# BUYER'S GUIDE TO EQUITY-INDEXED ANNUITIES

**Prepared by the National Association of Insurance Commissioners**

The National Association of Insurance Commissioners is an association of state insurance regulatory officials. This association helps the various insurance departments to coordinate insurance laws for the benefit of all consumers.

This guide does not endorse any company or policy.

This Guide has been written to help you understand annuities in general and equity-indexed annuities in particular. There are different kinds of annuities. It is important for you to understand the differences among various annuities so you can choose the kind that best fits your needs. At the end of this Guide are questions you should ask your agent or the company. Make sure you are satisfied with the answers before you make a purchase.

## WHAT IS AN ANNUITY?

An annuity is a series of income payments made at regular intervals by an insurance company in return for a premium or premiums you have paid. The most frequent use of income payments from an annuity is for retirement.

An annuity is neither a life insurance nor a health insurance policy. It is not a savings account or a savings certificate. You should not buy an annuity for short-term purposes.

## WHAT ARE THE DIFFERENT KINDS OF ANNUITY CONTRACTS?

### Individual or Group

An individual contract covers only one or two persons. A group contract covers a specific group of people, for example, the employees of an employer.

### Immediate or Deferred

An immediate annuity begins to make income payments soon after you pay the premium. The income payments from a deferred annuity start later, often many years later. Deferred annuities have an "accumulation" period, which is the time between when you start paying premiums and when income payments start. The time after income payments start is called the "payout" period.

### Single Premium or Installment Premium

You pay the insurance company only one premium for a single premium annuity. You pay for an installment premium annuity through a series of payments. There are two kinds of installment premium annuities. One kind is a flexible premium contract. You can pay as much as you want, whenever you want, within set limits. The other kind is a scheduled premium contract, which specifies how much your premiums will be and how often you will pay them.

**Fixed or Variable**

During the accumulation period of a fixed deferred annuity, premiums (less any applicable charges) earn interest at rates set by the company or in a way spelled out in the annuity contract. The company guarantees that it will pay no less than a minimum rate of interest. During the payout phase, the amount of each income payment you receive is generally set when the payments start and does not change.

During the accumulation period of a variable annuity, premiums (less any applicable charges) are put into a separate account of the insurance company. You decide how those premiums will be invested, from stock or bond mutual fund choices. The value of the separate account, and therefore, the value of your variable annuity, varies with the investment experience of the funds you choose. There is no guarantee that you will receive all of your premiums back. There is also no guarantee that you will earn any return on your annuity. During the payout period of a variable annuity, the amount of each income payment you receive may be fixed (predetermined) or variable (changing with the value of the investments in the separate account).

## WHAT ARE EQUITY-INDEXED ANNUITIES?

An equity-indexed annuity is a fixed annuity, either immediate or deferred, that earns interest or provides benefits that are linked to an external equity reference or an equity index. The value of the index might be tied to a stock or other equity index. One of the most commonly used indices is Standard & Poor's 500 Composite Stock Price Index (the S&P 500), which is an equity index. The value of any index varies from day to day and is not predictable.

When you buy an equity-indexed annuity you own an insurance contract. You are not buying shares of any stock of index.

While immediate equity-indexed annuities may be available, this Buyer's Guide will focus on deferred equity-indexed annuities.

## HOW ARE THEY DIFFERENT FROM OTHER FIXED ANNUITIES?

An equity-indexed annuity is different from other fixed annuities because of the way it credits interest to your annuity's value. Some fixed annuities only credit interest calculated at a rate set in the contract. Other fixed annuities also credit interest at rates set from time to time by the insurance company. Equity-indexed annuities credit interest using a formula based on changes in the index to which the annuity is linked. The formula decides how the additional interest, if any, is calculated and credited. How much additional interest you get and when you get it depends on the features of your particular annuity.

Your equity-indexed annuity, like other fixed annuities, also promises to pay a minimum interest rate. The rate that will be applied will not be less than this minimum guaranteed rate even if the index-linked interest rate is lower. The value of your annuity also will not drop below a guaranteed minimum. For example, many single premium annuity contracts guarantee the minimum value will never be less than 90 percent of the premium paid, plus at least 3% in annual interest (less any partial withdrawals). The guaranteed value is the minimum amount available during a term for withdrawals, as well as for some annuitizations (see "Annuity Income Payments") and death benefits. The insurance company will adjust the value of the annuity at the end of each term to reflect any index increases.

## WHAT ARE SOME OF THE CONTRACT FEATURES?

Two features that have the greatest effect on the amount of additional interest that may be credited to an equity-indexed annuity are the indexing method and the participation rate. It is important to understand the features and how they work together. The following describes some other equity-indexed annuity features that affect the index-linked formula.

Since new equity indexed annuity products are being developed, the contract you are interested in may contain a feature that is not discussed in this Buyer's Guide. If this is the case, ask your agent for an explanation that you understand.

### Indexing Method

The indexing method means the approach used to measure the amount of change, if any, in the index. Some of the most common indexing methods, which are explained more fully later on, include annual reset (ratcheting), high-water mark and point-to-point.

### Term

The index term is the period over which index-linked interest is calculated. In most product designs, interest is credited to your annuity at the end of a term. Terms are generally from one to ten years, with six or seven years being most common. Some annuities offer single terms while others offer multiple, consecutive terms. If your annuity has multiple terms, there will usually be a window at the end of each term, typically 30 days, during which you may withdraw your money without penalty. For installment premium annuities, the payment of each premium may begin a new term for that premium.

### Participation Rate

The participation rate decides how much of the increase in the index will be used to calculate index-linked interest. For example, if the calculated change in the index is 9% and the participation rate is 70%, the index-linked interest rate for your annuity will be 6.3% (9% x 70% = 6.3%). A company may set a different participation rate for newly issued annuities as often as each day. Therefore, the initial participation rate in your annuity will depend on when it is issued by the company. The company usually guarantees the participation rate for a specific period (from one year to the entire term). When that period is over, the company sets a new participation rate for the next period. Some annuities guarantee that the participation rate will never be set lower than a specified minimum or higher than a specified maximum.

### Cap Rate or Cap

Some annuities may put an upper limit, or cap, on the index-linked interest rate. This is the maximum rate of interest the annuity will earn. In the example given above, if the contract has a 6% cap rate, 6%, and not 6.3%, would be credited. Not all annuities have a cap rate.

### Floor on Equity Index-Linked Interest

The floor is the minimum index-linked interest rate you will earn. The most common floor is 0%. A 0% floor assures that even if the index decreases in value, the index-linked interest that you earn will be zero and not negative. As in the case of a cap, not all annuities have a stated floor on index-linked interest rates. But in all cases, your fixed annuity will have a minimum guaranteed value.

### Averaging

In some annuities, the average of an index's value is used rather than the actual value of the index on a specified date. The index averaging may occur at the beginning, the end, or throughout the entire term of the annuity.

### Interest Compounding

Some annuities pay simple interest during an index term. That means index-linked interest is added to your original premium amount but does not compound during the term. Others pay compound interest during a term, which means that index-linked interest that has already been credited also earns interest in the future. In either case, however, the interest earned in one term is usually compounded in the next.

### Margin/Spread/Administrative Fee

In some annuities, the index-linked interest rate is computed by subtracting a specific percentage from any calculated change in the index. This percentage, sometimes referred to as the "margin," "spread," or "administrative fee," might be instead of, or in addition to, a participation rate. For example, if the calculated change in the index is 10%, your annuity might specify that 2.25% will be subtracted from the rate to determine the interest rate credited. In this example, the rate would be 7.75% (10% - 2.25% = 7.75%). In this example, the company subtracts the percentage only if the change in the index produces a positive interest rate.

### Vesting

Some annuities credit none of the index-linked interest or only part of it, if you take out all your money before the end of the term. The percentage that is vested, or credited, generally increases as the term comes closer to its end and is always 100% at the end of the term.

## HOW DO THE COMMON INDEXING METHODS DIFFER?

### Annual Reset

Index-linked interest, if any, is determined each year by comparing the index value at the end of the contract year with the index value at the start of the contract year. Interest is added to your annuity each year during the term.

### High-Water Mark

The index-linked interest, if any, is decided by looking at the index value at various points during the term, usually the annual anniversaries of the date you bought the annuity. The interest is based on the difference between the highest index value and the index value at the start of the term. Interest is added to your annuity at the end of the term.

### Point-to-Point

The index-linked interest, if any, is based on the difference between the index value at the end of the term and the index value at the start of the term. Interest is added to your annuity at the end of the term.

## WHAT ARE SOME OF THE FEATURES AND TRADE-OFFS OF DIFFERENT INDEXING METHODS?

Generally, annuities offer *preset* combinations of features. You may have to make trade-offs to get features you want in an annuity. This means the annuity you choose may also have features you don't want.

| Features | Trade-Offs |
|---|---|
| **Annual Reset** | |
| Since the interest earned is "locked in" annually and the index value is "reset" at the end of each year, future decreases in the index will not affect the interest you have already earned. Therefore, your annuity 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. This design is more likely than others to give you access to index-linked interest before the term ends. | Your annuity's participation rate may change each year and generally will be lower than that of other indexing methods. Also an annual reset design may use a cap or averaging to limit the total amount of interest you might earn each year. |
| **High-Water Mark** | |
| Since interest is calculated using the highest value of the index on a contract anniversary during the term, this design may credit higher interest than some other designs if the index reaches a high point early or in the middle of the term, then drops off at the end of the term. | Interest is not credited until the end of the term. In some annuities, if you surrender your annuity before the end of the term, you may not get index-linked interest for that term. In other annuities, you may receive index-linked interest, based on the highest anniversary value to date and the annuity's vesting schedule. Also, contracts with this design may have a lower participation rate than annuities using other designs or may use a cap to limit the total amount of interest you might earn. |
| **Point-to-Point** | |
| Since interest cannot be calculated before | Since interest is not credited until the end of |

the end of the term, use of this design may permit a higher participation rate than annuities using other designs.

the term, typically six or seven years, you may not be able to get the index-linked interest until the end of the term.

## WHAT IS THE IMPACT OF SOME OTHER PRODUCT FEATURES?

### Cap on Interest Earned

While a cap limits the amount of interest you might earn each year, annuities with this feature may have other product features you want, such as annual interest crediting or the ability to take partial withdrawals. Also, annuities that have a cap may have a higher participation rate.

### Averaging

Averaging at the beginning of a term protects you from buying your annuity at a high point, which would reduce the amount of interest you might earn. Averaging at the end of the term protects you against severe declines in the index and losing index-linked interest as a result. On the other hand, averaging may reduce the amount of index-linked interest you earn when the index rises either near the start or at the end of the term.

### Participation Rate

The participation rate may vary greatly from one annuity to another and from time to time within a particular annuity. Therefore, it is important for you to know how your annuity's participation rate works with the indexing method. A high participation rate may be offset by other features, such as simple interest, averaging, or a point-to-point indexing method. On the other hand, an insurance company may offset a lower participation rate by also offering a feature such as an annual reset indexing method.

### Interest Compounding

It is important for you to know whether your annuity pays compound or simple interest during a term. While you may earn less from an annuity that pays simple interest, it may have other features you want, such as a higher participation rate.

If there is a product feature that you do not understand, ask your agent. If you still do not understand, send the company a letter telling them that you want a written response so you can study their reply. You will be doing yourself a service!

## CAN I TAKE MY MONEY OUT DURING THE TERM?

In most cases, you can take all or part of the money out of a deferred annuity at any time during the term. There may be a cost if you do. Sometimes the cost is a stated dollar amount. In other cases, you give up index-linked interest on the amount withdrawn. Some annuities do not let you make a partial withdrawal until the end of a term.

## WHAT WILL IT COST ME TO TAKE MY MONEY OUT EARLY?

If you withdraw all or part of the value in your annuity before the end of the term, a *withdrawal or surrender charge* may be applied. A withdrawal charge is usually a percentage of the amount being withdrawn. The percentage may be reduced or eliminated after the annuity has been in force for a certain number of years. Sometimes the charge is a reduction in the interest rate credited to the annuity.

Some annuities credit none of the index-linked interest or only part of it if you take out all your money before the end of the term. The percentage that is vested, or credited, generally increases as the term comes closer to its end and is always 100% at the end of the term.

## IS THERE ALWAYS A CHARGE TO TAKE MY MONEY OUT EARLY?

Your annuity may have a limited "free withdrawal" provision. This lets you make one or more withdrawals without charge each year. The size of the free withdrawal is limited to a set percentage of your annuity's guaranteed or accumulated value. If you make a larger withdrawal, you may pay withdrawal charges. You may also lose index-linked interest on amounts you withdraw.

Most annuities waive withdrawal charges on withdrawals made within a set number of days at the end of each term. Some annuities waive withdrawal charges if you are confined to a nursing home or diagnosed with a terminal illness. You may, however, lose index-linked interest on withdrawals.

## ARE DIVIDENDS INCLUDED IN THE INDEX?

Depending on the index used, stock dividends may or may not be included in the index's value. For example, the S&P 500 is a stock price index and only considers the prices of stocks. It does not recognize any dividends paid on those stocks.

## WHAT ARE SOME OTHER EQUITY-INDEXED ANNUITY CONTRACT BENEFITS?

### Annuity Income Payments

One of the most important benefits of deferred annuities is the right to use the value built up during the accumulation period to provide income payments during the payout period. While income payments are usually made monthly, you can often choose more or less frequent payments. The size of income payments is based on both the accumulated value in your annuity and the annuity's "benefit rate" that is in effect when income payments begin.

The insurance company uses the benefits rate to compute the amount of income payment it will pay you for each $1,000 of accumulated value in your annuity. The benefit rate usually depends on your age and sex, and the form of annuity payment you have chosen. You can usually choose from many forms of annuity payments. You might choose payments that continue as long as you live, or as long as either you or your spouse live, or payments that continue for a set number of years.

### Death Benefit

Annuities provide a variety of death benefits. The most common death benefit is either the guaranteed minimum value or the value determined by the index-linked formula.

**Tax Deferral**

Federal income tax on interest accumulated in an annuity is deferred until you take the interest out of the annuity. You may be required to pay taxes then on the tax-deferred accumulation. You may have to pay a tax penalty if you withdraw the accumulation before you are age 59½. The advantage of tax deferral is that you will probably be in a lower tax bracket in retirement than while you are employed. Also, during the accumulation period, you will be earning interest on money that you would otherwise have used to pay taxes. Tax-qualified annuities are subject to different rules. In any case, you should consult your own tax advisor.

## HOW DO I KNOW IF AN EQUITY-INDEXED ANNUITY IS RIGHT FOR ME?

The questions listed below may help you decide which type of annuity, if any, meets your retirement planning and financial needs. You should consider what your goals are for the money you may put into the annuity. You need to think about how much risk you're willing to take with the money. Ask yourself:

- How long can I leave my money in the annuity?
- What do I expect to use the money for in the future?
- Am I interested in a variable annuity with the potential for higher earnings that are not guaranteed and willing to risk losing the principal?
- Is a guaranteed interest rate more important to me, with little or no risk of losing the principal?
- Or, am I somewhere in between these two extremes and willing to take some risks?

## HOW DO I KNOW WHICH EQUITY-INDEXED ANNUITY IS BEST FOR ME?

As with any other insurance product, you must carefully consider your own personal situation and how you feel about the choices available. No single annuity design may have all the features you want. It is important to understand the features and trade-offs available so you can choose the annuity that is right for you. Keep in mind that it may be misleading to compare one annuity to another unless you compare all the other features of each annuity. You must decide for yourself what combination of features makes the most sense for you. Also, remember that it is not possible to predict the future market behavior of an index.

## QUESTIONS YOU SHOULD ASK YOUR AGENT OR THE COMPANY

- What is the guaranteed minimum interest rate?
- What charges, if any, are deducted from my premium?
- What charges, if any, are deducted from my contract value?
- How long is the term?
- What is the participation rate?
- For how long is the participation rate guaranteed?
- Is there a minimum participation rate?
- Does my contract have a cap?
- Is averaging used? How does it work?
- Is interest compounded during a term?

- Is there a margin, spread, or administrative fee? Is that in addition to or instead of a participation rate?
- Which indexing method is used in my contract?
- What are the surrender charges or penalties if I want to end my contract early and take out all of my money?
- Can I get a partial withdrawal without paying charges or losing interest? Does my contract have vesting?
- Does my annuity waive withdrawal charges if I am confined to a nursing home or diagnosed with a terminal illness?
- What annuity income payment options do I have?
- What is the death benefit?

## FINAL POINTS TO CONSIDER

It is very important that you choose an annuity that you understand well. The purpose of this Buyer's Guide is to help you to understand your annuity. Your agent or insurance company can guide you. Remember that the quality of service you can expect from the company and the agent should also be important to you when you buy an annuity.

When you receive your contract, read it carefully. It may offer a "free look" period for you to decide if you want to keep the contract. Ask your agent or insurance company for an explanation of anything you don't understand. If you have a specific complaint or can't get the answers you need from your agent or company, contact your state insurance department.