of market performance, is peace of mind to many retirees who do not want to assume the responsibility of money management.

4) **Maximization of Cash Flow:** For those persons who need to maximize the income producing ability of limited amount of retirement assets, SPIA is the most efficient income maximization product available. Through [liquidation](#) of the principal and earnings combined, SPIA offers certainty and a payout percentage that is hard to beat.

5) **Improved Returns over other Alternatives:** Other investment alternatives like CDs, other fixed annuities, mutual funds, etc., can generate a steady income, but the payout rate that SPIA delivers is higher because the principal and earnings are combined in the income stream.

6) **Favorable Tax Treatment:** When SPIAs are funded with nonqualified dollars, only a portion of the income is taxed. By contrast, CD income, most mutual fund income, and other retirement income paychecks are fully taxable.

7) **Protection from Creditors:** Immediate annuities provide a constant income, even during financial hardship. Many states in the US offer protection from attachment by creditors, so that even in bankruptcy, the income stream continues.

3. Seven Disadvantages of Immediate Annuities

1) **Locking in Low Rates:** By making a single immediate annuity purchase when interest rates are low, annuity owners lock in a payout rate that will not change. Although the payout rates that may be received through the SPIA are potentially higher than other currently available alternatives, there is no opportunity for increased payments when rates rebound.

2) **Loss of Control:** Once the funds are turned over to the insurance company, the annuitant has lost the ability to direct the use of these funds. They are no longer available for emergencies, for alternative investment opportunities, or as an inheritance for heirs.

3) **Lack of Liquidity:** No one knows when life emergencies will occur. SPIAs offer limited, and in some cases, no liquidity for emergencies. Purchasers should always have sufficient emergency funds available if SPIA is chosen to supply retirement income.

4) **Low Returns:** The general account of the insurance company invests conservatively. The annuity returns that are combined with principal to determine the SPIA payouts, may be well below returns achievable from other investment vehicles.

5) **No Changes:** When a SPIA payout choice is made, there are almost no opportunities for change. It is difficult for anyone to be sure about making a choice that is right for potentially 30 years in the future.

6) **Commissions and Fees:** The payouts made from SPIA are reduced by commissions for sales representatives and fees for insurance company administration. These charges can be substantial, and may be a high price for the loss of control.

7) **Adverse Selection:** Although the pooling concept of insurers can benefit those that live beyond their life expectancies, according to actuarial tables half of the people will not achieve these life expectancies. This group is contributing mortality credits to the payouts of those that live long lives. The [beneficiary](#) protection options protect against this, but more of the mortality credits are extended to those that live beyond life expectancy.

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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 59½. 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.

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Annuity Tax Concepts

We have commented on a variety of annuities tax concepts as we have progressed in our review of annuities thus far. Taxation and its impact on an investment choice is a very important part of determining the suitability of an investment. Income taxes, estate taxes and gift taxes may all apply to annuities at various stages of ownership.

A. Qualified vs. Nonqualified

An annuity can be categorized as a qualified or nonqualified annuity based on the money that is used to fund it. If the dollars that are used as purchase payments are after-tax dollars, the annuity plan is nonqualified. One of the foremost benefits available to purchasers of nonqualified annuities is the tax-deferred growth opportunity that is available within an annuity [contract](#). Tax-deferred growth is of great benefit in accumulating dollars for retirement, and thus far, the government has supported the use of annuities for this purpose by imposing no limits on the amount of contributions that can be made on a nonqualified basis.

Although there are no limits imposed on contributions to nonqualified plans by the government, insurers will sometime impose limits on exceptionally high premiums for risk management purposes. Generally, these limits do not affect the typical buyer.

Qualified annuities, on the other hand, are those that are used in tax-qualified retirement plans like IRAs, Roth IRAs, 401(k), Tax-Sheltered Annuity (TSA) or 403(b) plans, defined benefit and defined contribution pension plans, Simplified Employee Pension (SEP) plans, profit-sharing plans, and certain other government plans. They are funded with pre-tax dollars. Annuities used within qualified plans provide the same investment opportunities and guarantees as those that are nonqualified. There is no additional tax-deferred treatment of earnings. The same tax-deferral is a feature of both qualified and nonqualified annuities. Annuities used within qualified plans are, however, subject to the annual contributions limits that the government has stipulated for each of the respective tax-qualified plans.

Because there are no additional tax deferral benefits, many critics have claimed that annuities should not be included within qualified plans. For the purposes of determining suitability, it should be made clear that annuities should be used as funding vehicles for qualified plans for the other benefits they provide. If value is placed on their guarantees, and other features, then they are definitely appropriate.

1. Individual Retirement Accounts

Since individual retirement accounts (IRAs) were first established by Congress in the 1970s, the total account balance has grown to hundreds of billions of dollars. What is

needed are strong creative marketing strategies designed to convince skeptics that individual retirement accounts are, and always will be, a sound and prudent path to secure retirement.

Traditional IRA

Contributions are tax-deductible, and funds grow tax-deferred, but the individual must pay taxes on those contributions and earnings when the funds are withdrawn at retirement. IRS rules mandate that minimum distributions from a traditional IRA must be taken the year after one turns age 70½. The size of those distributions depends on the IRA owner's life expectancy and spouse's/beneficiary's life expectancy.

If an individual's income is too high to contribute to a tax-deductible IRA, he or she can contribute to a nondeductible IRA. Unlike the more common IRA, contributions to this type of IRA are not tax-deductible. Nondeductible contributions and deductible contributions can be combined, although the IRS requires one to track the amount of nondeductible contributions. This is important when the required minimum distributions begin because taxes won't have to be paid on the nondeductible portion.

Roth IRA

Contributions to a Roth IRA are not tax-deductible. However, distributions from a Roth IRA are tax-free when withdrawn, as long as the individual has owned the account for at least 5 years, and the money is withdrawn after age 59½. Roth IRAs are not subject to required minimum distributions at age 70½, like traditional IRAs and other qualified plans.

If maximizing current cash flow is a priority, the individual may want to select the traditional IRA and take the deduction. On the other hand, if the deduction is not a necessity and one qualifies for a Roth IRA, it may be more beneficial to opt for the tax-free distributions at retirement. With a Roth IRA, interest compounds tax-free and money withdrawn after age 59½ is tax-free. While each person's situation should be calculated individually, the Roth IRA may yield greater income at retirement because of the tax-free compounding and tax-free withdrawals. If an individual is fortunate enough to have money in a traditional IRA and a retirement plan with an employer, those funds will be taxed at ordinary rates in retirement, leaving the individual with less income from those plan distributions.

In the event the individual has not saved enough money for retirement, he or she should consider a traditional IRA if that makes the difference between contributing or not contributing at all. Contributing to a Roth IRA makes sense because the contributions will go farther in retirement on a tax-free basis.

Contributing to a Roth IRA is better if a substantial retirement savings is available and an individual wants to leave money to his or her heirs. Using the Roth IRA, a person can designate beneficiaries, who can spread out the required distributions they must take from an inherited Roth IRA throughout their lifetimes.

The ability to contribute to a Roth IRA is phased out at higher income limits.

The table below shows the 2016 Roth IRA contribution limits and phase out.

Tax-Filing Status	Modified Adjusted Gross Income	Contribution Allowed
Married filing jointly or qualifying widower	less than \$184,000	Full deduction
	\$184,000 or more but less than \$194,000	Partial deduction

	\$194,000 or more	No deduction
Married filing separately and you lived with your spouse at any time during the year	Less than \$10,000	Partial deduction
	\$10,000 or more	No deduction
Single, head of household, or married filing separately and you did not live with your spouse at any time during the year	less than \$117,000	Full deduction
	\$117,000 or more but less than \$132,000	Partial deduction
	\$132,000 or more	No deduction

Spousal IRA

One unique feature of IRAs (traditional IRAs and Roth IRAs) is that a spouse without earned income can contribute to an IRA. In order for a spouse without earned income to establish a spousal IRA or spousal Roth IRA their spouse must have earned income sufficient to qualify for the contribution (more on this later). NOTE: In order to qualify for a spousal IRA or spousal Roth IRA you must file a joint federal tax return with your spouse. If you are married, but file separate returns the spousal IRA or Spousal Roth is not allowed.

Establishing an IRA

There are three rules that must be met in order for an individual to contribute to a traditional IRA:

- The individual (or the individual's spouse) must have earned income.
- The individual must be under the age of 70½.
- The amount contributed must not exceed \$5,500 per year for those age 49 and younger (those age 50 and older can contribute \$6,500), or 100% of compensation, whichever is less.

Earned income includes compensation for personal services, wages, tips, commissions, self-employment earnings, and even alimony. It does not include retirement income, deferred compensation, investment income or other passive income. An individual whose only source of income, for example, is dividends from inherited stock, is not eligible to open an IRA. The age limitation was established to ensure that these accounts would be used for retirement purposes, and not as a means to shelter income and earnings from taxes.

2. Qualified Plan Options for Businesses

There are three general categories of retirement plans available to small businesses. The optimum plan should reflect the company's size, financial situation, and ability to comply with regulatory oversight and administrative responsibilities.

SEP-IRAs

A Simplified Employee Pension plan (SEP-IRA) is often preferred for a single-person business or a business with just a few employees. It is relatively inexpensive and simple to establish and administer. The employer contributes to a SEP-IRA. Employees do not contribute but are immediately 100% vested, and each employee determines how their account funds are invested.

Although there are a few exceptions, a SEP-IRA plan must cover all employees age 21 or older who earn at least \$600 annually from the business and have worked for the company during at least 3 of the preceding 5 years. Currently, the annual contribution limit for each employee is 25% of compensation (or, for the self-employed, net earnings) or \$53,000, whichever is less.

SEP-IRAs also offer small business owners flexibility regarding both the amount and timing of contributions. Employers need not contribute to the plan every year and can change the percentage of the contribution at any time. As a result, a SEP-IRA may make sense for a business with profits that tend to fluctuate from year to year.

SIMPLE IRAs

The Savings Incentive Match Plan for Employees (SIMPLE IRA) is also valued for its ease of administration and is available to businesses with 100 or fewer employees. A so-called “matching” SIMPLE IRA plan currently allows employees to contribute up to \$12,500 of salary (with the catch-up provision, the limit for age 50 and older is \$15,500, or \$3,000 more).

The employer must then make a dollar-for-dollar matching contribution of up to 3% of each worker’s annual compensation. However, the employer has the right to match as little as 1% in two out of any five consecutive years.

The other method for funding a SIMPLE IRA requires the employer to make nonelective contributions equal to 2% of compensation for each worker who has earned at least \$5,000 during the year, whether or not a worker has elected to contribute income.

Employers that would like to sponsor a retirement plan but that do not want to make contributions to employees’ accounts may want to consider a 401(k). A business owner must weigh the SIMPLE IRA’s benefit of low administrative fees and the requirement of the employer match against a 401(k), which has much higher administrative fees but does not require an employer match.

Qualified Plans

Most qualified retirement plans are more complex than SEP-IRAs or SIMPLE IRAs and, therefore, have more stringent reporting requirements. Employees must be covered if they are 21 or older and have at least 1 year of service (or 2 years if the plan is not a 401(k) plan and provides for full vesting within 2 years). There are several types of qualified plans, which can be broken down into two broad categories: defined benefit and defined contribution plans.

- **Defined Benefit Plans** – Defined benefit (DB) plans are more commonly referred to as traditional pension plans. They promise to pay employees a steady income stream in retirement. The amount each employee receives is generally based on that employee’s earnings history and length of service. Employers must contribute enough to the DB plan each year to satisfy what’s known as a minimum funding requirement. Actuarial assumptions and computations are necessary to calculate benefit and minimum funding amounts. For this reason, administration of these plans usually requires professional assistance.
- **Defined Contribution Plans** – With defined contribution (DC) plans, employers make a stated contribution into individual accounts for each employee. Employees may then be given the authority to invest the money as they see fit. DC plans do not require immediate vesting and may allow employee loans.
- **Profit-Sharing Plan** – A form of DC plan, employers can vary the amount and frequency of contributions based on fluctuating profits. Profit-sharing plans have the greatest flexibility because employers can decide how much to contribute in a given year, depending upon company profits.
- **Money Purchase Plan** – Another form of DC plan, contributions are mandatory, and the percentage amount may not vary from the percentage stated in the plan documents. In other words, the employer must make contributions each and every year, whether or not the company has profits.
- **401(k) Plans** – These popular DC plans allow employee contributions (or “elective deferrals”). In recent years, 401(k)-style plans have become less complex and less

expensive for smaller businesses.

Nondiscrimination testing, filing, and administration costs can make 401(k) and Roth 401(k) plans more difficult to manage than other types of plans. (Note that SIMPLE 401(k) plans allow employers to avoid some contribution discrimination tests.) Participants may contribute up to \$18,000 for 2016, and employers also may make contributions. Total contributions to an individual's account cannot exceed \$53,000 or 100% of compensation, whichever is less.

	SEP-IRAs	SIMPLE PLANS	OTHER QUALIFIED RETIREMENT PLANS
Funding Responsibility	Employer	Employer and employee	Employer (or, for 401(k)-style plans, employer and employee)
Level of Complexity/Reporting Requirements	Low	Low	High
Vesting	Immediate	Immediate	Flexible
Contribution Limits	25% of compensation or \$53,000	\$12,500 for employees; up to 3% of compensation for employers	Varies by plan type

3. Tax-Sheltered Annuities - 403(b) Plan

Designed for **nonprofit organizations** that qualify under Section 501(c)(3) of the Internal Revenue Code, such as public schools, churches, and research organizations, 403(b) plans allow employees to voluntarily defer their compensation, subject to the same contribution limits as a 401(k) plan. These plans also known as tax-sheltered annuities (TSAs). While most schools do not match contributions, matching contributions are permitted as long as all employees are treated equally. Occasionally, an employer will offer nonmatching contributions. All full-time employees are eligible upon hire. If the employer offers this plan, there is no qualification period and both employee and employer contributions are 100% vested immediately.

B. Taxation

The distinction between qualified and nonqualified annuities is important for ongoing administration. Reporting and taxation will differ based on this status.

1. Taxation of Annuity Premiums

As has already been mentioned, annuities that are nonqualified are paid for with after-tax dollars. The dollars that are contributed are not tax **deductible**. If annuities are part of a qualified plan, the purchase payments are viewed as plan contributions, and are not includable in the employee's income when they are contributed to the annuity.

Thus, contributions to qualified annuities are considered pre-tax. The exception to this categorization occurs with Roth plans. For example, in Roth IRAs or Roth 403(b) annuities, the annuity purchase payments are includable as income.

The **exclusion ratio** is used to determine the annuity amounts to be excluded from taxes. The annuitant is able to recover the cost basis nontaxable. The cost basis is the **principal amount**, or the amount that was paid into the annuity, which is excluded from taxes. The rest of each annuity payment is interest that has been earned and is taxable.

2. Tax Deferred Growth

The growth of annuity contracts is enhanced by the deferral of taxation on any dividends, interest, and capital gains that are credited prior to withdrawals. Transfers between subaccounts and other investment options within variable annuities benefit from this favorable treatment, and are not subject to taxation when they occur. By contrast, transfers between currently taxable investments are treated as a sale and repurchase, and any gains are currently taxable. *For example*, a transfer from a mutual fund growth fund to a mutual fund balanced fund, even if within the same fund family, is considered a sale for tax purposes. Any gain or loss on that transaction is currently subject to tax reporting.

There are tremendous financial advantages to tax deferred compounding, because it allows for significant growth over time. A compounded annual return on annuity investment, after, say, 20 years could result in a tax deferred value that is equal to or even higher than the taxable value. The long-term effect of tax-deferred compounding can be thought of as "earning interest on your interest." Continuing to earn interest on funds that would have otherwise been paid in taxes enables funds to grow faster and to accumulate to a greater amount over time.

The benefit of tax-deferred growth in annuities is one that has been made available only to individuals to promote retirement savings. Annuities owned by entities such as corporations do not get the benefit of tax deferral. The entity is taxed annually at ordinary income rates on the increase in the net surrender value of the contract, minus any purchase payments that were made for that year.

3. Gifts of Annuity Contracts

Income taxes may apply when an annuity **contract** owner gives a nonqualified annuity contract to another party as a gift. If the recipient is someone other than the spouse or an ex-spouse as part of a divorce decree, the contract holder may be liable for income taxes at the time the gift is given. The amount of income that must be recognized is the difference between the cash surrender value of the contract and owner's after-tax contributions to the contract. Gift taxes may also apply to this transaction. The giver of the gift may be subject to this tax, in addition to income taxes, if the gifted amount exceeds the current annual exclusion of \$14,000 per donee (2015 amount; subject to IRS announced inflation increases).

4. Withdrawals

Annuity **contract** owners may be subject to income taxation when they take lump-sum withdrawals. Because the money within the contract accumulated on a tax-deferred basis, income taxes are due on any contract earnings. Capital gains rates never apply to annuities (both qualified or nonqualified), so all earnings withdrawn from any annuity are always taxable as ordinary income.

In addition to income taxes, a further 10% federal tax penalty applies on the taxable amount of earnings withdrawn, if taken before the age of 59½. Taxation is in addition to any surrender charges that may apply.

When a partial withdrawal is taken from a nonqualified annuity, the earnings are determined using the *interest and earnings first* method.

To illustrate, assume that the owner of a nonqualified contract funded it with \$60,000 in after-tax money. Years later, the contract value is \$100,000, comprised of the \$60,000 in after-tax contributions and \$40,000 in earnings, which has not yet been taxed due to tax deferral. Now the 65-year-old owner takes a partial withdrawal of \$35,000. The *interest and earnings first* method assumes the first dollars withdrawn in a partial withdrawal are earnings (until all earnings have been withdrawn). The entire \$35,000 of the partial withdrawal is considered earnings and is taxable as ordinary income in the year withdrawn. Partial withdrawals are considered earnings as long as earnings remain in the contract.

If the above example were changed slightly and the partial withdrawal was \$45,000, there would have been \$40,000 taxed as earnings and \$5,000 would have been attributed to after-tax contributions and not taxable.

For qualified contracts, all contributions are made with pre-tax dollars, so any withdrawal is subject to full taxation as ordinary income. The 10% federal tax penalty also applies if the withdrawal is taken before age 59½.

Example:

Ellen has contributed \$48,000 to a nonqualified deferred annuity. It has earned \$48,000 in interest for a total current value of \$96,000. It is time for Ellen to begin receiving distribution payments from the annuity, but she is confused about the tax effects.

Each payment Ellen receives is made up of both principal and interest. Because nonqualified annuities are paid for with after-tax dollars, the portion of the payment that is attributable to after-tax contributions will not be taxed. The portion of the payment that is attributable to interest or earnings will be taxed as ordinary income. This is calculated using the **exclusion ratio**. The exclusion ratio benefits Ellen because it spreads her tax liability over the years she is receiving payments from the annuity.

If Ellen's annuity is set up to make distribution payments for 10 years, she will receive \$800 per month for 10 years (\$96,000/10 years/12 months). Fifty percent of each payment is principal, so \$400 is received with no tax consequences. The other \$400 is interest and taxed as ordinary income.

5. Assignments of Annuity Contracts

Assignments of annuity contracts are taxed like partial withdrawals. Any amount of an annuity contract's cash value that is assigned or pledged as collateral is subject to the income tax treatment just described. The portion attributable to earnings is withdrawn first and subject to income taxation.

6. Contract Surrenders

If an annuity owner surrenders a nonqualified contract in its entirety, income taxes are due at ordinary income tax rates on the earnings portion of the amount received. The earnings portion is the difference between the after-tax contributions made to the annuity and the amount that is received when surrendered. While there are limited

exceptions, the IRS 10% penalty will also apply to the earnings portion received when surrendered if the surrender occurs prior to the age of 59½.

Please note: **The IRS 10% penalty does not apply to amounts distributed from a nonqualified annuity that are attributable to after-tax contributions;** however, since contributions made to a qualified annuity (such as an IRA or 401(k)) are made with pre-tax dollars, all amounts distributed are considered earnings and therefore subject to the 10% IRS penalty if withdrawn prior to 59½.

7. Premature Distributions

Most premature distributions are subject to the 10% federal tax penalty that applies to withdrawals or complete [contract](#) surrenders that occur prior to the age of 59½. However, exceptions may apply. There is no tax if the distribution is made due to the owner's death or disability.

8. Taxation of Annuity Payments

Unlike partial withdrawals from a nonqualified annuity, distributions that are made pursuant to the election of an annuitization method (single life, joint life, period certain, etc.) are taxed using a calculation involving the exclusion ratio. Each payment is treated as part of a return of after-tax contributions and part earnings. The amount attributable to earnings is subject to taxation as income, and considered a return of after-tax contributions (also called principal or cost basis), so it is not taxed.

To determine the amount of principal returned in each annuity payment, the total principal that was contributed is divided by the amount of each annuity payment multiplied by the number of expected payments specified by the annuitization method elected (called the expected return). The ratio of the total principal contributed divided by the expected return is called the **exclusion ratio**, and is applied to each annuity payment to determine the amount excluded from taxation as a return of principal.

When annuity payments are to be made for life, determination of the expected return is based on the life expectancy of the annuitant.

For example, let's assume that over a number of years an individual had contributed \$85,000 in after-tax money to a nonqualified deferred annuity, and at age 70 elected a life-only annuitization that will pay \$1,000 a month in annuity payments. Let's further assume that the IRS mortality table indicated a 10-year life expectancy for a 70-year-old individual. The expected return would be \$120,000 (\$12,000 per year of annuity payments times a life expectancy of 10 years). In the first year of annuitization, the exclusion ratio would be .70834, which is calculated by dividing the after-tax premiums contributed by the expected return (\$85,000/\$120,000). Using this exclusion ratio, \$8,500 would be excluded from taxable income as a return of after-tax premiums paid into the annuity (\$12,000 in annuity payments X the exclusion ratio of .70834).

If you add in inflation riders or period certain, the calculation is more complicated. In addition, the expected return and exclusion ratio must be recalculated every year. The good news is that the burden of calculating the taxable and nontaxable amount of each year's annuity payments is placed on the annuity company. Each year the monies are paid out of an annuity, the annuity company must file a 1099R with the IRS and send a copy to the annuitant.

At times, annuity [contract](#) owners may choose partial annuitization, which means only a portion of the contract's cash value is used to produce annuity payments. When this

is the case, the contract is segmented into two parts. The part that is not annuitized is not subject to any tax consequences. The after-tax payments into the contract are allocated pro-rata between the two contract segments for determining the exclusion amount of each payment.

9. Taxation Rules at Death of the Owner

When the owner of an annuity dies, certain distributions must take place by law. This requirement helps prevent prolonged deferral of the income tax that applies to the gains in the [contract](#). If the owner dies before the commencement of annuity payments, tax rules require that the entire contract interest is distributed within 5 years of the date of the owner's death.

The [beneficiary](#) of the contract has the following choices:

- Take the full amount and pay all taxes at that time;
- Take withdrawals over the next 5 years and pay the taxes due on each withdrawal, as the remaining amount within the account continues to grow on a tax-deferred basis;
- Wait for the full 5 years to take the withdrawal, and allow it to grow tax deferred until that time. All taxes must be paid at the time of the withdrawal.

An exception to the 5-year distribution requirement may apply when payments are made to a beneficiary over life or for life expectancy. The beneficiary has 12 months from the date of the owner's death to choose to invoke either of these options. If the beneficiary selects the life option, each payment is treated as part return of principal, part earnings as described previously.

If the individual who died had a spousal beneficiary, the rules are slightly different. The surviving spouse is treated as the owner of the contract, and the after-death distribution rules are postponed until the surviving spouse's death.

If the owner dies on or after the annuity commencement date, but before the entire contract interest is distributed, the remaining portion must be distributed at least as rapidly as the distribution method that was in effect at death. For example, if the annuity owner died 10 years into a 20-year period certain, the remaining amount must be distributed over a period not to exceed 10 years.

10. Estate Tax Concepts

Although annuities are designed as retirement planning contracts, not estate planning tools, they do have some benefits that apply to estate tax situations. Annuities avoid probate and offer some benefits that can result in preservation of the value of the estate.

The probate process can be costly, long, and drawn out. Because annuities require the naming of a [beneficiary](#), the probate process can be avoided. Payout of the benefit is direct to the beneficiary.

An exception to this practice exists if the annuity owner named the estate as the beneficiary, did not name the beneficiary, or if the beneficiary rejected the benefit and there was no contingent beneficiary. In any of these examples, the proceeds are considered part of the estate, subject to its normal distribution process.

Annuity contracts offer a unique provision known as a "restricted beneficiary" option. This provision allows the annuity owner to specify the amount, frequency and timing of distributions to be paid to a beneficiary. The annuity will pay the benefit over the life of the beneficiary, during which the contract proceeds can continue to grow and

compound on a tax-deferred basis. The insurer must have the necessary paperwork completed by the owner for this type of distribution.

Most annuity products include death benefits that ensure that beneficiaries will receive no less than the original purchase amount minus any withdrawals. Enhanced benefits options sometimes increase the death benefit based on positive investment performance. When the beneficiaries receive the death benefit, they must typically recognize the earnings portion of the death benefit payout as income, and pay taxes on that amount. **The amount that is considered a return of principal is not taxable to the beneficiary.**

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1035 Exchanges and Replacements

Manufacturers of annuities continue to respond to the demands of the marketplace with new product ideas, new features, and new marketing approaches that are geared toward the needs of today's retirees and persons approaching retirement. As new features are introduced, owners of legacy products are sometimes intrigued by these fresh benefits when approached by advisers. The lure of the new product sometimes results in a request to terminate the old to acquire the new. It is this process of exchanging one [contract](#) for another that we will examine in this section. Its common name is replacement, and the IRS concept of 1035 exchanges plays a key role in making it occur.

A. Annuity Replacements

The replacement process can benefit customers immensely, resulting in the acquisition of a product with stronger benefits and more appropriate features. However, it can also be driven by advisors who are selfishly motivated by additional opportunities for compensation. Because of some questionable sales situations involving product replacements and unscrupulous financial representatives, there is substantial regulatory focus on customer protection. The practice of unnecessarily replacing an existing [insurance policy](#) or annuity contract with a new policy from the same or a different carrier to generate a new commission for the producer is a violation of state replacement laws. This prohibited practice is known as [churning](#).

FINRA has been on the forefront of advising financial consumers to be on the alert for churning with regard to variable annuities, and has published this message on its investor website:

"Variable annuity sales have dropped along with the decline in the equity marketplace. A recommendation for the exchange of an existing annuity contract for a new annuity contract may be the only way a salesperson can generate additional business. However, the new variable annuity contract may have a lower contract value and a smaller [death benefit](#). As in any circumstances, you should exchange your annuity only when it is better for you and not just better for the person trying to sell you a new annuity."

There are certainly times when replacement of an existing contract is appropriate. The following are circumstances that might warrant [consideration](#) of replacement:

- The new contract offers a bonus on purchase payments that greatly enhances the earnings in the contract;
- The new contract has investment options that are not available in the existing contract;

- Better features for lower fees and charges;
- Enhanced death benefits; or
- The living benefit choices are more attractive.

There are also times when replacement is clearly not in the best interest of the customer. Let's review some of those examples:

- Attractive benefits of the old contract are not available in the new contract; for example, the old contract includes higher minimum guarantees or death benefits.
- New surrender charges apply, which will limit contract liquidity.
- New contract acquisition requires costs that may impact the benefits.
- Appealing bonus payments are offset by high charges.
- Although many new and robust features are included in the contract, the customers do not need them to achieve their investment objectives.

The higher commission paid for the sale of an annuity product has resulted in the representative limiting the introduction and offer of other financial products that could be better suited to the situation.

In any case, the replacement of an annuity should only take place when it is determined that **it is in the best interest of the customer**, as in the following situations:

- A customer has identified a new financial need that the existing product cannot meet.
- A different product can better meet the customer's changing financial needs, goals or risk tolerances.
- A new product has a better price and/or benefits.

Careful evaluation of the benefits of the new contract, as well as the impact to the old, should precede any replacement activity.

1. When Does a Replacement Occur?

The industry definition of replacement is broader than one might immediately expect. It is understandable that the termination of one annuity [contract](#) to purchase another annuity contract with similar features is defined as a replacement, but other contract changes are also within the definition. *For example*, changes to life insurance contracts can be considered replacements if these changes are made to make funds available for the purchase of an annuity.

Generally, a replacement occurs when a new contract is purchased, and to complete the sale, an existing policy is

- Surrendered, lapsed, forfeited, or terminated in any way;
- Converted to a reduced paid-up policy, continued as extended term insurance, or otherwise reduce in value by use of nonforfeiture benefits or other policy values;
- Amended to reduce benefits or terms;
- Reissued with a reduction of cash value;
- Borrowed against, and a loan amount of more than 25% of the loan value is requested (whether as a single loan or a schedule of borrowing over a period of time); or
- Pledged as collateral for a loan.

2. Considerations in the Replacement Process

Before proceeding with a replacement for the purchase of an annuity [contract](#), the impact of the decision should be carefully considered with the customer. The following list of questions is helpful in this process.

Contract values:

- Acquisition cost for the old policy may have been paid; what are these costs for the new contract?
- What surrender charges do the policies have? What expense and sales charges will be paid on the new contract?
- Does the new policy provide more or less death benefit?

Insurability (relevant if a life [insurance policy](#) is being replaced):

- Has health has changed since the purchase of the old policy? If so, no new coverage may be available.
- The future purchase of a new life insurance policy may require medical examination and will restart the suicide provision.

If the owner keeps the old policy and purchases a new annuity:

- Are purchase payments or premiums for both contracts affordable?
- How will this affect the payments on the existing policy?
- Will a loan reduce any expected death benefits?
- What values from the old policy are being used to pay premiums?

If surrendering an annuity or interest-sensitive life product:

- Will surrender charges be payable on the old contract?
- What are the interest rate guarantees for the new contract?
- How do contract charges or other policy expenses on the new contract compare to the old?

Other issues to consider for all transactions:

- What are the tax consequences of the transactions?
- Is this a tax-free exchange? (See your tax adviser)
- Are there any beneficial "grandfathered" federal tax treatments of the old contract that may the owner is giving up?
- How does the quality and financial stability of the new company compare with the existing company?
- Is the company that issued the contract as financially strong as it was in the past?

3. Responsibilities of the Agent in a Replacement Sale

When proceeding with the replacement of a [contract](#) for the sale of an annuity, financial representatives must ensure compliance with applicable state law.

Representatives are required to disclose all aspects of a replacement sale to the customer. In the process, the representative must complete documentation of the objectives, rationale and suitability for the replacement, and any associated costs.

Typically a "**Notice Regarding Replacement**" form must be read to the [applicant](#) and then signed by both the representative and the applicant. The agent must leave a copy with the applicant and submit it with the [application](#). The applicant should also be given copies of any written or printed sales material, illustrations or proposals that were used in the sales process.

Representatives must maintain complete files to document their needs analysis and their resulting recommendations.

These procedures apply in replacement of both the policies of other companies, and any policies of the same issuer.

4. Responsibilities of the Insurer

The insurance company that will issue the new annuity **contract** must follow the internal guidelines and state-specific replacement regulations in the sale. All required forms must be accounted for and reviewed in the issue process. The insurer must prepare and require the appropriate **disclosure** forms for financial representatives to provide to purchasers.

Further, reviews of representative business practices are conducted to ensure proper business practices have been followed and necessary documentation has been maintained. Under new replacement regulations, issuing companies are required to "monitor" replacement activity and actively seek out replacements that have not been properly disclosed as replacements by either the client or agent. These "unreported" replacements must be tracked separately for each agent and are subject to review internal and by the state department of insurance.

The new company must also promptly send a "Notice of Proposed Replacement of Life Insurance or Annuity" to the customer's existing insurer stating that an existing policy is to be replaced. This notice must include a signed acknowledgement by the agent.

B. California Annuity Replacement Regulations (CIC 10509-10509.9)

Replacement is defined as the purchase of a new individual life insurance or a new annuity **contract** which will result in another policy or contract with another insurer to be lapsed, surrendered, terminated, forfeited, converted to another type of policy (*for example*, exercising a nonforfeiture option), or have the benefits reduced. When a replacement is involved (whether the new agent knows for sure or should reasonably suspect so), extra requirements apply. These include disclosures and notification to the client.

The nature of these replacement guidelines includes the following:

- Making sure the purchaser can make a complete and fair comparison between the two products to make the best decision;
- Reducing the opportunity to make misrepresentations and incomplete disclosures and evaluations; and
- Establishing penalties for failure to comply with these measures.

1. Requirements

During the time of taking the **application** and underwriting, **an agent** must do the following:

- When the client already has life insurance, the applications will require a signed statement by the client confirming his or her intentions to replace, as well as a signed statement from the agent determining whether he or she knows/suspects that a replacement may be involved. The application will ask for information on all current life insurance policies the client has.
- If there may be a replacement, there is another separate **disclosure** form, a "Notice Regarding Replacement of Life Insurance." This must be signed by the client and agent at time of application. On this form detailed information may also be listed concerning the current policy, including name and address of the current insurer(s), as well as policy number and amounts of coverage. A copy of this form (often a triplicate form) is to be left with the client for their records. Another must be sent in with the application, and the agent/branch office may retain the third.
- The new potential insurer is then required to send a copy of this disclosure to the original insurer. This allows the original insurer to contact the client and address any of their concerns. This attempt to "save" the original policy is called **conservation**. As long as it is done truthfully, this allows the client to better make an informed decision. Conservation is good and should be encouraged in the best

interest of the client. Copies of materials or information used in replacement or conservation should be left with the client. Remember, notifying the original insurer is not meant to protect the interests of the original agent; it's for the consumer protection.

- If an existing insurer attempts conservation, it has **20 days** to give the [policyowner](#) an outline of the current policy to help him or her make this fair comparison.

When annuities are involved, the disclosure information must be in the [contract](#) summary. The replacing insurer may request the existing insurer to furnish it with a copy of the summaries or ledger statement, which must be within 5 working days of the receipt of the request.

Replacement rules do not apply in the following situations:

- Replacing credit life insurance;
- Replacing group life insurance or group annuities;
- When converting or changing the current policy (with the same insurer); and
- Transactions where the replacing insurer and the existing insurer are the same (a new policy).

The burden of following the replacement rules falls on the replacing insurer to ensure that its agents are following these guidelines properly. This includes making sure the applications and disclosures properly ask replacement questions and returning to the agent any applications not correctly completed.

The replacing and existing insurers must retain evidence of all signed applications and disclosures, as well as other materials used in replacement or conservation, for **no less than 3 years**.

If the proposed new policy is underwritten and is then delivered to the client, the client has a **30-day free-look period** to evaluate the policies. Within this time period, if the client chooses to decline the new policy, the insurer must issue a full refund, no questions asked. The replacing insurer must provide a notice stating that the owner has a right to an unconditional refund of all premiums on the front of the policy jacket or on the cover page of its life [insurance policy](#) or annuity contract or, alternatively, as a separate written document which is delivered with the life insurance policy or annuity contract.

When an agent isn't used in the sales process (example: direct response or internet marketing), the replacing insurer must present to the client a [disclosure](#) similar to the one described earlier, as soon as a replacement is suspected, even if that means presenting the disclosure when the actual policy is delivered (usually via mail).

To maintain this standard, the insurer should still ask on the [application](#) what life insurance the applicant currently has, as well as whether a replacement is involved. Not using agents does not excuse companies of their replacement responsibility.

If the client, in his or her haste to save a month's premium, cancels the original policy or just fails to pay it, and then passes the [grace period](#), then the first policy will [lapse](#). The client will then get declined or rated by the new insurer during the underwriting process. If he or she decides against obtaining the new policy, then the person has lost the first policy and is now uninsurable. The client may have trouble reinstating and may be unable to get insurance with the new company. An agent should never leave a client in a worse condition (without any insurance) than the condition in which the client was found.

If a client insists on canceling or changing his or her current coverage before the proper time, the agent should have the client write and sign a letter saying he or she is acting contrary to the agent's advice. Hurting a client in the replacement process is an easy way for an agent to open himself or herself up to administrative troubles with the Department of Insurance and potential legal liability in court.

The following are replacement considerations:

- Even though the policies may be similar, the newer policy may be more expensive because the client is older and potentially not as insurable.
- Changing the current policy may make more sense than starting over with a new policy. The client might not have to worry about starting the incontestability period over as he or she might with a new company. Will the new company honor any incontestability periods that have already been met with the first company?
- Are premiums in either policy guaranteed, or can either change over time? If so, when or how often?
- If cash value, does the current policy have a surrender charge? Would a 1035 exchange benefit the client?

Sample Disclosure (CIC 10509.4(d))

NOTICE REGARDING REPLACEMENT REPLACING YOUR LIFE INSURANCE POLICY OR ANNUITY

Are you thinking about buying a new life [insurance policy](#) or annuity and discontinuing or changing an existing one? If you are, your decision could be a good one, or a mistake. You will not know for sure unless you make a careful comparison of your existing benefits and the proposed benefits.

Make sure you understand the facts. You should ask the company or agent that sold you your existing policy to give you information about it.

Hear both sides before you decide. This way you can be sure you are making a decision that is in your best interest. We are required by law to notify your existing company that you may be replacing their policy.

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(Applicant)	(Agent)	(Date)

2. Unnecessary Replacement (CIC 10509.8)

A violation occurs when an agent or insurer recommends the replacement or conservation of an existing policy based on a materially inaccurate presentation or comparison of the existing contract's premiums and benefits or dividends and values, or recommends that an insured 65 years of age or older purchase an unnecessary replacement annuity.

"Unnecessary Replacement" means the sale of an annuity to replace an existing annuity that requires the insured to pay a surrender charge for the annuity being replaced and does not confer a substantial financial benefit to the purchaser, so that a reasonable person would believe that the purchase is unnecessary.

A contract owner has the right to replace an existing annuity contract after indicating that replacement is not the intention. However, patterns of that action by contract owners using the same agent will be considered evidence that the agent knew

replacement was intended, and that the agent intended to violate the rules regarding replacement.

3. Penalties

Any person or entity that violates the replacement provisions of the Insurance Code is liable for the following administrative penalties:

Agents:

- A minimum of \$1,000 for a first violation;
- No less than \$5,000 and no more than \$50,000 per violation for a second or subsequent violation.

Insurer:

- \$10,000 for a first violation;
- No less than \$30,000 and no more than \$300,000 per violation for a second or subsequent violation.

The Commissioner may suspend or revoke the license of any person or entity that violates the articles of the Code.

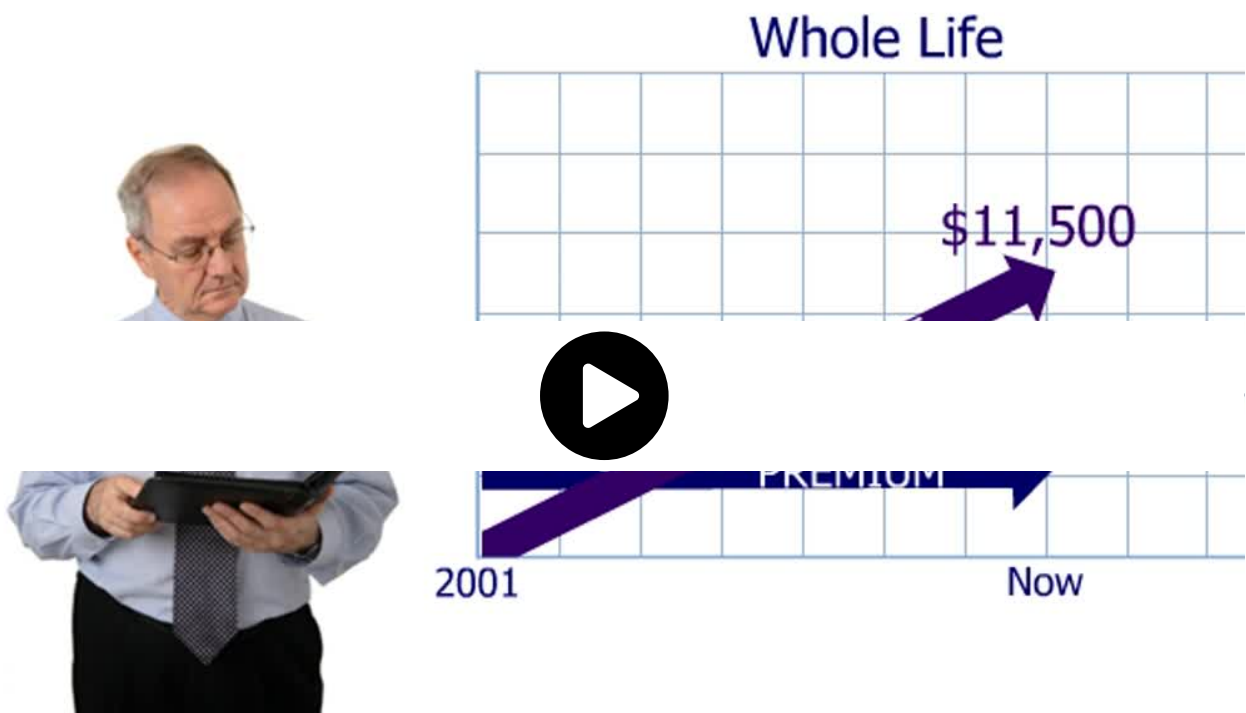
C. 1035 Exchanges

Many annuity sales are made possible through a tax-free exchange known as a 1035 Exchange, as codified in Section 1035 of the US Tax Code. A 1035 exchange involves the replacement of an existing insurance [contract](#) for the purchase of a new one, and permits tax advantages if the transaction qualifies as **like-kind exchange**. 1035 transactions have been instrumental in the sale of annuity products, and have contributed to much of the recent sales growth of variable annuities. In fact, 1035 exchanges are funding over 60% of new variable annuity sales. The numbers for fixed annuities are more in the range of 40%.

A 1035 exchange allows the contract owner to exchange outdated contracts for more current and efficient contracts, while preserving the original policy's tax basis and deferring recognition of gain for federal income tax purposes.

The following are exchange transactions that may qualify for favorable tax treatment under this code:

- A life [insurance policy](#) can be exchanged for another life insurance policy, an endowment insurance policy or a nonqualified annuity.
- An endowment insurance policy can be exchanged for a nonqualified annuity or another endowment policy.
- A nonqualified annuity can be exchanged for another nonqualified annuity.



1. Results of 1035 Exchange Transactions

When used appropriately, 1035 exchanges are highly effective in protecting against unfavorable tax consequences that could otherwise result when an old contract is terminated and new a contract is purchased.

Under most circumstances, the surrender of an existing insurance contract that has a gain in contract value is a taxable event. The gain must be recognized and reported as current income. However, if the purchase of a new contract qualifies as a 1035 exchange, the gain on the old contract is not currently taxable, and the cost basis is transferred to the new account. For this to take place, the exchange must occur between the two insurance companies involved. The exchange is not valid if the owner requests the proceeds from the insurance company by check and applies them to purchase a new contract.

Chapter Complete

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Quiz

Sales Practices for Annuity Producers

Our review of annuity features, benefits, advantages and disadvantages has been intended to lay the groundwork for you to ethically and proficiently help your clients prepare for the risks of retirement. The opportunity for advisors that have skill in both the retirement accumulation and distribution processes is staggering. Equally staggering is the responsibility that is on your shoulders. After all, you are advising people with regard to some of the most important decisions they will make in their entire lives. The consequences of bad decisions can subject people to years of financial discomfort and take away the dignity and freedom of a financially successful retirement.

Model Act Requirements: For all of these reasons, both the California Department of Insurance and the National Associations of Insurance Commissioners (NAIC) have raised the bar on education and supervision of annuity producers. They have mandated more stringent disclosures, higher levels of education, tighter guidelines on replacements, and additional protection for seniors to ensure that our industry establishes a reputation of doing the right thing for the customer instead of pushing products that have high fees and commissions.

Insurer Responsibilities: The regulations do not single out only annuity producers. They extend new requirements to insurance companies that issue annuities, and force them to take greater responsibility for ensuring that financial advisors are representing their products properly. The rules hold both insurers and producers responsible in ensuring that customer recommendations are appropriate, require the establishment of supervisory standards and procedures for suitability review, and direct that all producers complete product specific training delivered by the insurance company that issues each of the products they sell. Producers must complete the training before solicitation of the product.

Keeping Current: As basic as it seems, financial advisors need to know the details of the products they are recommending. It is their responsibility to educate their customers on why the product suits their situation, and to provide a fair and balanced overview of the features and benefits and advantages and disadvantages of the product. This is not possible unless the advisor has taken the time to learn the product in preparation. Completing training requires time and professional commitment. It simply is not easy to keep up with the continuing changes that insurers implement to keep their products competitive. Staying up to date with the slight variations in products like surrender charges, withdrawal provisions, state variations, and other regulations is a constant challenge.

Protection of Seniors: Another area of emphasis pertains to protection of senior citizens. Sales of annuity products to senior consumers have significantly increased in recent years. However, there has also been a rise in the sense of confusion among consumers, particularly seniors, who buy annuity products. Unfortunately, some of the blame for this confusion lies with financial representatives who have employed vague, questionable and even deceptive sales practices in dealing with less sophisticated customers. It is disappointing that greed can motivate companies and agents to take advantage of uninformed consumers, but it has happened and all too frequently.

A. Suitability Standards

The suitability rules impose certain duties and responsibilities on insurers and financial advisors regarding the suitability of an annuity sale or exchange of an annuity. Specifically, in recommending to a consumer the purchase of an annuity or the exchange of an annuity, the financial advisor must have reasonable grounds for believing that the recommendation is suitable for the consumer. This is based on facts disclosed by the consumer regarding financial preferences, experiences and needs. To ensure that an annuity product recommendation is suitable, financial advisors must make reasonable effort to gather the information below prior to the execution of the transaction. The same information standard applies for both a recommendation to purchase or exchange an annuity [contract](#).

Required Suitability Information for Annuity Recommendations

- Age
- Annual income
- Financial situation and needs, including the financial resources used for the funding of the annuity
- Financial experience
- Financial objectives
- Intended use of the annuity
- Financial time horizon
- Existing assets, including investment and life insurance holdings
- Liquidity needs
- Liquid net worth
- Risk tolerance
- Tax status
- Whether or not the consumer has a reverse mortgage

To properly position annuities and recommend appropriate product choices, financial advisors must explain that annuities are first and foremost long-term planning products that are appropriate for those with long-term investment horizons. Annuities generally satisfy needs associated with retirement; there are few exceptions where they are appropriate or efficient for other needs or other objectives.

1. Educating Your Customer

We have examined the suitability information that producers must gather to ensure appropriate recommendations for purchase and exchange. Collection of suitability information is a fundamental requirement in the sales process, but your responsibility in selling or recommending an annuity product or exchange requires that you clearly present the features and benefits of the products. If you have done your job thoroughly, you will be able to answer “yes” to each of these questions, and take pride in the work you have done to educate your customer.

- Has the consumer been reasonably informed of the features of the annuity, including

- Potential surrender period and surrender charges;
 - Potential tax penalties that apply upon withdrawals, exchanges, surrender or annuitization;
 - Fees and charges associated with the base annuity;
 - Fees and charges associated with riders; and
 - Limitations on investment choices and returns.
- Will the customer benefit from any of the following features of an annuity:
 - Tax-deferred growth;
 - Annuitization options;
 - Death benefits; and
 - Living benefit.
- Does the customer understand the unique features of the contracts such as
 - Underlying subaccounts and investment choices;
 - How interest earnings are credited; and
 - Riders and other product enhancements.
- Does the customer understand the purpose of the annuity, and
 - The problem it will solve?
 - Its role in the retirement plan?
- Does the customer recognize the long-term nature of the investment, and
 - The restrictions on liquidity?
 - The costly penalties that may apply on excess withdrawals?
- If an exchange or replacement is involved, does the customer understand the following:
 - That new surrender charges may apply;
 - The benefits that were relinquished in the old contract and why the benefits in the new contract are more attractive;
 - Why the exchange makes sense; and
 - The differences in any fees that apply.

This list of questions is by no means comprehensive, because with each product and situation there are unique circumstances that must be considered. Regardless, you should take your role as an educator very seriously when it comes to selling annuities. Taking time to help people understand what can be complicated products will help ensure that confusion and complaints do not arise after the sale.

B. Mitigating Retirement Risks with Annuities

The use of annuities within a retirement accumulation or distribution strategy, and how they can address challenges that people face while preparing for, or in retirement, have been covered throughout this course. Annuities, when suitable, can be ideal products for managing retirement risks. The 3 headlining risks to successful retirement, along with an annuity-based risk mitigation strategy are recapped below. While not all people are equally exposed to each of these risks, they all merit careful consideration in establishing a retirement plan.

1. **Longevity Risk:** The risk of outliving wealth and available income can be completely eradicated using the lifetime income payout options available through either immediate or deferred fixed annuities, or a variable annuity with a GLWB or GMIB rider.
2. **Market Risk:** The temporary or permanent loss of wealth from market downturns or poor market performance can be managed with a variety of annuity alternatives. Fixed annuities, both traditional and index, include minimum guarantees that ensure growth of contract value even when market performance is negative. Variable contracts with GMAB riders ensure that contract value never

falls below an established minimum, but can still increase in times of strong market performance.

3. **Inflation Risk:** The erosion of purchasing power is a well-founded retirement fear, particularly as people live in retirement for more years than ever before. The risk that rising costs will decrease purchasing power can be managed through the choice of inflation adjusted life income options, which can be chosen for both single and joint life payouts.

Today's annuity products provide strong answers for the risks, fears and uncertainties of retirement. Fred Reish, a well-known lawyer specializing in retirement issues, says it well: *"We've come from thinking that stocks and bonds were the answer to everything to worrying about how to arrange for monthly income to age 80 and beyond. Annuities can take away that worry."*

Thank you for your commitment to learning more about annuities and for sharing the annuity story with retirees and pre-retirees who yearn for retirement security. Your professionalism in helping people live comfortably in retirement will be well rewarded.

C. Suitability Standards for Recommending Annuity Purchases/Exchanges (CIC 10509.910)

Insurers are required to establish a system to supervise and set forth standards and procedures that apply when recommendations to consumers result in annuity product sales. This ensures that the insurance needs and financial objectives of consumers at the time of the transaction are appropriately addressed. These rules also apply to recommendations to exchange or replace an existing annuity.

1. Definitions (CIC 10509.913)

The following are key terms as defined by the California Insurance Code (CIC 10509.913):

Annuity means an annuity that is an insurance product under California law that is individually solicited, whether the product is classified as an individual or group annuity.

Insurance producer means a person required to be licensed under California law to sell, solicit, or negotiate insurance, including annuities.

Recommendation means advice or guidance provided or made by an insurance producer or by an insurer, to an individual consumer that results in a purchase, exchange, or replacement of an annuity in accordance with that advice or guidance.

Replacement means a transaction in which a new policy or [contract](#) is to be purchased, and it is known or should be known to the proposing producer (or insurer) that by reason of the transaction, an existing policy or contract is to be:

- Lapsed, forfeited, surrendered or partially surrendered, assigned to the replacing insurer, or otherwise terminated;
- Converted to reduced paid-up insurance, continued as extended term insurance, or otherwise reduced in value by the use of nonforfeiture benefits or other policy values;
- Amended so as to effect either a reduction in benefits or a reduction in the term for which coverage would otherwise remain in force or for which benefits would be paid;
- Reissued with a reduction in cash value; or
- Used in a financed purchase.

2. Suitability of Replacement Recommendations (CIC 10509.914)

In recommending to a consumer the purchase or exchange of an annuity that results in an insurance transaction, the insurance producer (or insurer if no producer is involved) must have reasonable grounds for believing that the recommendation is suitable for the consumer based on the consumer's investments and financial situation and needs, including the consumer's suitability information, and that there is a reasonable basis to believe:

- The consumer has been reasonably informed of various features of the annuity, such as the potential surrender period and surrender charge, potential tax penalty if the consumer sells, exchanges, surrenders, or annuitizes the annuity, mortality and expense fees, investment advisory fees, potential charges for and features of riders, limitations on interest returns, insurance and investment components, and market risk;
- The consumer would receive a tangible net benefit from the transaction;
- The particular annuity as a whole, the underlying subaccounts to which funds are allocated at the time of purchase or exchange, and riders and similar product enhancements, if any, are suitable, and in the case of an exchange or replacement, the transaction as a whole is suitable, for the particular consumer based on his or her suitability information;
- In the case of an exchange or replacement of an annuity, the exchange or replacement is suitable, taking into consideration:
 - Whether the consumer will incur a surrender charge, be subject to a new surrender period, lose existing benefits, such as death, living, or other contractual benefits, or be subject to increased fees, investment advisory fees, or charges for riders and similar product enhancements;
 - Whether the consumer would benefit from product enhancements and improvement;
 - Whether the consumer has had another annuity exchange or replacement and, in particular, an exchange or replacement within the preceding 60 months.

Prior to the execution of a purchase, exchange, or replacement of an annuity resulting from a recommendation, an insurance producer (or insurer where no producer is involved), shall make reasonable efforts to obtain the consumer's suitability information.

An insurer shall not issue an annuity recommended to a consumer unless there is a reasonable basis to believe the annuity is suitable based on the consumer's suitability information.

Neither a producer nor an insurer shall in any event recommend to a person 65 years of age or older the sale of an annuity to replace an existing annuity that requires the insured to pay a surrender charge for the annuity that is being replaced, where purchase of the annuity does not confer a substantial financial benefit over the life of the policy to the consumer, so that a reasonable person would believe the purchase is unnecessary.

Neither an insurance producer nor an insurer has an obligation to a consumer related to an annuity transaction if:

- No recommendation is made;
- A recommendation was made and was later found to have been prepared based on materially inaccurate information provided by the consumer;
- A consumer refuses to provide relevant suitability information and the annuity transaction is not recommended;
- A consumer decides to enter into an annuity transaction that is not based on a recommendation of the insurer or the insurance producer.

An insurer's issuance of an annuity shall be reasonable under all the circumstances which are actually known, or which after reasonable inquiry should be known, to the insurer or the insurance producer at the time the annuity is issued.

An insurance producer (or insurer representative if no insurance producer is involved) must at the time of sale:

- Make a record of any recommendation;
- Obtain a customer-signed statement documenting the customer's refusal to provide suitability information, if any; or
- Obtain a customer-signed statement acknowledging that an annuity transaction is not recommended if the customer decides to enter into an annuity transaction that is not based on the insurance producer's or insurer's recommendation.

3. System of Supervision

An insurer must establish a **supervision system** designed to achieve compliance with this article, including:

- Maintain reasonable procedures to inform its insurance producers of these requirements and incorporate them into relevant insurance producer training manuals;
- Establish standards for insurance producer product training and maintain reasonable procedures to require its producers to comply with the annuity suitability training requirements;
- Provide product-specific training and training materials which explain all material features of its annuity products to its insurance producers;
- Maintain procedures for review of each recommendation prior to issuance of an annuity that are designed to ensure that there is a reasonable basis to determine that a recommendation is suitable. The review procedures may apply a screening system for the purpose of identifying selected transactions for additional review and may be accomplished electronically or through other means, including physical review.
- An electronic or other system may be designed to require additional review only of those transactions identified for additional review by the selection criteria;
- Maintain reasonable procedures to detect recommendations that are not suitable. This may include confirmation of consumer suitability information, systematic customer surveys, interviews, confirmation letters, and programs of internal monitoring;
- Annually provide a report to its senior management, including to the senior manager responsible for audit functions, which details a review, with appropriate testing, reasonably designed to determine the effectiveness of the supervision system, the exceptions found, and corrective action taken or recommended, if any.

An insurer's supervision system must ensure reasonable supervision of contractual performance, including:

- Reasonable monitoring and, as appropriate, conducting audits to ensure that the contracted function is properly performed; and
- Annually obtaining a certification from a senior manager who has responsibility for the contracted function that the manager has a reasonable basis to represent, and does represent, that the function is properly performed.

An insurer is not required to include in its system of supervision an insurance producer's recommendations to consumers of products other than the annuities offered by the insurer.

An insurance producer or insurer may not dissuade, or attempt to dissuade, a consumer from any of the following:

- Truthfully responding to an insurer's request for confirmation of suitability information;
- Filing a complaint; or
- Cooperating with the investigation of a complaint.

These rules apply to FINRA broker/dealer sales of variable and fixed annuities. Compliance with the suitability and supervision system requirements set forth in FINRA Rule 2330 meet these requirements, provided that the suitability criteria used also include both the consumer's income and the intended use of the annuity.

4. Violations and Penalties (CIC 10509.916)

The insurer is responsible for compliance with the suitability requirements for annuity transactions established by the California Insurance Code, and if a violation occurs, either because of the action or inaction of the insurer or its insurance producer, the Commissioner may, in addition to any other available penalties, order the insurer, a managing general agent, and/or an insurance producer to take reasonably appropriate corrective action for any consumer harmed by the violation.

5. Recordkeeping (CIC 10509.917)

Insurers and insurance producers are required to maintain or be able to make available to the Commissioner records of the information collected from the consumer and other information used in making the recommendations that were the basis for insurance transactions for **5 years** after the insurance transaction is completed by the insurer. The insurer may maintain these records on behalf of the insurance producer.

6. Product-Specific Illustrations (CIC 10127.11)

All insurers and life agents offering individual life insurance or annuity contracts issued to senior citizens on and after January 1, 1995, who use nonpreprinted illustrations of nonguaranteed values must disclose on those illustrations or on an attached cover sheet the following statement:

"THIS IS AN ILLUSTRATION ONLY. AN ILLUSTRATION IS NOT INTENDED TO PREDICT ACTUAL PERFORMANCE. INTEREST RATES, DIVIDENDS, OR VALUES THAT ARE SET FORTH IN THE ILLUSTRATION ARE NOT GUARANTEED, EXCEPT FOR THOSE ITEMS CLEARLY LABELED AS GUARANTEED."

This statement must stand out prominently from the other text. All preprinted policy illustrations must contain this notice in 12-point bold print with at least one-half inch space on all four sides and must be printed:

- On the illustration form itself;
- On an attached cover sheet; or
- In the form of a contrasting color sticker placed on the front of the illustration.

All preprinted illustrations containing nonguaranteed values must show the columns of guaranteed values in **bold** print. All other columns used in the illustration must be in standard print. *Values* include cash value, surrender value, and death benefits.

7. Rights and Responsibilities of the Insurance Company (CIC 10127.12, 10127.13)

Whenever an insurer provides an annual statement to an individual annuity contract issued after January 1, 1995, the insurer shall also provide the current accumulation value and the current cash surrender value.

All individual life insurance policies and individual annuity contracts for senior citizens that contain a charge upon surrender, partial surrender, excess withdrawal, or penalties upon surrender shall contain a notice disclosing the location of the charge, the charge time period, the charge information, and any associated penalty information, in bold 12-point print on the front of the policy jacket or on the cover page of the policy.

A policy must have just one cover page. If the notice required by this section and the right to examine notice are both on the cover page, as opposed to the front cover of the policy jacket, they must appear on the same page.

General references to "policy" in this Code regulation refer to both life insurance policies and annuity contracts.

8. General Advertising - Printing License Number on Documents (CIC 1725.5)

In order to facilitate a potential client's investigation of a producer, each producer must place his/her license number on all printed materials placed before the public, including business cards, proposals, and all print advertisements in California.

To ensure that the number is not minimized and would not be missed by a prospective insurance purchaser, the license number must be printed *at least as large as the smallest address or telephone number on the same document*. For licensees with more than one license, a single license number will suffice. Solicitors must use the license number of their employer.

All business cards, written price quotations for insurance products, and any print advertisements must prominently display the word "**Insurance**" in type size no smaller than the largest indicated phone number or 12-point type, whichever is larger.

A first offense will be punished by a fine of \$200, a second by a fine of \$500, and a third by a fine of \$1,000. However, a separate penalty cannot be imposed for each piece of illegal material used. There is a process for explaining violations, and the Commissioner has the option to consider extenuating circumstances and relieve the licensee of the penalty.

The one exception to the license number requirement is motor club (A.A.A., etc.) advertisements which include insurance in a general list of services provided without giving details regarding the insurance products.

Direct Mailers

Mass marketing of insurance products through mail solicitations, print media advertisements, or television and radio are referred to as **direct response** marketing (aka *direct mailers*). The policies provided are generally low in benefits and low in premiums. The term *direct response* refers to the necessity of the potential client to take the initiative and respond to the advertisement through a telephone or mail contact with the insurer as directed in the ad. The rules of CIC 1725.5 for printed materials/print advertisements apply to direct mail.

9. Nonforfeiture (CIC 10168)

These rules do not apply to reinsurance, a group annuity purchased under an employee's retirement plan or deferred compensation plan, or by an employee organization, other than a plan providing individual retirement accounts or individual retirement annuities, premium deposit fund, variable annuity, investment annuity, immediate annuity, any deferred annuity contract after annuity payments have

commenced, or reversionary annuity, nor to any contract delivered outside this state through an agent or other representative of the company issuing the contract.

Minimum Guaranteed Interest Rates (CIC 10168.2, 10168.25)

There are protections in place for [contract](#) owners during periods of low interest rates. The protections apply differently for fixed and flexible contracts, and also depend on when the contracts were issued.

For contracts issued before January 1, 2006, the minimum values of any paid-up annuity, cash surrender or death benefits must be based upon the following minimum nonforfeiture amounts.

With respect to contracts providing for flexible considerations, the minimum nonforfeiture amount prior to the commencement of annuity payments must be equal to an accumulation up to that time at a rate of interest of **3% per annum** of percentages of the net considerations paid prior to that time, decreased by the sum of any prior withdrawals from or partial surrenders of the contract accumulated at a rate of interest of 3%, and the amount of any indebtedness to the company on the contract, including interest due and accrued, and increased by any existing additional amounts credited by the company to the contract.

The net considerations for a given contract year used to define the minimum nonforfeiture amount cannot be less than zero and must be equal to the corresponding gross considerations credited to the contract during that contract year less an annual contract charge of \$30 and less a collection charge of \$1.25 per consideration credited to the contract during that contract year. The percentages of net considerations must be 65% of the net consideration for the first contract year and 87.5% of the net considerations for the second and later contract years.

Notwithstanding these provisions, the percentage must be 65% of the portion of the total net consideration for any renewal contract year which exceeds by not more than two times the sum of those portions of the net considerations in all prior contract years for which the percentage was 65%.

With respect to contracts providing for fixed scheduled considerations, minimum nonforfeiture amounts must be calculated on the assumption that considerations are paid annually in advance, and must be defined as for contracts with flexible considerations which are paid annually with two exceptions:

1. The portion of the net consideration for the first contract year to be accumulated must be the sum of 65% of the net consideration for the first contract year plus 22.5% of the excess of the net consideration for the first contract year over the lesser of the net considerations for the second and third contract years; and
2. The annual contract charge must be the lesser of dollars \$30 or 10% of the gross annual consideration.

With respect to contracts providing for a single consideration, minimum nonforfeiture amounts must be defined as for contracts with flexible considerations except that the percentage of net consideration used to determine the minimum nonforfeiture amount must be equal to 90%, and the net consideration must be the gross consideration less a contract charge of \$75.

For contracts issued after January 1, 2006, the minimum values of any paid-up annuity, cash surrender, or death benefits must be based upon the following minimum nonforfeiture amounts.

The minimum nonforfeiture amount prior to the commencement of any annuity payments shall be equal to an accumulation up to that time, at the rates of interest indicated below, of the net considerations paid prior to that time, decreased by the sum of all of the following:

- Any prior withdrawals from or partial surrenders of the contract, accumulated at the rates of interest indicated below;
- An annual contract charge of \$50, accumulated at the rates of interest indicated below;
- Any state premium tax paid by the company for the contract, accumulated at the rates of interest indicated below;
- However, the minimum nonforfeiture amount may not be decreased by this amount if the premium tax is subsequently credited back to the company;
- The amount of any indebtedness to the company on the contract, including interest due and accrued.

The net considerations for a given contract year used to define the minimum nonforfeiture amount must be an amount equal to 87.5% of the gross considerations credited to the contract during that contract year.

The **interest rate** used to determine minimum nonforfeiture amounts must be the lesser of **3% per** annum and the following:

- The 5-year Constant Maturity Treasury Rate reported by the Federal Reserve as of a date, or averaged over a period, rounded to the nearest one-twentieth of 1%, specified in the contract no longer than 15 months prior to the contract issue date or redetermination date, reduced by 125 basis points, where the resulting rate is not less than 1%.

The interest rate shall apply for an initial period and may be redetermined for additional periods.

During the period or term that a contract provides substantive participation in an equity-indexed benefit, it may increase the reduction by up to an additional 100 basis points to reflect the value of the equity index benefit. The present value at the contract issue date, and at each redetermination date, of the additional reduction may not exceed the market value of the benefit. The Commissioner may require a demonstration that the present value of the additional reduction does not exceed the market value of the benefit. Lacking a demonstration that is acceptable, the Commissioner may disallow or limit the additional reduction.

Death Benefit Guarantees (CIC 10168.4)

For contracts which provide cash surrender benefits, the cash surrender benefits available prior to maturity cannot be less than the present value as of the date of surrender of that portion of the maturity value of the paid-up annuity benefit which would be provided under the contract at maturity arising from considerations paid prior to the time of cash surrender, reduced by the amount appropriate to reflect any prior withdrawals from or partial surrenders of the contract.

The present value must be calculated on the basis of an interest rate not more than 1% higher than the interest rate specified in the contract for accumulating the net considerations to determine such maturity value, decreased by the amount of any indebtedness to the company on the contract, including interest due and accrued, and increased by any existing additional amounts credited by the company to the contract. In no event may any cash surrender benefit be less than the minimum nonforfeiture amount at that time.

The **death benefit** under such contracts must be at least equal to the cash surrender benefit.

No Benefit Disclosure (CIC 10168.7)

Any **contract** that does not provide cash surrender benefits or death benefits at least equal to the minimum nonforfeiture amount prior to the start of any annuity payments must include a statement in a prominent place in the contract that such benefits are not provided.

D. Contract Disclosures

1. Notice of Right to Cancel Policy (CIC 10127.9)

Every policy of individual life insurance must include a notice stating that the policy may be returned by the owner for **cancellation** by delivering it to the insurer or agent through whom it was purchased. The period of time established by the insurer for return of the policy must be between 10 and 30 days. The insured may return the policy to the insurer at any time during the period specified in the notice. In the case of individual life insurance policies (other than variable contracts and modified guaranteed contracts), by delivering the policy during the cancellation period, the owner will void the policy from the beginning, and the parties will be in the same position as if no policy had been issued.

All premiums and policy fees paid for the policy must be refunded by the insurer to the owner within 30 days from the date that the insurer is notified that the insured has canceled the policy.

In the case of variable annuity contracts, variable life insurance contracts, and modified guaranteed contracts, return of the contract during the cancellation period entitles the owner to a refund of account value and any fee paid for the policy. The account value and policy fee must be refunded by the insurer to the owner within 30 days from the date that the insurer is notified that the owner has canceled the policy.

Age 60 or Over

If the insured on the individual life policy or the annuitant on an annuity **contract** is **60 years of age or older**, the insured has a right to cancel the policy for a full refund within **30 days**. Each individual life policy annuity contract (other than variable contracts and modified guaranteed contracts) delivered to a senior consumer must have the following notice either printed on the cover page or policy jacket in 12-point bold print with one inch of space on all sides, or printed on a sticker attached to the cover page or policy jacket:

"IMPORTANT!

YOU HAVE PURCHASED A [LIFE INSURANCE POLICY], [ANNUITY CONTRACT], [MODIFIED GUARANTEED ANNUITY CONTRACT] REFERRED TO BELOW AS A "POLICY." CAREFULLY REVIEW IT FOR LIMITATIONS.

THIS POLICY MAY BE RETURNED WITHIN 30 DAYS FROM THE DATE YOU RECEIVED IT FOR A FULL REFUND BY RETURNING IT TO THE INSURANCE COMPANY OR AGENT WHO SOLD YOU THIS POLICY. AFTER 30 DAYS, CANCELLATION MAY RESULT IN A SUBSTANTIAL PENALTY, KNOWN AS A SURRENDER CHARGE."

The phrase *"after 30 days, **cancellation** may result in a substantial penalty, known as a surrender charge"* may be deleted if the policy does not contain surrender charges or penalties.

Less than 60 Years of Age (CIC 10127.09-10127.10)

The **free look** or **right-to-return period** allowed for new individual life policies must last for at least **10 days**. By law, insurers may give up to 30 days but not less than 10. This does not apply to term conversions or credit life policies.

If the policy is a **replacement**, a minimum **30-day** period is required because this requires even more time for evaluation.

2. Required Disclosures for Immediate Investments (CIC 10127.10)

Individual life insurance policies and annuity contracts (other than variable contracts and modified guaranteed contracts) that are delivered in this state must have the following notice either printed on the cover page or policy jacket in 12-point bold print with one inch of space on all sides or printed on a sticker that is affixed to the cover page or policy jacket:

"IMPORTANT!

YOU HAVE PURCHASED A [LIFE INSURANCE POLICY], [ANNUITY CONTRACT], [MODIFIED GUARANTEED ANNUITY CONTRACT] REFERRED TO BELOW AS A "POLICY." CAREFULLY REVIEW IT FOR LIMITATIONS.

THIS POLICY MAY BE RETURNED WITHIN 30 DAYS FROM THE DATE YOU RECEIVED IT FOR A FULL REFUND BY RETURNING IT TO THE INSURANCE COMPANY OR AGENT WHO SOLD YOU THIS POLICY. AFTER 30 DAYS, CANCELLATION MAY RESULT IN A SUBSTANTIAL PENALTY, KNOWN AS A SURRENDER CHARGE."

According to the Code, the phrase *"after 30 days, **cancellation** may result in a substantial penalty, known as a surrender charge"* may be deleted if the policy does not contain those charges or penalties.

Individual variable annuity contracts, variable life insurance contracts, or modified guaranteed contracts must be accompanied by a notice that includes:

- Cancellation policy;
- Investments restrictions;
- Refund policy; and
- Penalty and surrender charge.

The following notice must be either printed on the cover page or policy jacket in 12-point bold print with one inch of space on all sides, or printed on a sticker that is affixed to the cover page or policy jacket:

"IMPORTANT!

YOU HAVE PURCHASED A [LIFE INSURANCE POLICY], [ANNUITY CONTRACT], [MODIFIED GUARANTEED ANNUITY CONTRACT] REFERRED TO BELOW AS A "POLICY." CAREFULLY REVIEW IT FOR LIMITATIONS.

THIS POLICY MAY BE RETURNED WITHIN 30 DAYS FROM THE DATE YOU RECEIVED IT. DURING THAT 30-DAY PERIOD, YOUR MONEY WILL BE PLACED IN A FIXED ACCOUNT OR MONEY-MARKET FUND, UNLESS YOU DIRECT THAT THE PREMIUM BE INVESTED IN A STOCK OR BOND PORTFOLIO UNDERLYING THE CONTRACT DURING THE 30-DAY PERIOD.

IF YOU DO NOT DIRECT THAT THE PREMIUM BE INVESTED IN A STOCK OR BOND PORTFOLIO, AND IF YOU RETURN THE POLICY WITHIN THE 30-DAY PERIOD, YOU WILL BE ENTITLED TO A REFUND OF THE PREMIUM AND POLICY FEES. IF YOU

DIRECT THAT THE **PREMIUM BE INVESTED IN A STOCK OR BOND PORTFOLIO DURING THE 30-DAY PERIOD**, AND IF YOU RETURN THE POLICY DURING THAT PERIOD, YOU WILL BE ENTITLED TO A **REFUND OF THE POLICY'S ACCOUNT VALUE ON THE DAY THE POLICY IS RECEIVED** BY THE INSURANCE COMPANY OR AGENT WHO SOLD YOU THIS POLICY, WHICH COULD BE LESS THAN THE PREMIUM YOU PAID FOR THE POLICY. A RETURN OF THE POLICY AFTER 30 DAYS MAY RESULT IN A SUBSTANTIAL PENALTY, KNOWN AS A SURRENDER CHARGE."

The sentence '*A return of the policy after 30 days may result in a substantial penalty, known as a surrender charge*' may be deleted if the contract does not contain those charges.

This law does not apply to life insurance policies issued in connection with a credit transaction or issued under a contractual policy change or conversion privilege provision contained in a policy. Also, this law does not apply to contributory and noncontributory employer group life insurance, contributory and noncontributory employer group annuity contracts, and group term life insurance.

During the 30-day [cancellation](#) (free look) period, the premium for a variable annuity may **only be invested in fixed-income investments** and money-market funds, unless the investor specifically requests that the premium be invested in the mutual funds underlying the variable annuity [contract](#).

3. Investment of Variable Annuity Premiums, Individual Annuity Insurance, and Procedures Involving Senior Citizens (CIC 10127.10)

For the purpose of the laws in this section, **senior citizens** are individuals who are 60 years of age or older on the date of purchase of the policy.

Every individual life insurance and annuity [contract](#) that is initially delivered to a senior citizen on or after January 1, 2004, must include a notice stating that the policy may be returned by the owner for [cancellation](#) by delivering it to the insurer or agent from whom it was purchased. The period of time set established by the insurer for return of the policy must be at least 30 days.

During the 30-day cancellation period, the premium for a variable annuity may be invested only in fixed-income investments and money-market funds, unless the investor specifically directs that the premium be invested in the mutual funds underlying the variable annuity contract.

Return of the policy within the 30-day cancellation period will have one of the following effects:

- In the case of individual life insurance policies and variable annuity contracts for which the owner has not directed that the premium be invested in the mutual funds underlying the contract during the cancellation period, return of the policy during the cancellation period will have the effect of voiding the policy from the beginning; the parties will be in the same position as if no policy had been issued. All premiums and policy fees paid will be refunded by the insurer to the owner within 30 days from the date the insurer is notified that the owner has canceled the policy; or
- In the case of a variable annuity for which the owner has directed that the premium be invested in the mutual funds underlying the contract during the 30-day cancellation period, cancellation will entitle the owner to a refund of the account value. The account value will be refunded by the insurer to the owner within 30 days from the date that the insurer is notified that the owner has canceled the contract.

This rule does not apply to life insurance policies issued in connection with a credit transaction or issued under a contractual policy-change or conversion privilege provision contained in a policy. Additionally, this rule does not apply to contributory and noncontributory employer group life insurance, contributory and noncontributory employer group annuity contracts, and group term life insurance.

When an insurer, its agent, group master **policyowner**, or association collects more than one month's premium from a senior citizen at the time of **application** or at the time of delivery of a group term life **insurance policy** or certificate, the insurer must provide the senior citizen a prorated refund of the premium if the senior citizen delivers a cancellation request to the insurer during the first 30 days of the **policy period**.

ADVANTAGES AND DISADVANTAGES OF ANNUITIES FOR INDIVIDUALS UNDER AGE 60

All consumers can benefit from the universal advantages of annuities, including tax deferral, a predictable future income stream, and asset protections and guarantees. However, individuals who are **under age 60** have a longer investment time horizon and have the added advantage of benefiting from the longer accumulation period required, for example, in a deferred annuity and could also withstand the fluctuations in the market that might occur with a variable annuity over time. Withdrawals will be taxed as ordinary income, but in general that will be at a time later in life when the individual is in a lower tax bracket.

Individuals who are under age 60 similarly confront the typical disadvantages of annuity contracts, such as higher fees and commissions, limited liquidity, but they face the further potential disadvantage of being penalized with an IRS penalty of 10% for any withdrawals taken prior to age 59½.

ADVANTAGES AND DISADVANTAGES OF ANNUITIES FOR INDIVIDUALS OVER AGE 60

Individuals **age 60 and over**, on the other hand, do not have the same opportunity for a long accumulation period and so the most suitable annuity contracts might include single premium immediate annuities (for example, to accommodate an early retirement package). The advantage of an annuity for an older individual would include the contract guarantees, asset protections, and a predictable income stream for life; however, depending on the type of annuity selected, these customers might be more susceptible to market risk and be more highly impacted by disadvantages such as surrender charges, higher fees and commissions, product complexity, limited liquidity, and the requirement to turn over control of funds to the insurance company. Individuals age 60 and over are considered "*seniors*" by sections of the California Insurance Code and are afforded additional consumer protections by virtue of their age. There are special rules for the free-look period (right to return), limits on how premiums may be invested in the early days of a variable contract, and special rules for illustrations, disclosures, and surrender charges.

E. Provisions for Life and Annuity Contracts, Illustrations, and Nonguaranteed Values for Senior Citizens (CIC 10127.11)

1. Senior Insurance (CIC 785-787)

All insurers, brokers, agents, and others engaged in the transaction of insurance owe a prospective insured who is 65 years of age or older a duty of **honesty, good faith, and fair dealing**.

Free Look

All individual and group disability insurance policies and certificates, and all group life insurance policies and certificates offered for sale to individuals age 65 or older in California must provide an **examination period of 30 days** after the receipt of the policy or certificate for purposes of review of the contract. If the policyholder or certificate holder chooses to cancel the policy or certificate and returns it for cancellation by mail or other delivery method within the 30-day examination period, the return will void the policy or certificate from the beginning, and the parties will be in the same position as if a policy or certificate had not been issued. All premiums paid and any policy or membership fee paid must be fully refunded to the policyholder or certificate holder by the insurer or entity in a timely manner.

Timely manner means no later than 30 days after the insurer or entity issuing the policy or certificate receives the returned policy or certificate.

If the insurer or entity issuing the policy or certificate fails to refund all of the premiums and any policy or membership fee paid in a timely manner, the policyholder or certificate holder must receive interest on the paid premium and policy fee.

Each policy or certificate must have a notice prominently printed in no less than 12-point bold print, on the front of the policy jacket or on the cover page of the policy or certificate and the outline of coverage, stating that the policyholder or certificate holder, as applicable, has the right to return the policy or certificate, by mail or other delivery method, within 30 days after its receipt, and to have the full premium and any policy or membership fee paid refunded.

Advertisements

Any **advertisement** that is directed toward persons age 65 or older must disclose that an agent may contact applicants because of their age. In addition, an agent who makes contact with a person as a result of acquiring that person's name from a lead generating device must disclose that fact in the initial contact with the person.

The term *advertisement* includes envelopes, stationery, business cards, worksheets, questionnaires, or other materials designed to describe and encourage the purchase of a policy or certificate of disability insurance, life insurance, or an annuity, or to collect personal or financial information about a prospective insured or purchaser of an annuity.

The following are rules associated with advertising to the senior market:

- Solicitations must not use names that are deceptive or misleading with regard to the soliciting entity (agent or insurer) or the true purpose of the advertisement (to solicit an insurance sale);
- It is illegal to assert that coverages are somehow provided by or are endorsed by any governmental agencies, nonprofit or charitable institutions, veterans or senior organizations;
- Advertisements may NOT use any of the following:
 - The name of a state or political subdivision in a policy name or description;
 - Any name, service mark, slogan, symbol, etc. implying that insurers or its products are connected with or endorsed by a governmental agency, such as the Social Security Administration or Department of Veterans Affairs;

- An address that would mislead a purchaser with regard to the identity, location, or license status of the insurer or agent.
- Advertisements may NOT imply that the reader may lose a right, privilege, or benefits under federal, state, or local law if he or she fails to respond to the advertisement; and
- All advertisements used by agents, producers, brokers, solicitors, or other persons for a policy of an insurer must have written approval of the insurer before they may be used.

No advertisement for an event at which insurance products will be offered for sale may use the terms "*seminar*", "*class*", "*information meeting*" and similar terms without adding "and insurance sales presentation".

Penalties (CIC 789, 789.3)

The Commissioner has the administrative authority to assess penalties against insurers, brokers, agents, and other entities engaged in the transaction of insurance or any other person or entity for violations of the Code section pertaining to insurance for seniors.

Upon a showing of a violation in any civil action, a court may also assess the penalties prescribed in this section of the Insurance Code.

Whenever the Commissioner has reasonable cause to believe or determines after a public hearing that any insurer, agent, broker, or other person or entity engaged in the transaction of insurance, has violated this article, the Commissioner may make and serve upon the insurer, broker, agent, or other person or entity a **notice of hearing**. The notice must state the Commissioner's intent to assess the administrative penalties, the time and place of the hearing, and the conduct, condition or ground upon which the hearing will be held, and assessing the penalties. The hearing must occur within **30 days after the notice is served**. Within 30 days after the hearing, the Commissioner will issue an order specifying the amount of the penalties to be paid. The penalties resulting from the hearing must be paid to the Insurance Fund.

Any **broker**, agent, or other person or other entity engaged in the transactions of insurance, other than an insurer, who violates these provisions is liable for an **administrative penalty** of no less than **\$1,000 for the first violation**.

Any broker, agent, other person, or other entity engaged in the business of insurance, other than an insurer, who engages in practices prohibited by this article a second or subsequent time or who commits a **knowing violation** is liable for an **administrative penalty** of no less than **\$5,000 and no more than \$50,000** for each violation.

If the Commissioner brings an action against a licensee pursuant and determines that the licensee may reasonably be expected to cause significant harm to senior consumers, the Commissioner may suspend the individual's license pending the outcome of the hearing.

Any insurer who violates this article is liable for an administrative penalty of \$10,000 for the first violation. Any insurer who violates this article with a frequency as to indicate a general business practice or commits a knowing violation of this article, is liable for an administrative penalty of no less than \$30,000 and no more than \$300,000 for each violation.

The Commissioner may require **rescission** of any contract found to have been marketed, offered, or issued in violation of these requirements.

Medi-Cal Required Disclosures (Senate Bill 483, CIC 789.8)

As defined in the California Insurance Code, **elder** means "any person residing in this state who is 65 years of age or older." If a life agent offers to sell to an elder any life insurance or annuity product, the life agent must advise an elder in writing that the sale or **liquidation** of any stock, bond, IRA, certificate of deposit, mutual fund, annuity, or other asset to fund the purchase of this product may have tax consequences, early withdrawal penalties, or other costs or penalties as a result of the sale or liquidation. The elder may wish to consult independent legal or financial advice before selling or liquidating any assets and prior to the purchase of any life or annuity products being solicited, offered for sale, or sold.

A life agent who offers for sale or sells a financial product to an elder on the basis of the product's treatment under the Medi-Cal program may not negligently misrepresent the treatment of any asset under the statutes and rules and regulations of the Medi-Cal program, as it pertains to the determination of the elder's eligibility for any program of public assistance.

A life agent who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal program must provide, in writing, the following **disclosure** to the elder or the elder's agent:

NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY

If you or your spouse are considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message!

You or your spouse do not have to use up all of your savings before applying for Medi-Cal.

RECOVERY

An annuity purchased on or after September 1, 2004, shall be subject to recovery by the state upon the annuitant's death under the regulations of the Medi-Cal Recovery Program. Income derived from the annuity must be used to meet the annuitant's share of costs and, if the annuitant is married, the income derived from the annuity may impact the minimum monthly maintenance needs of the annuitant's community spouse. An annuity purchased by a community spouse on or after September 1, 2004, may also be subject to recovery if that spouse is the recipient of past or future Medi-Cal benefits.

UNMARRIED RESIDENT

An unmarried resident may be eligible for Medi-Cal benefits if he or she has less than (insert amount of individual's resource allowance) in countable resources.

The Medi-Cal recipient is allowed to keep from his or her monthly income a personal allowance of (insert amount of personal needs allowance) plus the amount of any health insurance premiums paid. The remainder of the monthly income is paid to the nursing facility as a monthly share of cost.

MARRIED RESIDENT

COMMUNITY SPOUSE RESOURCE ALLOWANCE: If one spouse lives in a nursing facility, and the other spouse does not live in a facility, the Medi-Cal program will pay

some or all of the nursing facility costs as long as the couple together does not have more than (insert amount of community countable assets).

MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE: If a spouse is eligible for Medi-Cal payment of nursing facility costs, the spouse living at home is allowed to keep a monthly income of at least his or her individual monthly income or (insert amount of the minimum monthly maintenance needs allowance), whichever is greater.

FAIR HEARINGS AND COURT ORDERS

Under certain circumstances, an at-home spouse can obtain an order from an administrative law judge or court that will allow the at-home spouse to retain additional resources or income. The order may allow the couple to retain more than (insert amount of community spouse resource allowance plus individual's resource allowance) in countable resources. The order also may allow the at-home spouse to retain more than (insert amount of the monthly maintenance need allowance) in monthly income.

REAL AND PERSONAL PROPERTY EXEMPTIONS

Many of your assets may already be exempt. Exempt means that the assets are not counted when determining eligibility for Medi-Cal.

REAL PROPERTY EXEMPTIONS

ONE PRINCIPAL RESIDENCE: One property used as a home is exempt. The home will remain exempt in determining eligibility if the applicant intends to return home someday. The home also continues to be exempt if the applicant's spouse or dependent relative continues to live in it.

Money received from the sale of a home can be exempt for up to six months if the money is going to be used for the purchase of another home.

REAL PROPERTY USED IN A BUSINESS OR TRADE: Real estate used in a trade or business is exempt regardless of its equity value and whether it produces income.

PERSONAL PROPERTY AND OTHER EXEMPT ASSETS

IRAs, KEOGHs, AND OTHER WORK-RELATED PENSION PLANS: These funds are exempt if the family member whose name it is in does not want Medi-Cal. If held in the name of a person who wants Medi-Cal and payments of principal and interest are being received, the balance is considered unavailable and is not counted. It is not necessary to annuitize, convert to an annuity, or otherwise change the form of the assets in order for them to be unavailable.

PERSONAL PROPERTY USED IN A TRADE OR BUSINESS.

ONE MOTOR VEHICLE.

IRREVOCABLE BURIAL TRUSTS OR IRREVOCABLE PREPAID BURIAL CONTRACTS.

THERE MAY BE OTHER ASSETS THAT MAY BE EXEMPT.

This is only a brief description of the Medi-Cal eligibility rules. For more detailed information, you should call your county welfare department. Also, you are advised to contact a legal services program for seniors or an attorney that is not connected with the sale of this product.

I have read the above notice and have received a copy.

Dated:_____ Signature:_____

2. Effects on Medi-Cal Eligibility (CIC 789.9)

In addition to any other reasons that a sale of an individual annuity to a senior may violate any provision of law, an annuity may not be sold to a senior in any of the following circumstances:

- The senior's purpose in purchasing the annuity is to affect Medi-Cal eligibility and either of the following is true:
 - The purchaser's assets are equal to or less than the community spouse resource allowance established annually by the State Department of Health Services pursuant to the Medi-Cal Act;
 - The senior would otherwise qualify for Medi-Cal;
- The senior's purpose in purchasing the annuity is to affect Medi-Cal eligibility and, after the purchase of the annuity, the senior or the senior's spouse would not qualify for Medi-Cal.

In the event that a fixed annuity is issued to a senior, the issuer must rescind the contract and refund to the purchaser all premiums, fees, any interest earned under the terms of the contract, and costs paid for the annuity. This remedy must be in addition to any other remedy that may be available.

California's Role as a Remainder Beneficiary of Annuities (*California Welfare and Institutions Code (WIC) 14006.15, 14006.41, 14009.6, 14015.1, 14015.2*)

"Equity interest" means the lesser of the following:

- The assessed value of the principal residence determined under the most recent tax assessment, less any encumbrances of record; or
- The appraised value of the principal residence determined by a qualified real estate appraiser who has been retained by the applicant or beneficiary, less any encumbrances of record.

An individual is not eligible for Medi-Cal if his or her equity interest in the principal residence exceeds \$750,000 (this amount is increased annually based on the consumer price index).

This does not apply if:

- The spouse of the individual or the individual's child under age 21 or who is blind or who is disabled is lawfully residing in the individual's home;
- The individual was determined eligible based on an application filed before January 1, 2006;
- The department determines that ineligibility would result in demonstrated hardship on the individual, which is defined as:
 - The individual was receiving Medi-Cal home and facility care prior to January 1, 2006, or qualified for such assistance based on an application filed after that date but before these regulations were finalized;
 - The individual purchased and received benefits under an LTC policy with the California Partnership for Long-Term Care;
 - The individual's equity interest in the principal residence would not exceed the equity interest limit if it had been increased by using the quarterly House Price Index (HPI) for California, published by the Office of Federal Housing Enterprise Oversight (OFHEO);
 - The applicant or beneficiary has been denied a home equity loan by at least three lending institutions, or is ineligible for a Federal Housing Administration (FHA) approved loan or reverse mortgage;

- The applicant or beneficiary, with good cause, is unable to provide verification of the equity value.

WIC 14006.41: When applying to qualify for Medi-Cal, an individual must disclose any interest that he or she or his or her spouse has in an annuity, regardless of whether the annuity is irrevocable or is treated as income or as a resource.

The Department must inform the individual and his or her spouse that, by virtue of its provision of Medi-Cal medical assistance for home and facility care to the individual, the state will, by operation of law, become a remainder **beneficiary** of certain annuities.

WIC 14009.6: As a result of providing Medi-Cal care to an individual, the state must, by operation of law, become a remainder **beneficiary**, of annuities purchased in whole or in part by the individual or his or her spouse in which the individual or his or her spouse is an annuitant, unless the individual or his or her spouse notifies the department in writing that he or she prohibits the state from acquiring a remainder interest in his or her annuity, in which case the purchase of the annuity must be treated as the **transfer** of an asset for less than fair market value.

This applies only to annuities purchased on or after February 8, 2006, or to annuities purchased prior to that date but which have been altered by a transaction occurring after February 8, 2006.

The term **transaction** includes any action taken by the individual or his or her spouse that changes the course of payments to be made by the annuity or the treatment of the income or principal of the annuity.

Transaction does not include:

- Routine changes and automatic events that do not require any action or decision;
- Changes that occur based on the terms of the annuity that existed prior to February 8, 2006, and that do not require a decision, election, or action to take effect;
- Changes that are beyond the control of the individual or the individual's spouse.

Any provision in any annuity that restricts the right of the state to become a remainder beneficiary is void.

If an individual or his or her spouse notifies the department in writing that he or she prohibits the state from acquiring a remainder interest in his or her annuity, the purchase of the annuity must be treated as the transfer of an asset for less than fair market value.

When the state becomes aware of an annuity in which it has acquired a remainder interest, the department will notify the issuer. Upon notification, the issuer must inform the department of the amount of income and principal being withdrawn from the annuity.

The issuer of the annuity must immediately notify the department if there is any change in either of the following:

- The amount of income or principal being withdrawn; or
- The named beneficiaries of the annuity.

WIC 14015: The providing of Medi-Cal may not impose any limitation or restriction upon the person's right to sell, exchange or change the form of property holdings nor may the care provided constitute any encumbrance on the holdings. However, the

transfer or gift of assets, including income and resources, for less than fair market value will result in a period of ineligibility for Medi-Cal.

Assets transferred exclusively for a purpose other than to qualify for medical assistance will not result in ineligibility for Medi-Cal and include:

- Assets that would have been considered exempt for purposes of establishing eligibility at the time of transfer;
- Property with a net market value that, when the property is transferred, if included in the property reserve, would not result in ineligibility;
- Assets for which adequate **consideration** is received;
- Property upon which foreclosure or repossession was imminent at the time of transfer, provided there is no evidence of collusion;
- Assets transferred in return for an enforceable **contract** for life care that does not include complete medical care; and A
- Assets transferred without adequate consideration, provided that the **applicant** or **beneficiary** provides convincing evidence to overcome the presumption that the transfer was for the purpose of establishing eligibility or reducing the share of cost.

Assets transferred by the applicant or beneficiary prior to the look-back period established by the department preceding the date of initial application will be presumed to have not been transferred in order to establish Medi-Cal eligibility or reduce the share of cost, and **may not be considered in determining eligibility**.

WIC 14015.1: The department will consider, at initial **application** or redetermination, whether an undue hardship exists prior to imposing a period of ineligibility for Medi-Cal.

An **undue hardship** exists when:

- The individual was found eligible based on an application filed after January 1, 2006 but before these regulations were finalized;
- The deprivation would cause an endangerment to the life or health of the individual;
- The denial would result in the eviction of the individual from a nursing home;
- The individual is otherwise eligible for the Medi-Cal program and unable to obtain home and facility care without Medi-Cal;
- The denial would cause the individual to be unable to remain at home or in the community and would hasten or cause the individual's entry into a medical or long-term care institution; or
- The individual would be deprived of food, clothing, shelter, or other necessities of life.

WIC 14015.2: The following may request a fair hearing on the issue of undue hardship:

- An individual requesting or receiving Medi-Cal;
- A personal representative of an individual requesting or receiving Medi-Cal; or
- The facility in which the individual requesting or receiving Medi-Cal is residing, with the consent of that individual or the personal representative of that individual.

3. In-Home Solicitations: 24-hour Notice Requirement for Persons 65 Years and Older (CIC 789.10)

Any person who meets with a senior in the senior's home is required to notify the senior in writing regarding the visit, its purpose, and the nature of the sales presentation, no less than **24 hours** prior to the initial meeting. If the senior has an existing insurance relationship with an agent and requests a meeting with the agent in

the senior's home on the same day, a notice must be delivered to the senior prior to the meeting.

Upon contacting the senior in the senior's home, the person must, before making any statement other than a greeting, state that the purpose of the contact is to talk about insurance or to gather information for a follow-up visit to sell insurance (if that is the case). The person must then state the name and titles of all persons arriving at the senior's home and the name of the insurer represented by the person (if known).

4. Allegations of Misconduct against a Person 65 Years or Over (CIC 1738.5)

A proceeding that involves allegations of misconduct against a person age 65 or over must be held **within 90 days** after receipt by the department of the notice of defense, unless a continuance is granted by the department or the administrative law judge.

When the hearing has been set, only **the administrative law judge may grant a continuance**, and only upon finding one or more of the following:

- The death or incapacitating illness of a party, a representative or attorney of a party, a witness to an essential fact, or of the parent, child, or member of the household of any of these persons, when it is not feasible to substitute another representative because of the proximity of the hearing date;
- Lack of notice of hearing;
- A material change in the status of the case requiring postponement, or when an executed settlement or stipulated findings of fact eliminate the need for hearing;
- A stipulation for continuance signed by all parties and communicated to the administrative law judge at least 25 business days before the hearing;
- The substitution of the representative or attorney of a party upon showing that the substitution is required;
- The unavailability of a party, representative, attorney, or witness, due to a conflicting and required appearance in a judicial matter if the person did not know and could neither anticipate nor avoid the conflict, and the conflict, with the request for continuance, is immediately communicated to the administrative law judge;
- The unavailability of a party, representative, attorney, or material witness due to an unavoidable emergency;
- Failure by a party to comply with a timely discovery request if the continuance request is made by the party who requested the discovery.

F. Miscellaneous Rules Affecting California Annuity Contracts

1. Issue Age (CIC 10112)

When an annuity **contract** is issued to a minor under age 18, or is issued on the life of the minor for the benefit of the minor's relatives, as long as there is **insurable interest**, the minor may not be deemed incompetent to enter into the contract based on his or her age. The minor must also have all rights and benefits under the policy, including surrender and discharge of benefits. If the minor is under age 16, the exercise of rights requires written consent by the parent or guardian.

All such contracts made by a minor under the age of 18 which may result in any personal liability for assessment must have the written assumption of liability by a parent or guardian in **consideration** of the issuance of the contract.

2. Premium Payments (CIC 10540)

An incorporated life insurer issuing life insurance policies on the reserve basis may collect premiums in advance, and may accept payment of future premiums. The amount **may not exceed the lesser** of:

- The sum of future unpaid premiums; or
- The sum of 10 future unpaid annual premiums.

This does not apply to funds that accumulate under an agreement allowing the purchase of annuities at future dates.

3. Competence (California Civil Code 38, 39)

A **person entirely without understanding** has no power to make a [contract](#) of any kind, but the person is liable for the reasonable value of things furnished to the person necessary for the support of the person or the person's family.

A *conveyance* or other contract of a person of unsound mind, but not entirely without understanding, made before the incapacity of the person has been judicially determined, is subject to [rescission](#).

A *rebuttable presumption* affecting the burden of proof that a person is of unsound mind must exist for purposes of this section if the person is substantially unable to manage his or her own financial resources or resist fraud or undue influence. Substantial inability may not be proved solely by isolated incidents of [negligence](#) or improvidence.

How Cognitive Impairment May Impact an Annuity Purchase

Insurance agents must be alert to the possibility that senior consumers may suffer from cognitive impairments that impact their ability to understand complex insurance products such as annuities.

The signs that a person may be suffering from impaired short-term memory are not as simple as just having difficulty remembering things. Other indications that a prospective client may have a significant cognitive impairment include trouble with language, communication, focus, and reasoning. The individual may suffer from abrupt changes in mood, may be apathetic, or may have difficulty concentrating. They may have trouble carrying on a conversation, often struggling to find words and/or repeating themselves. The person may seem confused about the date and time of day, and not clear on the reason for the meeting/appointment. Any of these behaviors should serve as a red flag that the prospective insured may not have the mental capacity to knowingly enter into a life insurance or annuity [contract](#) and may need to have an attorney, family member or other personal representative in attendance at any sales presentations.

4. Unauthorized Practice of Law (California Business and Professions Code 6125)

No person may practice law in California unless the person is an active member of the State Bar.

Furthermore, an agent, [broker](#), or solicitor who is not an active member of the State Bar of California may not share a commission or other compensation relating to the sale or renewal of an annuity with an active member of the State Bar of California. This includes a bonus, gift, prize, award, or finder's fee. (CIC 1724)

5. Special Ethical Concerns for Senior Citizens (CIC 791.03)

Seniors are among the least likely to report financial crimes or abuses against them because they might be embarrassed at having “been taken,” or because they do not wish to appear to be losing the ability to manage their lives or personal finances.

Unethical agents have been caught selling multiple, duplicative policies to seniors, proposing one type of [insurance policy](#) or annuity contract but delivering another (*bait and switch*), and misleading senior consumers into believing that an annuity product is actually a long-term care contract (or vice-versa).

The California's Medicare supplement and long-term care insurance regulations address unethical practices such as inaccurate or misleading comparisons of existing and proposed replacement contracts, selling a person a third long term care policy within 12 months, or a second Medicare supplement policy. California enacted the **Financial Elder Abuse statutes** in 2002, which, in part, specifically addresses insurance agent abuses of persons age 65 or older.

Under most circumstances, insurance institutions, agents, and insurance-support organizations are not allowed to use **pretext interviews** to obtain information that relates to an insurance transaction.

A **pretext interview** is conducted when any person, in an attempt to gain information about another natural person, does one or more of any of the following:

- Pretends to be someone he or she is not;
- Pretends to represent someone he or she is not actually representing;
- Misrepresents the purpose of the interview; or
- Refuses to identify himself or herself upon request.

Pretext interviews are prohibited during any phase of the transaction process of insurance. This includes information gathering during underwriting. Obviously, the use of a pretext interview could reveal information that is privileged and would not normally be available to the insurer or agent. It could result in an **adverse underwriting decision**. However, in the investigation of a [claim](#), particularly when [fraud](#) is suspected, as an investigative technique, pretext interviews are permitted.

It is further required that the reason of the interview must be to investigate a claim where there is a reasonable basis for suspecting criminal activity, fraud, material [misrepresentation](#), or material nondisclosure in connection with a claim.

6. Recordkeeping by Administrators (CIC 1759.3)

An **administrator** is any person who collects any charge or premium from, or who adjusts or settles claims on, residents of this state in connection with life or health insurance coverage or annuities. "Administrator" does not include employers, unions, insurance companies, producers, and adjusters when engaged in the performance of their duties, creditors, banks, credit card companies, or attorneys who settle claims but do not collect premiums in connection with life coverage or annuities.

There must be a written agreement between an administrator and the insurer, and such written agreement must be retained as part of the official records of both the insurer and the administrator for the duration of the agreement and **5 years** thereafter. The insurer has the right to access the books and records in order to fulfill all of its contractual obligations to insureds. The Commissioner may also have access for the purpose of examination, audit, and inspection.

Failure to keep or maintain the books and records as required will be grounds for the suspension or revocation of the certificate of registration of the administrator.

7. Cause for Suspension of a Producer License (CIC Section 1668.1)

The following actions are cause for suspension of the producer's license:

- The licensee has induced a client to cosign or make a loan, make an investment, make a gift, including a testamentary gift, or provide any future benefit through a right of survivorship to the licensee (or to a relative, friend, or business associate of the licensee).
- The licensee has induced a client, to make the licensee (or the relative, friend, or business associate of the licensee) a **beneficiary** or trustee under the terms of any intervivos or testamentary trust or the owner or beneficiary of a life **insurance policy** or an annuity policy.
- However, if the licensee is also licensed as an attorney, the licensee may be made a trustee under the terms of any intervivos or testamentary trust, provided that the licensee does not sell insurance to the trustor of the trust.
- The licensee who has a power of attorney for a client has sold to the client or has used the power of attorney to purchase an insurance product on behalf of the client for which the licensee has received a commission.

This does not apply if the client is related to the licensee by birth, marriage, or adoption, or is registered as a domestic partner of the licensee.

8. Other Penalties (CIC 780-782)

Statements that are **misrepresentations** of the terms, benefits, or future dividends or benefits of a policy **are prohibited**. Misrepresentations used to induce the sale of a policy (or to cause a policyholder to **lapse**, forfeit, or surrender a policy) are prohibited.

Violations are punishable by a fine of up to \$25,000 or, if the actual loss exceeds \$10,000, then up to three times the amount of the loss, as well as up to one year in jail. Restitution to the victim must be satisfied before any fine is collected.

G. Senate Bill 426

SENATE BILL 426

Effective: January 2016

New consumer protections were enacted with Senate Bill 426, passed in July 2015. The new law protects seniors and their beneficiaries from financial losses incurred when insurers apply surrender penalties to annuities paid as a **death benefit**.

Seniors often buy annuities to protect themselves from outliving their money, although these contracts also contain death benefit provisions in case the annuitant dies before the annuity begins paying benefits.

Surrender penalties are often charged by insurance companies in the first few years of an annuity contract because insurers typically invest in longer duration, liquid assets. Companies have been permitted to apply those penalties to death benefits in the same way that a voluntary surrender is charged a penalty. Because of this, early death in an annuity contract can result in minimal interest earnings or even a death benefit that is lower than what was actually paid in premiums.

While many companies do not currently pay out a death benefit that is less than the premium paid, some insurers do apply surrender penalties reducing the death benefit below the total premiums.

The new law codifies a current best practice for insurers by requiring that the death benefit for fixed deferred annuities be at least equal to the annuity amount or the accumulation value for those annuities issued to consumers 65 years of age or older. This law also prohibits companies from charging a surrender penalty on the death benefit payment.

H. Course Recap

1. Exam Breakdown

The Exam Breakdown should be used to see where to focus your valuable study time. Each test is weighted per chapter, so concentrating your efforts will benefit you when taking the actual exam.



California 8-Hour Annuity Suitability - Final Examination 50 Questions - 2-hour time limit

Chapter	Percentage of Exam
The Importance of Suitable Annuity Sales	3%
Annuity Basics and Definitions	10%
Fixed Annuities	14%
Index Annuities	10%
Immediate Annuities	14%
Variable Annuities	15%
Annuity Tax Concepts	10%
1035 Exchanges and Replacements	4%
Sales Practices for California Producers	20%

2. Key Concepts

THE IMPORTANCE OF SUITABLE ANNUITY SALES	
Retirement Income Planning Concerns	• Retirees are living longer – need for retirement income is increasing • Social Security funds may run out in 25 years • Retirement trends: ◦ Decline in defined benefit plans ◦ Uncertainty of Social Security benefits ◦ Increase in longevity
Annuities in Retirement Planning	Annuities provide income the annuitant cannot outlive; income for retirement NAIC Model Annuity Suitability Act • Act holds insurers and agents responsible for suitability, especially for seniors Annuity disadvantages: • High fees • Limited liquidity • Loss of control of funds
Guaranty	• Protect consumers from insolvent insurers

Associations	Insurers cannot state that their policies are guaranteed by the existence of the insurance Guaranty Association in a sales presentation – unfair trade practice
ANNUITY BASICS AND DEFINITIONS	
Annuity Categories	- Single premium - payments can begin immediately or be deferred - Flexible or periodic premiums – payments can only be deferred - Single premium vs. flexible premium: - Difference: the number of payments that purchase the annuity
Annuity Definitions	- Annuity features and fees: - Tax-deferred accumulation - Multiple payout options - Death benefits (during accumulation) - Tax-free <u>transfer</u> of <u>contract</u> values - Bailout – allowing the annuity owner to surrender the annuity without a charge
Parties to Annuity Contracts	The owner - Most often a natural person who controls the policy (can be a trust or corporation) The annuitant: must be a natural person The <u>beneficiary</u> - Receives death benefits; may be more than one person - Has no rights to change policy The insurance company - Rated for financial stability by A.M. Best, Moody's and Standard and Poor's - Annuity contract value is protected by the state guaranty association
Owner-driven vs. Annuitant-driven Annuity Contracts	Annuitant – driven contract - Beneficiaries receive death benefit at annuitant's death - If owner is not the annuitant, the annuitant receives the contract value only (not death benefit) at owner's death Owner – driven contract - Pays beneficiaries a death benefit when owner dies - If owner is not the annuitant and the annuitant dies, the owner designates a new annuitant and the contract continues
FIXED ANNUITIES	
The Basics of Fixed Annuities	Single payments or multiple payments possible Insurer guarantees interest rate Accumulation grows tax deferred in insurer's general account

Insurer keeps the “spread” between rates it earns on investments and the rates it credits to the annuity

Fixed annuities vs. CDs

- Annuities are not FDIC insured, but backed by insurer’s assets
- Advantage of fixed annuities: interest grows tax deferred (not currently taxable)
- Early withdrawal penalties reduce CD returns; annuities can allow some withdrawals without penalty;
- Annuities have lifetime payout options; CDs do not have structured payout options

Fixed annuities vs. Money Market Accounts

- Annuities have withdrawal limits and fees; money markets are completely liquid
- Money markets earn lower rates, have no tax deferral and no provision for lifetime income
- Advantage of money markets: greater liquidity

Types of Fixed Annuities

- Multi-year guarantee (MYG) or CD-type annuities
 - Rate is often guaranteed for the same term as the surrender charge period
 - Guarantee for several years favors older, risk-adverse investors
- Banded rate or single year guaranteed annuities
 - First year rate is “base rate,” following rates are renewal rates
- Higher, first year “bonus rate” is typical

GRA and MVA Fixed Annuities

- Guaranteed return annuities pay 100% of purchase payment or “book value”
- Market value adjustment annuities pay an adjusted value based on interest rate fluctuations when premature withdrawals exceed any free withdrawal amounts

Fixed Annuity Contract Features

- Issue ages 0 to 85; typical – age 55 and above
- Contract term – 3 to 10 years
- Bail-out provisions allow policyowners to cash out the contract penalty-free if interest rates fluctuate significantly
 - Policies with a bail-out typically pay lower commissions
- Banding – larger purchases often have higher interest rates, smaller purchase may have higher administrative costs
- Death benefit – in accumulation phase, most often is 100% of purchase payments with surrender penalties waived
- Premium bonus – if bonus is offered, it can be recaptured if contract cancelled in early years

Fixed Annuities and Suitable Sales

Fixed annuities are suitable for older, risk-adverse buyers

Advantages of fixed annuities

	• Safety of principal, easy to understand, tax- deferral, stable growth avoids market volatility, guaranteed income for life feature, penalty-free withdrawals, assets avoid probate Disadvantages of fixed annuities • Lack of liquidity, low interest rates, surrender charges, No preferable capital gains tax treatment, losses to inflation, many fees and charges, possible lock-in at low interest rates
INDEX ANNUITIES	
The Basics of Index Annuities	• Created in response to poor economic times to gain more interest by hedging short call options on market indices • Also called equity indexed annuities – tied to a market index that fluctuates, but not invested in stock or the index
Interest Crediting Strategies	Owner chooses one or more market indices that determines contract benchmark Contract value increases in up markets, is protected in down markets Participation rate determines amount of market gain credited to contract Spread, margin or administrative fee • Spread is the amount (fee) the insurer keeps from the investment of contract purchase payments • Does not result in negative earnings Interest rate caps • Maximum rate credited to annuity contract • Account value does not decrease with negative market performance • Rate cap may be fixed at issue or changed annually if contract permits • May be combined with participation rates
Methods of Calculating Index Returns	Point-to-point method – 2 points: one at start of a term, one at end of a term (simple to calculate) High-water/Low-water method – difference between points in the index's value during the year • High-water calculates difference between starting point and the highest point • Low-water calculates difference between the end of the term and the lowest overall index value Annual reset method – calculates the difference between the end of one year to the end of the next • If index is higher at end of the year, the percentage is credited and locked in • If index is lower at the end of the year, declines in the index value are ignored Average method – daily, monthly, or quarterly; average determines amount to be credited

Index Annuity Contract Features	Same as fixed annuities, except: • Term – 1 to 10 years; longer terms offer higher index interest crediting • Vesting – if contract value is withdrawn prior to end of the term, no interest or partial interest may be credited • Minimum guarantees – range is 1% to 3%, calculated at end of a specified term; contract values will always increase • Surrender charges – typically longer than other annuities • 10/10 rule: charges to 10% in first year, 10-year maximum term • Long surrender periods may not be suitable for clients over age 65
Index Annuities and Suitable Sales	Purchaser wants downside protection and needs inflation protection Company financial strength and past crediting performance are important Broad index choices, not individual investment choices, simplify purchaser's selection and increase account value Long term investment time frame means surrender charge period will not impact investment returns Advantages of index annuities: • Potential upside market increases with no downside loss • Minimum guarantees • Multiple interest crediting methods available • Death benefits • Inflation protection • Protection from market volatility • Life income options Disadvantages of index annuities • Multiple contract "moving parts" make contract complex • Fees and costs often not easy to see in statements • Contract choices make comparisons difficult • Surrender charges are long and restrictive • Early withdrawal penalties may result in purchase payment (principal) losses • Interest crediting methods may result in zero gains for the year Insurers can change key contract features annually
IMMEDIATE ANNUITIES	
Introduction to Single Premium Immediate Annuities	• Income begins within 13 months of purchase • Fills in the gap between guaranteed pension fund income and basic living expenses • Few SPIAs are sold • Types of risk ◦ Longevity – outliving savings and other income sources ◦ Withdrawal risk – retiree may take out too much from liquid investments, too soon, depleting account value early ◦ Sequence of returns – negative market performance early in retirement means account may not provide enough income later

The Basics of SPIA	• No accumulation period: income begins in 30 days to 13 months from purchase • Selected, fixed (unadjusted) monthly, quarterly, semi-annual or annual payments guaranteed for annuitant's life ◦ Used for lump-sum inheritances, legal settlements, lottery winnings, or sale of a large asset
How Income from SPIA is Determined	• The amount of retirement asset used to purchase an immediate annuity should be limited to 25-40% • Income received: earnings and principal • Factors that determine the amount of an SPIA payment: ◦ Interest rate ◦ Size of the initial investment ◦ Payment period
Immediate Annuity Contract Features	Issue ages: 0 to 95; younger annuitants have smaller payouts, unless payout option is "period certain" Potential tax benefits – payments include a return of principal that is not taxed again and investment earnings that are taxable Contract type – fixed (guaranteed) and variable (fluctuating) annuity types available; variable annuity payouts may have a guaranteed minimum Complex features – complete disclosure is necessary Annuity Payout Options • Fixed-period (period certain) – payouts for fixed period, often 5, 10 or 20 years • Fixed amount – owner determines payouts and time period is defined • Life only – lifetime income to a single annuitant as long as they live ◦ Generally, the highest payment amount ◦ Payments stop at death, regardless of contract value or purchase amount • Life with period certain – lifetime payments to single annuitant as long as they live, with payments for a guaranteed time ◦ If annuitant dies before end of period, beneficiary receives payment until the end of the period ◦ If annuitant outlives the period, payments continue until annuitant dies • Life with refund – annuitant receives payments for life ◦ If annuitant has not received the amount of the purchase payment before death, the balance is paid to a beneficiary in a lump sum or installment • Joint and survivor – payments are made for life, based upon 2 lives; often there is a payment reduction after first annuitant dies • Inflation adjusted lifetime income – payments increase by an inflation percentage ◦ Often lower initial payments are followed by higher payments in later years

Single Premium Immediate Annuities and Suitable Sales	Considers current income needs, payout period length and legacy gifts to family and beneficiaries Advantages of immediate annuities - Predictable income for life, many payout options, simplicity with no concerns for market <u>conditions</u>, cash flow maximization, higher returns than CDs, favorable taxes, protection from creditors Disadvantages of immediate annuities - Low rate lock-in, loss of control, lack of liquidity, low returns, no changes are allowed after contract is completed, commissions and fees – payouts are reduced by commission, and insurer administrative fees, <u>adverse selection</u> – annuitant may not live long enough to see promised payout
VARIABLE ANNUITIES	
The Basics of Variable Annuities	Tax deferral and investment flexibility into equities, debt securities, alternative securities, index funds, fixed account options in a single product Annuity investment strategies: - Target Allocation Funds – simplifies choices with active management in a broad index using a fund of funds strategy - Model portfolios – designed by investment managers to meet specific risk and return objectives, from conservative to aggressive - Large institutions use a wide variety of strategies not available to smaller groups - Index funds – designed to duplicate the performance of a market index; can use exchange traded funds (ETFs) - Passive strategy, often results in lower fund costs - Dollar Cost Averaging – fixed amount periodic purchase amounts in fluctuating markets; owner buys more shares when the market declines resulting in a lower average cost per share than the average price per share
Variable Annuity Share Classes	B-shares – no upfront sales charge, but a contingent deferred sales charge if money is withdrawn in 6 to 8 years - Typically, lowest mortality and expense (M & E) charges C-shares – cash surrenders without front-end or back-end fees - M & E and administrative fees apply X-shares – like a premium bonus, an amount credited to account at purchase - Often higher administrative fees and longer surrender charge periods - Recovery provisions allow bonus recovery for early withdrawal A-shares – upfront sales charges with no surrender fees

	• Breakpoints allow lower sales charges for larger purchases • Often have lower M & E and lower administrative fees L-shares – like B-shares, but with a shorter surrender charge period • Typically higher M & E and administrative costs
Other Considerations in the Purchase of Variable Annuities	• Guaranteed death benefit is common • Withdrawal provisions – typically 10% to 15% of initial purchase amounts without surrender charges ◦ Surrender charges often waived for confinement in a nursing facility, terminal illness diagnosis, involuntary job loss, or natural disaster • Transfer fees – a flat fee paid when owner transfers money between subaccounts
Variable Annuity Payout Phase	• Accumulation units are converted to a fixed number of annuity units ◦ Value of annuity units fluctuates depending upon underlying investment performance resulting in a variable payout ◦ Value of the first payment is based upon the assumed interest rate (AIR); a low AIR selection results in faster payment increases ◦ On a month-to-month basis, when investments outperform AIR, payment increase; when investments underperform AIR, payments decrease; if investments equal AIR, payment remains the same
Riders and Living Benefits	Each <u>rider</u> carries a separate charge Death Benefit Riders • Guaranteed Minimum Death Benefit (GMDB) – the standard death benefit • Contract Anniversary or Ratchet – death benefits raise or “step-up” GMDB to the greater of the contract value at death, the purchase payments minus withdrawals, or the contract value on a specified date • Initial Purchase Payment with Interest or Rising Floor – increases GMDB a specified percentage to the greater of the contract value at death or total of purchase payments minus withdrawals • Enhanced Earnings Benefit (EEB) – base death benefit plus a percentage of the contract’s earnings at death Guaranteed Minimum Living Benefit Riders • Guaranteed Minimum Income Benefit (GMIB) – guarantees a minimum return on subaccounts ◦ Available only at annuitization for life, life with period certain and joint life annuitization options • Guaranteed Minimum Withdrawal Benefit (GMWB) – guarantees return of all premiums paid, regardless of subaccount performance • Guaranteed Lifetime Withdrawal Benefit (GLWB) – guarantees income for life and protects against market losses • Guaranteed Minimum Accumulation Benefit (GMAB) – guarantees a minimum account value on a certain date.

	regardless of subaccount performance - Standalone Lifetime Benefits (SALB) – independent of a variable annuity, guarantees an income stream for life - Step-up feature: an annual increase in income
Variable Annuities and Suitable Sales	Considerations include investment risk tolerance, lack of liquidity and high surrender charges Agent must match client risk tolerance and investment choices: may not be suitable for seniors Advantages of variable annuities: - Numerous investment choices – with ability to transfer at will - Tax deferral - Flexibility in investment choices – owners can adjust investments for market conditions and to rebalance portfolio - Alternative fee structures – many sales charge and surrender charge structures allow investors to meet liquidity needs and minimize fees - Professional management – subaccounts and model portfolios give access to professional managers investors could otherwise not afford - Living Benefit Riders – guaranteed income for life and riders to offset market risk - Death benefits – protects original investment for beneficiaries Disadvantages of variable annuities: - High fees - Limited liquidity – surrender charges may last up to 10 years - Market risk – unless owner chooses the fixed account, value is subject to market declines - Complicated features – understanding the many features is difficult - Too many choices – many options make product hard to understand - Unfavorable tax treatment – earnings are taxed as ordinary income; penalties apply to income withdrawals before age 59½ - Forced investment changes – some insurers restrict equity investments in adverse market times
ANNUITY TAX CONCEPTS	
Qualified vs. Nonqualified	- Qualified annuities: - Earnings accumulate tax deferred - Contribution limits (depending on the type of plan) - Distributions are fully taxable
Taxation	Taxation depends upon whether the premiums were paid with pre-tax or after-tax dollars Taxation of annuity premiums - Nonqualified annuity premiums are the contract's cost basis and are not tax deductible; qualified annuity premiums are tax deductible; there is no cost basis - The exclusion ratio establishes the amount of each annuity payment that is a return of cost basis on which taxes have been paid

	Tax-deferred growth • Transfers between subaccounts are not counted as taxable sales and repurchases and gains are deferred • Corporate-owned annuities are subject to current taxes on net investment value gains, minus purchases, annually Gifts of annuity contracts • Taxable income is the difference between the purchase payments and the contract value at the time of the gift • The giver may be subject to gift taxes Withdrawals • Owners must pay ordinary income taxes on all earnings • Nonqualified withdrawals are “earnings first,” e.g., taxable, until all earnings are distributed • Earnings withdrawn prior to age 59½ have 10% IRS penalties • All qualified annuity withdrawals are taxable as ordinary income and a 10% penalty applies before age 59½ Assignments of annuity contracts • Treated as a partial withdrawal • Cash value pledged is a withdrawal • Earnings are distributed first and taxable to assignor Taxation of annuity payments • Amount of principal invested is divided by the number of payment periods; if life income is selected, payment periods are based on the annuitant’s life expectancy • Difference between the periodic payment amount and the amount attributable to return of principal is the exclusion amount • All qualified annuity payments are taxable as ordinary income Beneficiary may: • Take a lump-sum withdrawal and pay taxes • Make withdrawals over 5 years and pay taxes annually • Defer withdrawals to the end of year 5, then withdraw the funds and pay taxes • Take installments over life or over life expectancy and pay taxes on the exclusion ratio annually • Life installments or life expectancy payout option must be selected within 12 months of owner’s death • If beneficiary is the spouse, spouse is treated as the owner and no distributions are required until surviving spouse dies
Estate Tax Concepts	• If a beneficiary is named, no probate • Under the restricted beneficiary feature, the owner can restrict beneficiary, amount, and frequency of benefits paid out after owner’s death if insurer receives the instructions prior to owner’s death
1035 EXCHANGES AND REPLACEMENTS	
Annuity Replacements	Reasons for replacement: • New or changed needs

	• New products with better benefits Responsibilities of the agent in a replacement sale • Full disclosure of all material facts, disadvantages and advantages • Provide “Notice Regarding Replacement” to applicant and have it signed by both the applicant and the agent; copy submitted with application • Provide copies of all written sales material, illustrations or proposals used • Maintain complete files to document the needs analysis and recommendations
• 1035 Exchanges	• Tax-free exchange for like-kind transactions ◦ Life policy to life policy, endowment insurance policy or nonqualified annuity ◦ Endowment life insurance to another endowment life insurance policy or to a nonqualified annuity ◦ Nonqualified annuity to a nonqualified annuity • Results of 1035 Exchange transactions ◦ Cost basis preservation of the original contract ◦ Gains in the old contract are not currently taxed in a 1035 exchange
YOUR RESPONSIBILITY IN SUITABLE ANNUITY SALES	
Suitability Standards	• NAIC Model Act requires agent education and supervision to assure that agents and insurers make suitable recommendations • Ensure producer understanding by the consumers, especially seniors • Must have reasonable grounds to believe that recommendation is suitable • Must consider, at minimum, client’s age, annual income, financial needs, current assets and funding sources, current insurance policy death benefits, financial experience and risk tolerance, financial objectives, intended annuity use, financial time line, liquidity needs and liquid net worth, and tax status • Educating Your Customer ◦ Client should understand that an annuity is long-term investment designed to provide retirement income ◦ Client should have a separate emergency fund for liquidity ◦ Client should understand all aspects of the product, including costs, penalties, fees, restrictions, death benefits, living benefits, annuitization, how earnings are credited, liquidity restrictions, tax deferral and tax penalties ◦ If annuity is a qualified annuity, client should understand IRA withdrawal rules

I. Attachments

1. Attachment I: Annuity Legislative History – Provider Reference

Provider Legislative Reference

Understanding of the following annuity legislation is significant. It provides the evolutionary changes for each law throughout the years. It is important to know what impact the following pieces of legislation have had on annuity insurance. To review or obtain copies of the following pieces of legislation, you may log onto the California Legislature's Web site at <http://www.leginfo.ca.gov> or you may call the Legislative Bill Room at (916) 445-2645 to order copies of this legislation.

Year: 2003

SB 620, 2003, (Scott, Chapter 547), Annuities: life insurance: required disclosures and prohibited sales practices.

An act to amend Sections 787, 1725.5, 10127.10, and 10509.8 of, and to add Sections 789.9, 789.10, 1724, and 1749.8 to, the Insurance Code, relating to insurance.

- Enacts additional restrictions on advertising practices that target senior citizens and would expand the scope of existing restrictions, currently applicable to disability insurance, to life insurance and annuities.
- Prohibits the sale of annuities to seniors in certain circumstances.
- Prohibits insurance agents, brokers, and solicitors who are not attorneys from sharing commissions or other compensation with attorneys.
- Requires, effective January 1, 2005, specific training for life agents in order for these producers to sell annuities, unless the agents are nonresident agents who represent a direct response provider, as defined.
- Limits the investment of premiums during the 30-day cancellation period, except as specified, and revises the disclosure requirements applicable to the sale of life insurance and annuity products to seniors.
- Imposes restrictions on the sale of life insurance policies and annuities in the home of a senior citizen.
- Prohibits an agent or insurer from recommending the unnecessary replacement, as defined, of an annuity by a senior citizen.
- Imposes certain duties on the Insurance Commissioner in this regard, and enacts other related provisions.

SB 618, (Scott, Chapter 546), Insurance: unfair acts: licenses.

An act to amend Sections 782, 786, 789.3, and 10509.9 of, and to add Sections 1668.1 and 1738.5 to, the Insurance Code, relating to unfair acts.

- Raises the fine for a violation of these provisions to \$1,500.
- Extends to individuals age 65 or older who purchase life insurance the protections described above that apply to those individuals who purchase disability policies.
- Declares that it applies to the purchase of life insurance only to the extent that it does not conflict with the provisions of law regarding cancellation of life insurance policies and annuities.
- Increases the amounts of these monetary penalties, as specified.

Provider Legislative Reference**Annuities****Page 15**

- Provides that, if the commissioner brings an action against a licensee under these provisions and determines that the licensee may reasonably be expected to cause significant harm to seniors, the commissioner may suspend the license pending the outcome of the action. It allows the commissioner to require the rescission of any contract marketed, offered, or issued in violation of these provisions.
- Authorizes the commissioner to suspend or revoke any permanent license issued if the licensee induces the client to make a loan or gift to or investment with the licensee, or to otherwise act in other specified ways that benefit the licensee or other people acquainted with or related to the licensee.
- Requires that, if a disciplinary hearing of this type involves allegations of misconduct directed against a person age 65 or over, the hearing be held within 90 days after the Department of Insurance receives the notice of defense, unless a continuance is granted.
- Sets forth the grounds for granting a continuance, and provides that the burden of proof in a hearing shall be by a preponderance of the evidence.
- Increases the amounts of these monetary penalties, as specified, and allows the commissioner to suspend or revoke the license of any person who violates these provisions.

AB 284 (Chavez, Chapter 381), Deferred annuities: nonforfeiture

An act to amend Sections 10168.1 and 10168.2 of, and to add Sections 10168.25 and 10168.92 to, the Insurance Code, relating to annuities.

- Requires that these annuity contracts also provide that the company shall grant the paid-up annuity benefit upon the written request of the contract owner.
- Eliminates the requirement applicable to certain contracts that a company reserve the right to defer the payment of the cash surrender benefit for a period of 6 months, and instead allows the company to reserve that right after making written request and receiving written approval of the commissioner, as specified.
- Allows payment of the cash surrender benefit to be deferred for a period not to exceed 6 months.
- Provides for a uniform method of calculating minimum nonforfeiture amounts under these contracts. It modifies the interest rate applicable to accumulations under these contracts, the amounts by which those accumulations may be decreased, and the minimum amount of considerations used to determine the minimum nonforfeiture amount, as specified.
- Provides that these provisions shall apply to contracts issued on and after January 1, 2006, but that a company may elect to apply them, on a contract-form-by-contract-form basis, to any contract issued on or after January 1, 2004, and before January 1, 2006.
- Allows the Insurance Commissioner to adopt regulations to implement these provisions and to adjust the calculation of minimum nonforfeiture amounts for certain other contracts.

Provider Legislative Reference**Annuities****Page 16*****Year: 2002*****AB 2984 (Committee on Insurance, Chapter 203), Insurance: depository institutions: production agencies: surplus line brokers: reinsurance intermediaries.**

An act to amend Sections 1628, 1637, 1639, 1656, 1662, 1679, 1704, 1750.5, 1765.2, 1767, 1768, 1781.3, and 10234.93 of, to add Sections 1638.5 and 1639.1 to, to add Article 5.2 (commencing with Section 759) to Chapter 1 of Part 2 of Division 1 of, and to repeal Sections 1647, 1648, 1649, 1659, and 1714 of, the Insurance Code, relating to insurance.

- Establishes provisions regulating retail sales practices, solicitations, advertising, and offers of any insurance product or annuity to a consumer by a depository institution, or any person engaged in those activities at the office of a depository institution or on behalf of a depository institution.
- Revises licensing provisions with regard to production agencies, surplus line brokers, and reinsurance intermediaries, and also revises requirements for certain licensees within those categories. Because this bill expands the duties of a surplus line broker and thereby expand the definitions of crimes associated with a violation of these duties, the bill imposes a state-mandated local program.
- Provides that no reimbursement is required by this act for a specified reason.

Year: 2000**SB 423 (Johnston, Chapter 694), Life insurance: guaranteed living benefits**

An act to add Section 10506.5 to the Insurance Code, relating to insurance, and declaring the urgency thereof, to take effect immediately.

- Authorizes a life insurer to deliver or issue for delivery variable contracts or riders to variable contracts containing guaranteed living benefits, as defined, under certain conditions.

AB 2107 (Scott, Chapter 442), Elder Abuse

An act to add Section 6177 to the Business and Professions Code, and to amend and renumber Section 10193 of, to amend Section 10234.8 of, and to add Section 789.8 to, the Insurance Code, and to amend Section 15610.30 of the Welfare and Institutions Code, relating to elder abuse.

- Imposes the duty of honesty, good faith, and fair dealing on insurers, brokers, agents, and others engaged in the business of Medicare supplemental insurance and long-term care insurance with respect to prospective policyholders.
- Only permits life agents, on or after July 1, 2001, to sell or offer for sale to an elder or his or her agent any financial product on the basis of the product's treatment under Medi-Cal after providing the elder or his or her agent with a specified disclosure, in writing, explaining the resource and income requirements of the Medi-Cal program, including, but not limited to, certain exempt resources, certain protections against spousal impoverishment, and certain circumstances under which an interest in a home may be transferred without affecting Medi-Cal eligibility. The bill excludes from the application of these disclosure provisions credit life insurance, as defined.

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- Requires the State Bar to make a report, by December 31 of each year, to the Legislature on the provision of financial services by lawyers to elders, as specified. The report would include the number of complaints filed and investigations initiated, the type of charges made, and the number and nature of disciplinary actions taken by the State Bar.
- Revises the definition of existing law that defines financial abuse for the purpose of reporting and investigating elder and dependent adult abuse.

Year: 1998**SB 1718 (Calderon, Chapter 386), Life insurance.**

An act to amend Sections 10509.6 and 10541 of the Insurance Code, relating to life insurance.

- Existing law provides that every life insurer that uses an agent shall, among other things, when a replacement of insurance is involved, provide a notice delivered with the policy that the applicant has a right to an unconditional refund of all premiums, which right may be exercised within 20 days of the date of delivery of the policy. Existing law contains other provisions applicable to variable annuity contracts, variable life insurance contracts, and modified guaranteed contracts that authorize the return of the contract during the cancellation period. This bill adds the latter provision to the previous provisions requiring the applicant to be given notice of a right to an unconditional refund, and changes the 20-day period for the exercise of the right to obtain a refund to a 30-day period.
- Existing law permits certain insurers to issue funding agreements and provides that this authorization does not affect the priority of claims against insolvent insurers. This bill corrects a cross-reference relating to this priority of claims.

Year: 1997**SB 203 (Lewis, Chapter 28), Insurers: mortality tables.**

An act to amend Sections 10163.2, 10489.2, and 10489.3 of the Insurance Code, relating to insurance.

- Existing law regulates the types of benefits to be paid under a policy of life insurance in the event of a default in premium payments or upon surrender of the policy, and also regulates the manner in which reserves are to be maintained by insurers issuing life insurance policies and annuity and pure endowment contracts.
- Existing law provides for insurers to use certain mortality tables for these purposes that have been approved by the Insurance Commissioner through promulgation of a regulation. This bill alternatively allows the commissioner to approve mortality tables through issuance of a bulletin.

Year: 1994**SB 1505 (Calderon, Chapter 984), Life insurance and annuity contracts: senior citizen**

Provider Legislative Reference**Annuities****Page 18****policies and annuities**

An act to amend Sections 10127.10, 10127.11, 10127.12, 10127.13, and 10506.3 of the Insurance Code, relating to life insurance, and declaring the urgency thereof, to take effect immediately.

- Makes specified changes in the cancellation procedures and notice requirements and, in addition, applies those procedures and requirements to individual annuity contracts. In addition, for variable annuity contracts, variable life insurance contracts, and modified guaranteed contracts, a cancelling purchaser would be entitled to a refund of any policy fee paid as well as payment for the value of the account. These provisions do not apply to specified types of group life insurance or group annuity contracts. Under specified circumstances, senior citizens are entitled to refunds if they cancel policies of group term life insurance during the first 30 days of the policy period. The bill also makes conforming changes.
- Also adds the options of stating only the location in the policy text of the required information in 12-point bold type on the cover page of the policy, or by disclosing that information on a sticker that is affixed to the cover page of the policy or to the policy jacket.
- Provides that modified guaranteed annuities are subject to the forfeiture provisions for individual deferred annuities computed under the terms of the annuity, but excluding market adjustment factors, as specified. In addition, group annuities exempted from the provisions governing individual deferred annuities are also exempted from any modified guaranteed annuity regulations.
- This exemption is retroactive to January 1, 1987, to the extent that the assets underlying the group contracts have not been maintained in a separate account. The bill provides that it is to take effect immediately as an urgency statute.

AB 1667 (Hoge, Chapter 6), California Insurance Guarantee Association

An act to amend Sections 1063, 1063.1, 1063.2, 1063.4, 1063.5, 1063.7, 1067.04, 1067.05, and 10112.5 of, to add Section 1067.055 to, and to repeal and add Section 1063.3 of, the Insurance Code, relating to insurance, and declaring the urgency thereof, to take effect immediately.

- Existing law establishes a California Insurance Guarantee Association and specifies those insurers that are required to be members of the association. It exempts certain classes of insurance from assessments and other requirements of the association. This bill specifically enumerates those exempt classes of insurance, and provides that any insurer admitted to transact only those classes or kinds of insurance excluded from specified provisions shall not be a member of the association.
- Existing law provides that the association shall be managed by a board of governors serving for 3 year terms. Those terms expire each year. This bill provides that those terms expire each year on December 31.
- This bill also, among other things, does all of the following with respect to the California Insurance Guarantee Association: (a) Revises the definition of "insolvent insurer," and "covered claims," and defines "ocean marine insurance," as specified. (b) Revises certain policy construction and cancellation provisions with respect to insurer insolvency. (c) Revises the authorization of the association to submit reports

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and make recommendations to the Insurance Commissioner regarding the financial condition of member insurers, and certain examination and other report requirements, as specified. (d) Revises insolvency premium provisions, as specified. (e) Specifies certain notice provisions with respect to an ancillary liquidator.

- Existing law provides for the California Life and Health Insurance Guarantee Association. The statute that established that association abolished the California Life Insurance Guaranty Association and the Robbins-Seastrand Health Insurance Guaranty Association. This bill provides that the California Life and Health Insurance Guarantee Association is created by the merger of the Robbins-Seastrand Health Insurance Guaranty Association with and into the California Life Insurance Guaranty Association and that the association succeeds to the rights, property, and obligations of the predecessors, as specified.
- Revises provisions dealing with the applicability of specified disability insurance policies issued outside of California to an employer whose principle place of business and majority of employees are located outside of California.

Year: 1993

SB 1065 (Mello, Chapter 516), Life insurance.

An act to add Sections 10127.10, 10127.11, 10127.12, and 10127.13 to the Insurance Code, relating to insurance.

- Adds additional provisions which permit a senior citizen, as defined, to cancel any policy of life insurance within 30 days following delivery, as specified. It requires those policies to contain a notice of that provision. Those provisions are inapplicable to individual life insurance policies issued in connection with a credit transaction or issued under a contractual policy change or conversion privilege provisions contained in a policy.
- Additionally makes those provisions inapplicable to noncontributory employer group life insurance contracts.
- Requires offerings of life insurance policies to senior citizens that contain illustrations of nonguaranteed values to contain certain disclosures. It requires annual statements to senior citizen policyowners to disclose the current accumulation value and current cash surrender value and requires life insurance policies for senior citizens, which contain a surrender charge period to disclose the surrender period and penalties associated therewith.

2. Attachment II: Life Agent Disclosure Requirements

Attachment II**Life Agent Disclosure Requirements
for Sales to Elders****Assembly Bill 2107**

Effective July 1, 2001, Chapter 442, Statutes of 2000 (Assembly Bill 2107, Scott), strengthens the Elder Abuse and Dependent Civil Protection Act with respect to selling insurance and financial products to elders and clarifies the definition of financial abuse. (The definition of "elders" is any person residing in this state that is 65 years of age or older.)

At the time of the enactment of this law, a life agent is required to make specified disclosures about the potential consequences of entering into financial transactions related to an elder's potential eligibility for Medi-Cal coverage and prohibits a life agent from negligently misrepresenting a product based on its treatment under Medi-Cal.

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for Sales to Elders - Assembly Bill 2107
Page 2**

Required Medi-Cal Disclosure

A life agent who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal program shall provide, in writing, the following disclosure to the elder or the elder's agent:

NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY

If you or your spouse are considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message!

You or your spouse does not have to use up all of your savings before applying for Medi-Cal.

UNMARRIED RESIDENT

An unmarried resident may be eligible for Medi-Cal benefits if he or she has less than \$2,000 in countable resources.

The Medi-Cal recipient is allowed to keep from his or her monthly income a personal allowance of \$35 plus the amount of any health insurance premiums paid. The remainder of the monthly income is paid to the nursing facility as a monthly share of cost.

MARRIED RESIDENT

COMMUNITY SPOUSE RESOURCE ALLOWANCE: If one spouse lives in a nursing facility, and the other spouse does not live in a facility, the Medi-Cal program will pay some or all of the nursing facility costs as long as the couple together does not have more than \$92,760 + \$2,000 (for 2004).

MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE: If a spouse is eligible for Medi-Cal payment of nursing facility costs, the spouse living at home is allowed to keep a monthly income of at least his or her individual monthly income or \$2319 (for 2004), whichever is greater.

FAIR HEARINGS AND COURT ORDERS

Under certain circumstances, an at-home spouse can obtain an order from an administrative law judge or court that will allow the at-home spouse to retain

**Life Agent Disclosure Requirements
for Sales to Elders - Assembly Bill 2107
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additional resources or income. The order may allow the couple to retain more than \$92,760 + \$2,000 (for 2004) in countable resources. The order also may allow the at-home spouse to retain more than \$2319 (for 2004) in monthly income.

REAL AND PERSONAL PROPERTY EXEMPTIONS

Many of your assets may already be exempt. Exempt means that the assets are not counted when determining eligibility for Medi-Cal.

REAL PROPERTY EXEMPTIONS

ONE PRINCIPAL RESIDENCE. One property used as a home is exempt. The home will remain exempt in determining eligibility if the applicant intends to return home someday.

The home also continues to be exempt if the applicant's spouse or dependent relative continues to live in it.

Money received from the sale of a home can be exempt for up to six months if the money is going to be used for the purchase of another home.

REAL PROPERTY USED IN A BUSINESS OR TRADE. Real estate used in a trade or business is exempt regardless of its equity value and whether it produces income.

PERSONAL PROPERTY AND OTHER EXEMPT ASSETS

IRAs, KEOGHs, AND OTHER WORK-RELATED PENSION PLANS. These funds are exempt if the family member whose name it is in does not want Medi-Cal. If held in the name of a person who wants Medi-Cal and payments of principal and interest are being received, the balance is considered unavailable and is not counted. It is not necessary to annuitize, convert to an annuity, or otherwise change the form of the assets in order for them to be unavailable.

PERSONAL PROPERTY USED IN A TRADE OR BUSINESS

ONE MOTOR VEHICLE

IRREVOCABLE BURIAL TRUSTS OR IRREVOCABLE PREPAID BURIAL CONTRACTS.

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Page 4**

THERE MAY BE OTHER ASSETS THAT MAY BE EXEMPT.

This is only a brief description of the Medi-Cal eligibility rules, for more detailed information, you should call your county welfare department. Also, you are advised to contact a legal services program for seniors or an attorney that is not connected with the sale of this product.

I have read the above notice and have received a copy.

Dated: _____

Signature: _____

Signature: _____

The statement required in this subdivision shall be printed in at least 12-point type, shall be clearly separate from any other document or writing, and shall be signed by the prospective purchaser and that person's spouse, and legal representative, if any.

The State Department of Health Services (<http://www.dhs.ca.gov/mcs/default.htm>) shall update this form to ensure consistency with state and federal law and make the disclosure available to agents and brokers through its Internet Web site.

Life Agent's Duties

Pursuant to Section 10193 of the California Insurance Code, with regard to Medicare supplement insurance and long-term care insurance, all insurers, brokers, agents, and others engaged in the business of insurance owe a policyholder or a prospective policyholder a duty of honesty, and a duty of good faith and fair dealing.

Conduct of an insurer, broker, or agent during the offer and sale of a policy previous to the purchase is relevant to any action alleging a breach of the duty of honesty, and a duty of good faith and fair dealing.

**Life Agent Disclosure Requirements
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Elder Abuse

Pursuant to Section 15610.30 of the California Welfare & Institutions Code:

(a) "Financial abuse" of an elder or dependent adult occurs when a person or entity does any of the following:

- (1) Takes, secretes, appropriates, or retains real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.
- (2) Assists in taking, secreting, appropriating, or retaining real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.

(b) A person or entity shall be deemed to have taken, secreted, appropriated, or retained property for a wrongful use if, among other things, the person or entity takes, secretes, appropriates or retains possession of property in bad faith.

(1) A person or entity shall be deemed to have acted in bad faith if the person or entity knew or should have known that the elder or dependent adult had the right to have the property transferred or made readily available to the elder or dependent adult or to his or her representative.

(2) For purposes of this section, a person or entity should have known of a right specified in paragraph (1) if, on the basis of the information received by the person or entity or the person or entity's authorized third party, or both, it is obvious to a reasonable person that the elder or dependent adult has a right specified in paragraph (1).

Life Agent Financial Products Disclosure

Pursuant to Section 789.8 of the California Insurance Code, if a life agent offers to sell to an elder any life insurance or annuity product, the life agent shall advise an elder or elder's agent in writing that the sale or liquidation of any stock, bond, IRA, certificate of deposit, mutual fund, annuity, or other asset to fund the purchase of this product may have tax consequences, early withdrawal penalties, or other costs or penalties as a result of the sale or liquidation, and that the elder or elder's agent may wish to consult independent legal or financial advice before selling or liquidating any assets and prior to the purchase of any life or annuity products being solicited, offered for sale, or sold. This section does not apply to a credit life insurance product.

A life agent who offers for sale or sells a financial product to an elder on the basis of the product's treatment under the Medi-Cal program may not negligently misrepresent the treatment of any asset under the rules and regulations of the Medi-Cal program, as it pertains to the determination of the elder's eligibility for any program of public assistance.

A life agent who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal Program shall provide, in writing, the required disclosure.

**Life Agent Disclosure Requirements
for Sales to Elders - Assembly Bill 2107
Page 6**

BILL NUMBER: AB 2107 CHAPTERED
BILL TEXT

CHAPTER 442

FILED WITH SECRETARY OF STATE SEPTEMBER 14, 2000

APPROVED BY GOVERNOR SEPTEMBER 13, 2000

PASSED THE ASSEMBLY AUGUST 29, 2000

PASSED THE SENATE AUGUST 28, 2000

AMENDED IN SENATE AUGUST 24, 2000

AMENDED IN SENATE AUGUST 18, 2000

AMENDED IN SENATE AUGUST 7, 2000

AMENDED IN ASSEMBLY MAY 31, 2000

AMENDED IN ASSEMBLY MAY 16, 2000

AMENDED IN ASSEMBLY APRIL 24, 2000

AMENDED IN ASSEMBLY APRIL 3, 2000

INTRODUCED BY Assembly Member Scott

(Coauthor: Assembly Member Jackson)

FEBRUARY 22, 2000

An act to add Section 6177 to the Business and Professions Code, and to amend and renumber Section 10193 of, to amend Section 10234.8 of, and to add Section 789.8 to, the Insurance Code, and to amend Section 15610.30 of the Welfare and Institutions Code, relating to elder abuse.

LEGISLATIVE COUNSEL'S DIGEST

AB 2107, Scott. Elder abuse.

(1) Existing law imposes on all insurers, brokers, agents, and others engaged in the business of Medicare supplemental insurance and long-term care insurance with a policyholder, a duty of honesty, good faith, and fair dealing.

This bill would impose the duty of honesty, good faith, and fair dealing on insurers, brokers, agents, and others engaged in the business of Medicare supplemental insurance and long-term care insurance with respect to prospective policyholders.

The bill would only permit life agents, on or after July 1, 2001, to sell or offer for sale to an elder or his or her agent any financial product on the basis of the product's treatment under Medi-Cal after providing the elder or his or her agent with a specified disclosure, in writing, explaining the resource and income requirements of the Medi-Cal program, including, but not limited to,

**Life Agent Disclosure Requirements
for Sales to Elders - Assembly Bill 2107
Page 7**

certain exempt resources, certain protections against spousal impoverishment, and certain circumstances under which an interest in a home may be transferred without affecting Medi-Cal eligibility.

The bill would exclude from the application of these disclosure provisions credit life insurance, as defined.

(2) Existing law prohibits conflicts of interest between an attorney and client.

This bill would require the State Bar to make a report, by December 31 of each year, to the Legislature on the provision of financial services by lawyers to elders, as specified. The report would include the number of complaints filed and investigations initiated, the type of charges made, and the number and nature of disciplinary actions taken by the State Bar.

(3) Existing law defines financial abuse for the purpose of reporting and investigating elder and dependent adult abuse. This bill would revise that definition.

THE PEOPLE OF THE STATE OF CALIFORNIA DO ENACT AS FOLLOWS:

SECTION 1. Section 6177 is added to the Business and Professions Code, to read:

6177. The State Bar by December 31 of each year shall report to the Legislature on the number of complaints filed against California attorneys alleging a violation of this article. The report shall also include the type of charges made in each complaint, the number of resulting investigations initiated, and the number and nature of any disciplinary actions take by the State Bar for violations of this article.

SEC. 2. Section 789.8 is added to the Insurance Code, to read:

789.8. (a) "Elder" for purposes of this section means any person residing in this state, 65 years of age or older.

(b) If a life agent offers to sell to an elder any life insurance or annuity product, the life agent shall advise an elder or elder's agent in writing that the sale or liquidation of any stock, bond, IRA, certificate of deposit, mutual fund, annuity, or other asset to fund the purchase of this product may have tax consequences, early withdrawal penalties, or other costs or penalties as a result of the sale or liquidation, and that the elder or elder's agent may wish to consult independent legal or financial advice before selling or liquidating any assets and prior to the purchase of any life or annuity products being solicited, offered for sale, or sold. This section does not apply to a credit life insurance product as defined in Section 779.2.

(c) A life agent who offers for sale or sells a financial product to an elder on the basis of the product's treatment under the Medi-Cal program may not negligently misrepresent the treatment of any asset under the statutes and rules and regulations of the Medi-Cal program, as it pertains to the determination of the elder's eligibility for any program of public assistance.

**Life Agent Disclosure Requirements
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Page 8**

(d) A life agent who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal program shall provide, in writing, the following disclosure to the elder or the elder's agent:

"NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY

If you or your spouse are considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message!

You or your spouse do not have to use up all of your savings before applying for Medi-Cal.

UNMARRIED RESIDENT

An unmarried resident may be eligible for Medi-Cal benefits if he or she has less than (insert amount of individual's resource allowance) in countable resources.

The Medi-Cal recipient is allowed to keep from his or her monthly income a personal allowance of (insert amount of personal needs allowance) plus the amount of any health insurance premiums paid. The remainder of the monthly income is paid to the nursing facility as a monthly share of cost.

MARRIED RESIDENT

COMMUNITY SPOUSE RESOURCE ALLOWANCE: If one spouse lives in a nursing facility, and the other spouse does not live in a facility, the Medi-Cal program will pay some or all of the nursing facility costs as long as the couple together does not have more than (insert amount of community countable assets).

MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE: If a spouse is eligible for Medi-Cal payment of nursing facility costs, the spouse living at home is allowed to keep a monthly income of at least his or her individual monthly income or (insert amount of the minimum monthly maintenance needs allowance), whichever is greater.

FAIR HEARINGS AND COURT ORDERS

Under certain circumstances, an at-home spouse can obtain an order from an administrative law judge or court that will allow the at-home spouse to retain additional resources or income. The order may allow the couple to retain more than (insert amount of community spouse resource allowance plus individual's resource allowance) in countable resources. The order also may allow the at-home spouse to retain more than (insert amount of the monthly maintenance need allowance) in monthly income.

**Life Agent Disclosure Requirements
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REAL AND PERSONAL PROPERTY EXEMPTIONS

Many of your assets may already be exempt. Exempt means that the assets are not counted when determining eligibility for Medi-Cal.

REAL PROPERTY EXEMPTIONS

ONE PRINCIPAL RESIDENCE. One property used as a home is exempt. The home will remain exempt in determining eligibility if the applicant intends to return home someday.

The home also continues to be exempt if the applicant's spouse or dependent relative continues to live in it.

Money received from the sale of a home can be exempt for up to six months if the money is going to be used for the purchase of another home.

REAL PROPERTY USED IN A BUSINESS OR TRADE. Real estate used in a trade or business is exempt regardless of its equity value and whether it produces income.

PERSONAL PROPERTY AND OTHER EXEMPT ASSETS

IRAs, KEOGHs, AND OTHER WORK-RELATED PENSION PLANS. These funds are exempt if the family member whose name it is in does not want Medi-Cal. If held in the name of a person who wants Medi-Cal and payments of principal and interest are being received, the balance is considered unavailable and is not counted. It is not necessary to annuitize, convert to an annuity, or otherwise change the form of the assets in order for them to be unavailable.

PERSONAL PROPERTY USED IN A TRADE OR BUSINESS.

ONE MOTOR VEHICLE.

IRREVOCABLE BURIAL TRUSTS OR IRREVOCABLE PREPAID BURIAL CONTRACTS.

THERE MAY BE OTHER ASSETS THAT MAY BE EXEMPT.

This is only a brief description of the Medi-Cal eligibility rules, for more detailed information, you should call your county welfare department. Also, you are advised to contact a legal services program for seniors or an attorney that is not connected with the sale of this product.

I have read the above notice and have received a copy. Dated:

Signature: _____"

The statement required in this subdivision shall be printed in at least 12-point type, shall be clearly separate from any other document or writing, and shall be signed by the prospective purchaser and that person's spouse, and legal representative, if any.

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(e) The State Department of Health Services shall update this form to ensure consistency with state and federal law and make the disclosure available to agents and brokers through its Internet website.

(f) Nothing in this section allows or is intended to allow the unlawful practice of law.

(g) Subdivisions (b) and (d) shall become operative on July 1, 2001.

SEC. 3. Section 10193 of the Insurance Code is amended and renumbered to read:

10192.55. (a) With regard to Medicare supplement insurance, all insurers, brokers, agents, and others engaged in the business of insurance owe a policyholder or a prospective policyholder a duty of honesty, and a duty of good faith and fair dealing.

(b) Conduct of an insurer, broker, or agent during the offer and sale of a policy previous to the purchase is relevant to any action alleging a breach of the duty of honesty, and a duty of good faith and fair dealing.

SEC. 4. Section 10234.8 of the Insurance Code is amended to read:

10234.8. (a) With regard to long-term care insurance, all insurers, brokers, agents, and others engaged in the business of insurance owe a policyholder or a prospective policyholder a duty of honesty, and a duty of good faith and fair dealing.

(b) Conduct of an insurer, broker, or agent during the offer and sale of a policy previous to the purchase is relevant to any action alleging a breach of the duty of honesty, and a duty of good faith and fair dealing.

SEC. 5. Section 15610.30 of the Welfare and Institutions Code is amended to read:

15610.30. (a) "Financial abuse" of an elder or dependent adult occurs when a person or entity does any of the following:

(1) Takes, secretes, appropriates, or retains real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.

(2) Assists in taking, secreting, appropriating, or retaining real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.

(b) A person or entity shall be deemed to have taken, secreted, appropriated, or retained property for a wrongful use if, among other things, the person or entity takes, secretes, appropriates or retains possession of property in bad faith.

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(1) A person or entity shall be deemed to have acted in bad faith if the person or entity knew or should have known that the elder or dependent adult had the right to have the property transferred or made readily available to the elder or dependent adult or to his or her representative.

(2) For purposes of this section, a person or entity should have known of a right specified in paragraph (1) if, on the basis of the information received by the person or entity or the person or entity's authorized third party, or both, it is obvious to a reasonable person that the elder or dependent adult has a right specified in paragraph (1).

(c) For purposes of this section, "representative" means a person or entity that is either of the following:

(1) A conservator, trustee, or other representative of the estate of an elder or dependent adult.

(2) An attorney-in-fact of an elder or dependent adult who acts within the authority of the power of attorney.

**Life Agent Disclosure Requirements
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(SAMPLE FROM INSURER)

TITLE: _____

To: _____
Prospective California Client *(please print)*

From: _____
Agent *(please print)*

Pursuant to California Insurance regulation, I am required to advise you of the following:

In the event I recommend that you sell or liquidate any stocks, bonds, IRA, certificate of deposit, mutual fund annuity, or other assets to fund the purchase of an annuity from an insurance company, you may be subject to some or all of the following:

1. Tax consequences;
2. Early withdrawal penalties;
3. Or, other costs or penalties.

You may wish to consult an independent legal or financial advisor before selling or liquidating any assets and prior to purchasing an annuity.

I acknowledge receipt of this disclosure and understand its contents.

Signature of Prospective California Client

Date

Signature of Agent

Date

**Life Agent Disclosure Requirements
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(SAMPLE FROM INSURER)

NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY

If you or your spouse are considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message!

You or your spouse do not have to use up all of your savings before applying for Medi-Cal.

UNMARRIED RESIDENT

An unmarried resident may be eligible for Medi-Cal benefits if he or she has less than \$2,000 in countable resources.

The Medi-Cal recipient is allowed to keep from his or her monthly income a personal allowance of \$35 plus the amount of any health insurance premiums paid. The remainder of the monthly income is paid to the nursing facility as a monthly share of cost.

MARRIED RESIDENT

COMMUNITY SPOUSE RESOURCE ALLOWANCE: If one spouse lives in a nursing facility, and the other spouse does not live in a facility, the Medi-Cal program will pay some or all of the nursing facility costs as long as the couple together does not have more than \$92,760 + \$2,000 (for 2004).

MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE: If a spouse is eligible for Medi-Cal payment of nursing facility costs, the spouse living at home is allowed to keep a monthly income of at least his or her individual monthly income or \$2319 (for 2004), whichever is greater.

FAIR HEARINGS AND COURT ORDERS

Under certain circumstances, an at-home spouse can obtain an order from an administrative law judge or court that will allow the at-home spouse to retain additional resources or income. The order may allow the couple to retain more than \$92,760 + \$2,000 (for 2004) in countable resources. The order also may allow the at-home spouse to retain more than \$2319 (for 2004) in monthly income.

REAL AND PERSONAL PROPERTY EXEMPTIONS

Many of your assets may already be exempt. Exempt means that the assets are not counted when determining eligibility for Medi-Cal.

REAL PROPERTY EXEMPTIONS

ONE PRINCIPAL RESIDENCE. One property used as a home is exempt. The home will remain exempt in determining eligibility if the applicant intends to return home someday.

The home also continues to be exempt if the applicant's spouse or dependent relative continues to live in it.

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Money received from the sale of a home can be exempt for up to six months if the money is going to be used for the purchase of another home.

REAL PROPERTY USED IN A BUSINESS OR TRADE. Real estate used in a trade or business is exempt regardless of its equity value and whether it produces income.

PERSONAL PROPERTY AND OTHER EXEMPT ASSETS

IRAs, KEOGHs, AND OTHER WORK-RELATED PENSION PLANS. These funds are exempt if the family member whose name it is in does not want Medi-Cal. If held in the name of a person who wants Medi-Cal and payments of principal and interest are being received, the balance is considered unavailable and is not counted. It is not necessary to annuitize, convert to an annuity, or otherwise change the form of the assets in order for them to be unavailable.

PERSONAL PROPERTY USED IN A TRADE OR BUSINESS

ONE MOTOR VEHICLE

IRREVOCABLE BURIAL TRUSTS OR IRREVOCABLE PREPAID BURIAL CONTRACTS.

THERE MAY BE OTHER ASSETS THAT MAY BE EXEMPT.

This is only a brief description of the Medi-Cal eligibility rules, for more detailed information, you should call your county welfare department. Also, you are advised to contact a legal services program for seniors or an attorney that is not connected with the sale of this product.

I have read the above notice and have received a copy.

Dated: _____

Signature: _____

Signature: _____

3. Attachment III: Penalties

Eight-Hour Annuity Training Outline

Attachment III

Penalties Defined (Section 782, 786, 789.3, 1738.5, 10509.910 et seq. of the CIC)

California Insurance Code	Violation	Penalty
Section 782 Establishes penalties for violation of section 780 and section 781	Section 780 - Prohibited Misrepresentation Section 781 - Twisting (see page 3 for actual language)	Punishable by fine not to exceed \$25,000, or if victim loss exceeds \$10,000, the fine not to exceed 3 times the loss suffered by the victim, by imprisonment not to exceed 1 year or by both a fine and imprisonment Restitution to victim pursuant to Section 1202.4 of the Penal Code shall be satisfied before any fine imposed by this section is collected
Section 786 Provides for an examination period of 30 days after the receipt of the policy or certificate for purposes of review of the contract	no violations or penalties cited in this section (see page 3 for actual language)	
Section 789.3 Administrative penalties; amounts; rescission of contracts	Section 789.3: (a) and (b) by broker, agent, or other person engaged in the transactions of insurance other than an insurer (see page 4 for actual language) (d) and (e) by insurer	789.3(a) minimum \$1,000 for the first violation 789.3(b) minimum \$5,000 and no more than \$50,000 each subsequent violation 789.3(c) Commissioner may suspend or revoke license 789.3(d) \$10,000 for the first violation 789.3(e) minimum \$30,000 and no more than \$300,000 each violation thereafter 789.3(f) Commissioner may require rescission of contract

Section 1668.1 Acts that constitute cause to suspend or revoke any permanent license issued pursuant to this chapter	no violations or penalties cited in this section (see page 5 for actual language)	
Section 1738.5 A proceeding held pursuant to section 1668, 1668.5, 1738, 1739, or 12921.8	no violations or penalties cited in this section (see page 5 for actual language)	
Section 10509.9 Administrative penalties:	Section 10509.9: (a) and (b) by any agent or other person or entity engaged in the business of insurance other than an insurer (see page 6 for actual language) (c) and (d) by insurer (see page 6 for actual language) (e) by person or entity after a hearing (see page 6 for actual language)	10509.9 (a) \$1,000 for the first violation 10509.9 (b) minimum \$5,000 and no more than \$50,000 each subsequent violation 10509.9 (c) \$10,000 for the first violation 10509.9 (d) minimum \$30,000 and no more than \$300,000 each violation thereafter 10509.9 (e) the Commissioner may suspend or revoke the license
Section 10509.916 Insurer responsibilities	violations and penalties to be determined (see page 7 for actual language)	

Current Law

This list includes the statutes stated in SB 618 and the penalty statute from AB 689 (Chapter 295, Statutes of 2011) Insurance: annuity transactions, Section 10509.914 of the California Insurance Code, which will take effect on January 1, 2012.

Section 780: An insurer or officer or agent thereof, or an insurance broker or solicitor shall not cause or permit to be issued, circulated or used, any statement that is known, or should have been known, to be a misrepresentation of the following:

- (a) The terms of a policy issued by the insurer or sought to be negotiated by the person making or permitting the misrepresentation.
- (b) The benefits or privileges promised thereunder.
- (c) The future dividends payable thereunder.

Section 781: (a) A person shall not make any statement that is known, or should have been known, to be a misrepresentation (1) to any other person for the purpose of inducing, or tending to induce, such other person either to take out a policy of insurance, or to refuse to accept a policy issued upon an application therefor and instead take out any policy in another insurer, or (2) to a policyholder in any insurer for the purpose of inducing or tending to induce him or her to lapse, forfeit or surrender his or her insurance therein.

(b) A person shall not make any representation or comparison of insurers or policies to an insured which is misleading, for the purpose of inducing or tending to induce him or her to lapse, forfeit, change or surrender his or her insurance, whether on a temporary or permanent plan.

Section 782: Any person who violates the provisions of Section 780 or 781 is punishable by a fine not exceeding twenty-five thousand dollars (\$25,000), or in a case in which the loss of the victim exceeds ten thousand dollars (\$10,000), by a fine not exceeding three times the amount of the loss suffered by the victim, by imprisonment in a county jail for a period not to exceed one year, or by both a fine and imprisonment. Restitution to the victim ordered pursuant to Section 1202.4 of the Penal Code shall be satisfied before any fine imposed by this section is collected.

Section 786: All disability insurance and life insurance policies and certificates offered for sale to individuals age 65 or older in California shall provide an examination period of 30 days after the receipt of the policy or certificate for purposes of review of the contract, at which time the applicant may return the contract. The return shall void the policy or certificate from the beginning, and the parties shall be in the same position as if no contract had been issued. All premiums paid and any policy or membership fee shall be fully refunded to the applicant by the insurer or entity in a timely manner.

a) For the purposes of this section a timely manner shall be no later than 30 days after the insurer or entity issuing the policy or certificate receives the returned policy or certificate.

b) If the insurer or entity issuing the policy or certificate fails to refund all of the premiums paid, in a timely manner, then the applicant shall receive interest on the paid premium at the legal rate of interest on judgments as provided in Section 685.010 of the Code of Civil Procedure. The interest shall be paid from the date the insurer or entity received the returned policy or certificate.

(c) Each policy or certificate shall have a notice prominently printed in no less than 10-point uppercase type, on the cover page of the policy or certificate and the outline of coverage, stating that the applicant has the right to return the policy or certificate within 30 days after its receipt via regular mail, and to have the full premium refunded.

(d) In the event of any conflict between this section and Section 10127.10 with respect to life insurance, the provisions of Section 10127.10 shall prevail.

Section 789.3: (a) Any broker, agent, or other person or other entity engaged in the transactions of insurance, other than an insurer, who violates this article is liable for an administrative penalty of no less than one thousand dollars (\$1,000) for the first violation.

(b) Any broker, agent, other person, or other entity engaged in the business of insurance, other than an insurer, who engages in practices prohibited by this article a second or subsequent time or who commits a knowing violation of this article, is liable for an administrative penalty of no less than five thousand dollars (\$5,000) and no more than fifty thousand dollars (\$50,000) for each violation.

(c) If the commissioner brings an action against a licensee pursuant to subdivision (a) or (b) and determines that the licensee may reasonably be expected to cause significant harm to seniors, the commissioner may suspend his or her license pending the outcome of the hearing described in subdivision (c) of Section 789.

(d) Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars (\$10,000) for the first violation.

(e) Any insurer who violates this article with a frequency as to indicate a general business practice or commits a knowing violation of this article, is liable for an administrative penalty of no less than thirty thousand dollars (\$30,000) and no more than three hundred thousand dollars (\$300,000) for each violation.

(f) The commissioner may require rescission of any contract found to have been marketed, offered, or issued in violation of this article.

Section 1668.1: (a) The licensee has induced a client, whether directly or indirectly, to cosign or make a loan, make an investment, make a gift, including a testamentary gift, or provide any future benefit through a right of survivorship to the licensee, or to any of the persons listed in subdivision (e).

(b) The licensee has induced a client, whether directly or indirectly, to make the licensee or any of the persons listed in subdivision (e) a beneficiary under the terms of any intervivos or testamentary trust or the owner or beneficiary of a life insurance policy or an annuity policy.

(c) The licensee has induced a client, whether directly or indirectly, to make the licensee, or a person who is registered as a domestic partner of the licensee, or is related to the licensee by birth, marriage, or adoption, a trustee under the terms of any intervivos or testamentary trust. However, if the licensee is also licensed as an attorney in any state, the licensee may be made

a trustee under the terms of any inter vivos or testamentary trust, provided that the licensee is not a seller of insurance to the trustor of the trust.

(d) The licensee, who has a power of attorney for a client has sold to the client or has used the power of attorney to purchase an insurance product on behalf of the client for which the licensee has received a commission.

(e) Subdivisions (a) and (b) shall also apply if the licensee induces the client to provide the benefits in those subdivisions to the following people:

- (1) A person who is related to the licensee by birth, marriage, or adoption.
- (2) A person who is a friend or business acquaintance of the licensee.
- (3) A person who is registered as a domestic partner of the licensee.

(f) This section shall not apply to situations in which the client is:

- (1) A person related to the licensee by birth, marriage, or adoption.
- (2) A person who is registered as a domestic partner of the licensee.

Section 1738.5: A proceeding held pursuant to Section 1668, 1668.5, 1738, 1739, or 12921.8 that involves allegations of misconduct perpetrated against a person age 65 or over shall be held within 90 days after receipt by the department of the notice of defense, unless a continuance of the hearing is granted by the department or the administrative law judge. When the matter has been set for hearing, only the administrative law judge may grant a continuance of the hearing. The administrative law judge may, but need not, grant a continuance of the hearing, only upon finding the existence of one or more of the following:

(a) The death or incapacitating illness of a party, a representative or attorney of a party, a witness to an essential fact, or of the parent, child, or member of the household of any of these persons, when it is not feasible to substitute another representative, attorney, or witness because of the proximity of the hearing date.

(b) Lack of notice of hearing as provided in Section 11509 of the Government Code.

(c) A material change in the status of the case where a change in the parties or pleadings requires postponement, or an executed settlement or stipulated findings of fact obviate the need for hearing. A partial amendment of the pleadings shall not be good cause for continuance to the extent that the un-amended portion of the pleadings is ready to be heard.

(d) A stipulation for continuance signed by all parties, or their authorized representatives, that is communicated with the request for continuance to the administrative law judge no later than 25 business days before the hearing.

(e) The substitution of the representative or attorney of a party upon showing that the substitution is required.

(f) The unavailability of a party, representative, or attorney of a party, or witness to an essential fact, due to a conflicting and required appearance in a judicial matter if, when the hearing date was set, the person did not know and could neither anticipate nor at any time avoid the conflict,

and the conflict, with the request for continuance, is immediately communicated to the administrative law judge.

(g) The unavailability of a party, a representative or attorney of a party, or a material witness due to an unavoidable emergency.

(h) Failure by a party to comply with a timely discovery request if the continuance request is made by the party who requested the discovery.

Section 10509.9: (a) Any agent or other person or entity engaged in the business of insurance, other than an insurer, who violates this article is liable for an administrative penalty of no less than one thousand dollars (\$1,000) for the first violation.

(b) Any agent or other person or entity engaged in the business of insurance, other than an insurer, who engages in practices prohibited by this chapter a second or subsequent time or who commits a knowing violation of this article, is liable for an administrative penalty of no less than five thousand dollars (\$5,000) and no more than fifty thousand dollars (\$50,000) for each violation.

(c) Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars (\$10,000) for the first violation.

(d) Any insurer who violates this article with a frequency as to indicate a general business practice or commits a knowing violation of this article, is liable for an administrative penalty of no less than thirty thousand dollars (\$30,000) and no more than three hundred thousand dollars (\$300,000) for each violation.

(e) After a hearing conducted in accordance with Chapter 4.5 (commencing with Section 11400) and Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code, the commissioner may suspend or revoke the license of any person or entity that violates this article.

(f) Nothing in this section shall be deemed to affect any other authority provided by law to the commissioner.

Section 10509.916: (a) An insurer is responsible for compliance with this article. If a violation occurs, either because of the action or inaction of the insurer or its insurance producer, the commissioner may, in addition to any other available penalties, remedies, or administrative actions, order any or all of the following:

(1) An insurer to take reasonably appropriate corrective action for any consumer harmed by the insurer's, or by its insurance producer's, violation of this article.

(2) A managing general agent or an insurance producer to take reasonably appropriate corrective action for any consumer harmed by the insurance producer's violation of this article.

(3) Penalties and sanctions pursuant to Section 10509.9. For purposes of Section 10509.9, this article shall be deemed to be part of Article 8 (commencing with Section 10509), and the

commissioner may in a single enforcement action seek penalties for a first and a second or subsequent violation.

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California Civil Code: http://www.leginfo.ca.gov/.html/civ_table_of_contents.html

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FINRA:

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http://www.insurance.illinois.gov/Life_Annuities/equityindex.asp

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Chapter Complete

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