Annuity Basics

CANNEX Financial Exchanges Ltd. (September 2014)

Annuities have existed for over 2,000 years and the original principle is the same today – to support retirement or other long range goals by way of periodic income payments. However, as with any financial instrument, annuities have evolved over time resulting in many variations… along with some confusion to the general public. The 5 most common annuity contracts offered in the U.S. market today include:

Income Annuities

1) Immediate Income Annuities (SPIA)
2) Deferred Income Annuities (DIA, Longevity Insurance, or QLAC)

Deferred Annuities

3) Variable Annuities (VA)
4) Fixed Annuities (Fixed Rate)
5) Fixed Indexed Annuities (FIA, EIA)

This summary attempts to provide an overview on how an annuity works along with a general explanation about the different variations of annuities available today.

1. WHAT IS AN ANNUITY?

It's Insurance

An annuity is an insurance contract that provides protection in the event of someone living too long (in the form of a sustainable income stream), whereas a life insurance policy provides protection in the event of someone dying too soon (in the form of a lump sum payment to the estate). Both forms of insurance are based on a mortality table (i.e., a "probability of death" table) managed by actuaries at the insurance carrier. Like any insurance, the benefits received from an annuity contract can be tied to either the lifetime of one person (a **Single Life** contract) or two people (a **Joint Life** contract). **Certain Only** contracts are also available which limit benefits to a specific period of time, rather than for a lifetime (generally for Income Annuities only).

The Anatomy of an Annuity

All annuity contracts contain 2 basic components: a *deferral phase* and an *annuity phase*.

- The ***deferral phase*** is the period of time that elapses from when the annuity is purchased to when the annuity phase starts. Additional money can be deposited and accumulate in this phase depending on the type of contract. This phase is also referred to as the *savings phase* or *accumulation phase*.

- The ***annuity phase*** is the period of time during which a guaranteed payment stream is produced – typically for a lifetime. This phase is also referred to as the *income phase*.

Types of Annuities

All annuities can be divided into 2 basic groups or categories: Income Annuities or Deferred Annuities.

- With an ***Income Annuity***, the terms of both the *deferral phase* and the *annuity phase* are specifically defined at the time of purchase. In other words, the length of time before payments start is set along with the actual amount or form of the payment. Sometimes these terms can be adjusted after purchase depending upon the product available. Income Annuities offer a large variety of *annuity phase* options compared to what is typically offered with a Deferred Annuity.

- With a ***Deferred Annuity*** (also known as a ***Savings Annuity***) the length of the *deferral phase* is not defined and is open ended, thus leaving the contract holder with the option to initiate the *annuity phase* at any time – or not at all. The terms associated with the *annuity phase* are not necessarily set at purchase either. Deferred Annuities offer a large variety of *deferral phase* options compared to what is typically offered with an Income Annuity.

Common Features within an Annuity
Each annuity in the market may have its own set of unique features, however, they all will generally offer the following elements:

- ***Deferral Phase Options*** –

  - Deferred Annuities offer **investment options** that allow the contract holder to potentially grow their savings during the *deferral phase* depending upon investment preferences (variable return, fixed rate, or market indexed). Any earnings growth is tax deferred. Income Annuities do not typically offer investment options for this phase.

  - Deferred Annuities also allow for **access to cash** in the form of ad hoc or systematic withdrawals during the *deferral phase* given certain rules and restrictions. Any withdrawals taken from the annuity are taxed at ordinary income rates, and not capital gains rates. Income Annuities provide limited access to cash in this phase.

  - Some Deferred Annuities also offer an **income benefit** option (also known as a living benefit or income rider) which provides for some form of withdrawal or income guarantee during the *deferral phase* without having to initiate the *annuity phase* of the contract (see Section #3 below for further explanation). Income Annuities do not offer this option.

  - Both Deferred Annuities and Income Annuities may offer some form of **death benefit** option (or return of premium option) that will pay a beneficiary a specified minimum amount in the event the contract holder (or annuitant) passes away during the *deferral phase*.

- ***Annuity Phase Options*** –
  The level of income received during the *annuity phase* is contingent upon a) the form of income payment, b) the death benefit option, and c) the type of contract (e.g., Single Life, Joint Life or Certain Only).

  - The **form of income payment** can either be fixed or variable (or a combination of both):

    - ✓ The most common form of payment used today is *fixed* (i.e., the same amount throughout the life of the contract). Fixed payments can also be modified after income starts through an "inflation adjustment" feature (which must be chosen at purchase) or a "one-time" option to adjust the amount to a new level.

    - ✓ There are also *variable* forms of payment available (i.e., variable payments) that will fluctuate the income amount from year to year based on the market performance of **investments options** held in the contract during the *annuity phase*, depending on the product

  - You can also define the type of **death benefit** (or beneficiary guarantee) for the *annuity phase*. The most common forms of death benefit are either a "Lifetime with a 10 Year Certain Period" – where periodic payments will continue to a beneficiary if death occurs within the first 10 years – or a "Refund" where the beneficiary would receive an amount equal to the original premium less any payments already made - either on a lump sum basis (i.e., "Cash Refund") or systematically over time (i.e., "Installment Refund").

2. INCOME ANNUITIES

How Are They Used?
Income Annuities are used in situations where the investor needs to create - and specifically define – a source of guaranteed and predictable income. Therefore, the terms and the amount of benefits are defined at the time of purchase.

How Liquid are Income Annuities?
In return for receiving an income stream that is defined and guaranteed up front by the insurance company, the investor must commit to holding that contract for a long duration. In the case of a lifetime guarantee that duration is for life. However, many Income Annuities offered today provide the investor for some ability to "cash out" or return the contract if needed given certain rules and restrictions. Similar to cashing in a 5 Year Bank CD after a couple of years, there are also costs involved in cancelling an income annuity contract, if allowed.

Two Types of Income Annuities
There are 2 basic types of Income Annuities available today:

a. ***Immediate Income Annuities***
   Otherwise known as a SPIA (or Single Premium Immediate Annuity), the *deferral phase* is generally less than or equal to 12 months. Most Immediate Income Annuities will start the *annuity phase* one month after purchase. The typical investor purchasing this type of contract is between 65 to 70 years old (i.e., someone who needs to lock-in an income amount "now").

b. ***Deferred Income Annuities***
   Also known as Longevity Insurance or Qualified Longevity Annuity Contract (QLAC), the *deferral phase* can range anywhere from 2 to 30+ years. Today, the average age of an investor purchasing a Deferred Income Annuity is in the late-50s with an average deferral period of 5 to 10 years (which corresponds to an income payment starting close to when the investor plans to retire). A recent ruling by the U.S. Treasury will allow the investor, under certain rules, to set the *deferral phase* past age 71 for qualified assets without having to trigger Required Minimum Distributions (RMDs). During the *deferral phase*, the insurance company manages the money on behalf of the investor. This typically results in an income payment amount that is higher than what you would receive with an Immediate Income Annuity for the same amount of premium or deposit.

How Much Do They Cost?
There are no explicit fees associated with an Income Annuity. Like a Bank CD, these expenses are not necessarily disclosed at purchase and are embedded in the quote or rate you are given.

3. DEFERRED ANNUTIES

How Are They Used?
Deferred Annuities are typically used as a savings and protection vehicle by providing investment options within an insurance contract that are managed during the *open ended deferral phase*. By purchasing investment options within a Deferred Annuity, the investor may receive additional protections and benefits such as tax deferred growth for non-qualified assets, a guaranteed return or contract value, as well as a death benefit.

In practice, very few investors elect to trigger the *annuity phase* within these types of contracts. However, there are income options (i.e., income riders) available that will allow the investor, under certain rules and restrictions, to start withdrawing guaranteed income payments from the contract during the *deferral phase* while a) maintaining liquidity and access to cash, and b) maintaining a guaranteed income level that can be

extended into the *annuity phase* if the account value drops to $0. These income options are referred to as **living benefits** with the most common being a Guaranteed Minimum Withdrawal Benefit (GMWB) or Guaranteed Lifetime Withdrawal Benefit (GLWB). A Deferred Annuity that is combined with a living benefit rider provides the investor with a) the potential for investment growth when markets are good, and b) the protection of guaranteed returns or guaranteed income when markets are bad. This protection and flexibility comes at an additional cost.

How Do They Work?

An investor may receive up to 3 different values on their Deferred Annuity statement: a) the account value, b) the death benefit base value and c) the living benefit base value. The account value is the actual cash value of the contract, whereas the death benefit base and living benefit base values are not "cashable" but rather help define the level of the benefit you may receive at any time based upon certain rules and conditions specified in the contract.

How Liquid are Deferred Annuities?

Depending on the type of Deferred Annuity purchased, there may be a Surrender Charge (i.e., a Cancellation Charge) in place during the first few years after purchase while the contract is in the *deferral phase*. The length of the surrender charge period can range anywhere between 0 to 10+ years. If or when the contract enters the *annuity phase*, the ability to cash-in the product is much more restrictive, similar to income annuity products.

Three Types of Deferred Annuities

There are 3 basic types of Deferred Annuities available today:

a. Variable Annuities

A Variable Annuity (or VA) is like purchasing mutual funds wrapped in an insurance contract. The funds you select in a variable annuity are typically managed by the same mutual fund providers you can access outside of the annuity, but the total expense is higher because of the added benefits and protections provided by the insurance contract.

b. Fixed Annuities

A Fixed Rate Annuity is like purchasing a Bank CD within an insurance contract where a guaranteed interest rate is locked in for a specific period of time. After the initial duration, interest rates may be adjusted periodically (generally each year), however, there will typically be a guaranteed minimum interest rate regardless of market conditions.

c. Fixed Indexed Annuities

A Fixed Indexed Annuity (sometimes referred to as an Equity Indexed Annuity) falls somewhere in-between what a Variable Annuity and a Fixed Annuity offer. The insurance carrier credits you with a return that is based on changes in an index, such as the S&P 500 Stock Price Index. Fixed Indexed Annuity contracts also provide that the contract value will be no less than a specified minimum, regardless of index performance. A maximum return or credit is typically capped in some way as well.

How Much Do They Cost?

With a Fixed Rate or Fixed Indexed Annuity (as with an Income Annuity), expenses are not necessarily disclosed at purchase and are usually embedded in the quote or rate you are given by the insurance carrier. On the other hand, a Variable Annuity will charge an explicit asset based fee (e.g., a Mortality & Expense Fee) against a value in a contract.