Annuity Primer

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ZINGLE AND ASSOCIATES, INC.

Annuity Primer

Welcome to Zingle and Associates, Inc. Management Series, offering insights on a number of current topics. Additional information on our services and other subjects can be obtained through our web site. We would be pleased to receive feedback from any of our readers. Feel free to contact us by mail, phone, or e-mail.

Why publish a white paper about annuities in a web site emphasizing retirement plans?

1. *Similarity*: Because many of the same principles of retail annuities apply within retirement plans.

2. *Funding*: Because retirement plans can offer annuities as a product choice (or in the case of 412(e)(3) plans, must do so).

3. *Annuitization*: Because there is a trend among 401(k) plans to offer lifetime retirement income options. Consider the hundreds of papers written on the subject on the web site of the Society of Actuaries.

4. *Risk Management*: Because small pension plans may consider purchasing them to offset its longevity risk.

5. *Distribution*: Because terminating employees or terminating plans may consider them as a distribution option (called a terminal funding annuity).

6. *Education*: Because there seems to be uncertainty and even confusion among some of our clients. Hopefully this paper will help clarify things.

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1. INTRODUCTION

Annuities are contracts between a purchaser and an investment company (insurance company). Any guarantees specified in the contract rely on the financial strength and claims-paying ability of the issuing company. In the descriptions which follow, "investment company" is used generically and most often takes the form of a "life insurance company". By law, only life insurance companies can issue annuity contracts containing lifetime payout options (called life annuities).

The following descriptions are common, but variations exist in practice, and terminology can differ from company to company. What's more, the following is considered a sampling and not exhaustive of all types of annuities available. Finally, new concepts emerge from time to time, so the breakdown which follows may not fully reflect future concepts.

Before making any decision, consult your financial advisor or other reliable professional. Above all, understand the product you are purchasing. For additional information, refer to the web site of the National Association of Insurance Commissioners (NAIC).

2. DETAILS

Market Breakdown

Annuities can be broken down into the following differences. In this way, in practice an annuity can be constructed as the sum of one option from each of the following sets.

Based on the method of premium payment:

- Single Premium Annuities: A single sum is invested.
- Flexible Premium Annuities: Multiple sums are invested over a period of time, usually years. Regular investment intervals are permitted but not required (subject to the terms of the actual contract).

Based on when the payout begin:

- Deferred Annuity: Money accumulates over a period of time, and payout begins later.
- Immediate Annuity: Payout begins immediately or soon after the initial investment.

Based on where assets are invested:

- Fixed Annuity: Rate of return is declared periodically by the investment company, based on the combined experience of its general account. The investor makes no investment decisions and largely is protected from market volatility. Principal is guaranteed (perhaps subject to surrender charges), and a minimum rate of return is specified as part of the contract.
- Variable Annuity: Rate of return is passed through to the investor by the investment company, based on the experience of its separate account.

Offered by prospectus. The investor bears greater risk as well as the opportunity for greater return, based on his/her investment choices (called sub-accounts). Guarantees may be available only through the annuity's general account option.

- Equity-Indexed Annuity: A variation of a fixed annuity where investment returns are based on a specified outside index, such as the S&P 500. Typically the contract pays a base rate, but may be higher if the index increases.

Based on the phase of the annuity:

- Accumulation Phase: The period of time during which money is accumulating, before the Payout Phase commences.
- Payout Phase: Sometimes called the annuitization phase or settlement phase, this is the period of time during which payout amounts are made to the annuitant or beneficiary.

Based on the payout process:

- Annuitize: The process of converting a 401(k), IRA, or similar lump sum distribution into an Immediate Annuity:
- Settlement Option: The annuitization process internal to a Deferred Annuity.

Based on the annuitant:

- Sex distinct: Lifetime payout rates (annuitization conversion factors) are different for males vs. females of the same age and same payment option.
- Unisex: Lifetime payout rates (annuitization conversion factors) are identical for males vs. females of the same age and same payment option. Typically associated with ERISA-based retirement plans.

Based on the number of annuitants:

- Single life: Payments continue during the lifetime of the individual annuitant.
- Joint lives: Payments continue during the lifetime of the primary annuitant, with a lower level of payments continuing thereafter during the lifetime of the surviving joint annuitant. For example, a 50% Joint and Survivor annuity, where payments are reduced to one-half after the death of the primary annuitant.

Based on the payout options:

- Life Annuity: Payouts are received during the continued life of the annuitant(s).
- Period Certain: Payouts are received for a specific period of time, regardless of the longevity of the annuitant. The periodic payout amount can be calculated from this.
- Amount Certain: Payouts are received in a specific periodic amount, regardless of the longevity of the annuitant. The length of payout period can be calculated from this.
- Combination: Terms of the payout contain elements of both life annuity and period certain. For example, during the annuitant's lifetime, but in no event fewer than 120 months (called "10 Years Certain and Life"). Various other combinations exist.

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Based on liquidity options:

- Penalty-Free: Withdrawal of up to 10% of the account within any 12-month period is not subject to surrender charges. The 10% may differ by contract. Typically used with tax qualified plans and IRAs, where Required Minimum Distributions may force withdrawals. The percentage may be increased to 100% for a withdrawal triggered by the death of the annuitant.
- Not Penalty-Free: All withdrawals may be subject to surrender charge.

Based on product expense loads:

- Front-End Loaded: A fee is charged against deposits (premium payments), and no loads are imposed upon withdrawals.
- Back-End Loaded: Commonly called a surrender charge. May be a percentage based on the time the contract has been in force, or may apply separately to the time each premium has been in force. Typically the percentage decreases over time, so that given sufficient years a withdrawal may be penalty-free. As a rule of thumb, contracts becoming completely penalty-free will occur sooner under surrenders based on the contract duration than under surrenders based on premiums durations.

Based on the nature of the investment company:

- Nonpar annuities: Interest (or investment income) is received as declared or earned.
- Bonus annuities: Additional interest is credited at one or more future intervals as an incentive to keep the contract in force.
- Par annuities: May be available from mutual insurers, where additional interest can be declared in the form of policy dividends. The term, *par*, is shorthand for *participating*, a reference to participating in the dividends declared by the insurer based on product criteria.

Based on tax status:

- Tax Qualified: Also called pre-tax, invested deposits (premiums) grow tax deferred during the Accumulation Phase. Future withdrawals will be subject to income tax. Some also may be subject to a 10% excise tax if received before age 59½.
- Non-Qualified: Money is deposited after income taxes have been paid by the investor.

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