



Module One: Annuity Overview and Basic Design

Annuities are designed to give customers a long-term growth and retirement planning vehicle. They offer many benefits including tax deferral and retirement income.

Features and Benefits of an Annuity:

- Tax deferral
- Retirement income through systematic payouts, including lifetime guaranteed income options from annuitization
- Variety of payout options
- Penalty-free withdrawals by Company practice (available through most contracts)
- The potential to avoid probate at death
- Death Benefit

There are two distinct primary methods the majority of insurers use to credit interest: the “new money” method and the “portfolio” method.

New Money Interest Crediting Method

North American utilizes a new money method for crediting interest to annuities. The new money method credits interest according to the rates available when the funds are received by the Company. This takes place because North American purchases long-term fixed rate investments at the time each initial premium deposit is received. One important feature to keep in mind with this type of crediting method is that renewal rates will normally remain close to the initial declared rate in both rising and falling interest rate scenarios.

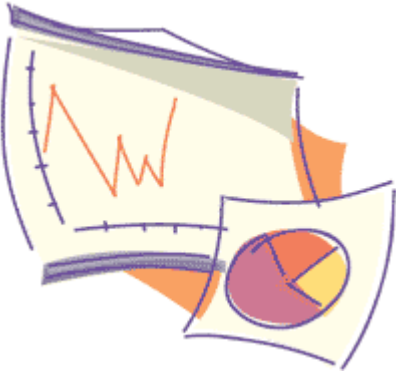
Portfolio Interest Crediting Method

In contrast, there is also a portfolio method for crediting interest to annuities. The portfolio method credits the average interest rate of an entire group of contract holders, regardless of when the funds were contributed. Renewal rates fluctuate as the average interest rate of that particular group of contract holders increases or decreases. Therefore, renewal rates tend to reflect a combination of new interest rates averaged with existing interest rates.

There are **two broad categories of annuities - fixed and variable annuities**. There are many benefits to both and the following section explains the main differences between these two categories.

| Fixed Annuities | Variable Annuities |
|---|--|
| <ul style="list-style-type: none">• Declare a current interest rate, Participation Rate, and/or Index Margin (depending on type of fixed annuity)• Guarantee a minimum rate of return• Guarantee a return of premium if held to term• Regulated as an insurance contract• No securities license is needed to sell• Includes fixed index annuities | <ul style="list-style-type: none">• Separate Account returns are based on market performance• Investor bears the market risk• Prior earnings and principal are subject to loss• Regulated as a security and an insurance contract• Securities license is necessary to sell |

Fixed annuities include both traditional fixed annuities and fixed index annuities. Because fixed index annuities include similar guarantees as a traditional fixed annuity, they are not considered a variable product, and therefore a securities license is not necessary to sell them. **The main difference between a traditional fixed annuity and a fixed index annuity is that an index annuity's interest earnings are based on the**



performance of an external index, subject to Caps, Margins or Participation Rates, and the index accounts do not include a declared interest rate. *Fixed Index Annuities are not an investment in the stock market. Index Values do not include dividends.*

Index Annuity Features:

- May credit excess interest based on index performance
- Do not include a declared interest rate (in index account crediting method)
- No securities license is needed to sell
- No loss of premium due to market downturns
- Guarantee a minimum rate of return

INDEX ANNUITY TERMINOLOGY

In order to fully understand how an index annuity works, producers must also have a clear knowledge of the terms used. Listed below are some basic terms and their definitions. These will be helpful when comparing different products and when trying to understand the different designs offered. Each of these topics will be covered more thoroughly throughout the module series.

Index - Underlying external benchmark that is used to measure the growth of an index annuity.

Participation Rate - The percentage of index gain credited to the annuity.

Margin or Spread - Percentage deducted from the index increase prior to crediting the index gain to the annuity. This is often used in products that have a 100% Participation Rate.

Return Cap - The maximum interest that can be credited to the annuity for the period (caps may permit a higher Participation Rate or a lower Margin).

Minimum Surrender Value ("floor") - The surrender value is the amount that is available at the time of surrender. The surrender value is equal to the Accumulation Value, subject to the Interest Adjustment, less applicable surrender charges and state premium taxes. The surrender value will never be less than the minimum requirements set forth by state laws at the time of issue in the state where the contract is delivered. This amount accumulates interest regardless of index performance, and is a separate calculation from Index Growth.

FIXED INDEX ANNUITY HISTORY & SALES GROWTH

The current generation of fixed index annuities were introduced in early 1995. The financial tools to create index annuities have been around for several years, so why were index annuities suddenly introduced?

One reason is that the psychology of the times was right. 1994 had been a rocky year - bond fund returns were poor, the S&P 500® ended the year on a down note, and many stock funds and variable annuities had minimal or negative returns. In addition, the 8% and 9% interest rates customers had become accustomed to traditional fixed annuities appeared to be over. Interest rates were on a long downward slope from a historic point of view and insurers were looking for a fixed annuity designed to deliver respectable returns. Thus, the fixed index annuity concept was born. It was designed to attract risk-adverse investors that wanted protection of premium and the opportunity for higher returns than those of a traditional fixed annuity or CD-type vehicle.

Since their inception, fixed index annuity sales have vastly increased. Fixed index annuity sales were \$400 million in 1995 and by the end of 2005, annual total sales reached a record of over \$27 billion! Growth not only occurred in sales, but also in the number of insurance companies offering these products. Currently, there are in excess of 230 fixed index annuities available from over 30 different insurers (*Source: The*

Advantage Group, Inc., St. Louis, MO, 314-434-6030). These index annuities differ with varying Participation Rates, Caps, Margins, minimum guarantees, available indices and crediting methods.

THE LINK TO AN INDEX

All fixed index annuities have at least one thing in common, the link to an external index. But what exactly is an index and what is indexing? **An index is a benchmark or relative measure of performance.** An index's value is an average, or weighted average, of the stocks included in the index. It offers diversification through multiple securities across various sectors. This reduces the volatility and risk associated with owning only one, or a few securities. **An important point to understand when studying fixed index annuities is that the index does not sponsor, endorse, or sell any index annuity.**

The most common index utilized with fixed index annuities is the S&P 500®.

- The S&P 500® is widely regarded as the standard for measuring large-cap U.S. stock market performance. It includes a representative sampling of leading companies in leading industries, including the industrial, utility, financial and transportation industries.

Although the S&P 500® Index is the dominant external index utilized, other indices are used as well. Today, North American offers indices beyond the S&P 500®. These indices include:

- The Dow Jones Industrial AverageSM (DJIA) - Includes 30 of the largest U.S. stocks and leaders in their respective industries.
- The NASDAQ-100® - Represents 100 of the largest non-financial U.S. and non-U.S. companies listed on the National Market tier of the NASDAQ-100® Stock Market.
- The S&P MidCap 400® - Measures the performance of the U.S. mid-size company segment.
- The Russell 2000® - Measures the performance of the U.S. small company stocks.
- The Dow Jones EuroSTOXX 50® - Measures the stock market performance on a Euro-wide basis. The index represents the largest and most liquid stocks in the market.
- Lehman Brothers U.S. Aggregate Index

INDEX ANNUITIES VS. INDEX MUTUAL FUNDS

If indices alone are so beneficial, why not just sell an index mutual fund? The chart below illustrates a comparison of an index annuity to an indexed mutual fund.

| | Index Mutual Fund | Fixed Index Annuity |
|------------------------------------|-------------------|---------------------|
| Management Fees | Yes | No |
| Downside Market Risk | Yes | No |
| Past Interest Earnings Protected | No | Yes |
| Premium Protected From Market Risk | No | Yes |
| Includes Reinvested Dividends | Yes | No |

Additionally, a securities license is needed to sell an index mutual fund.

BASIC DESIGNS OF FIXED INDEX ANNUITIES



There are a wide variety of fixed index annuity designs! The most familiar design is the Annual Reset/Ratchet method. The main components are illustrated below.

Annual Reset Method

- Gains are calculated and interest credited each year
- Interest is "locked-in," this means once interest has been earned, it cannot be subtracted in the future due to a market downturn
- Because interest is "locked-in" each year, the contract holder benefits from compounding
- This design is usually coupled with a Participation Rate or Margin that is reset each year

Potential Customers for Annual Reset

- Customers who want the potential to earn greater than fixed rates over the term of the contract.
- Customers who want to see a return credited annually
- Customers who feel market is choppy or unstable
- Customers who want "locked-in" growth.

The number of crediting methods and combinations is virtually boundless. This makes it extremely difficult for a producer to compare "apples to apples". However, the more knowledge obtained about the different crediting methods, guarantee provisions, and features of index annuities (Caps, Margins, Participation Rates, etc.) the more effective producers will be in determining which products to offer customers. The modules that follow will help to increase fixed index annuity knowledge.

Module Two: Fixed Index Annuity Mechanics and Crediting Methods

When investing fixed index annuity premium, the insurance company needs to take into consideration the contractual guarantees, expenses and profits, and the goals of the annuity.

The 3 components of fixed index annuity investing consist of:

- Bonds
- Expenses/Profit
- Call Options

The mechanics of fixed index annuity investing occur in the following order:

- First, fixed rate investments (bonds) are used to support the underlying minimum guarantee
- Second, the company covers normal expenses and profit margins (the cost of doing business)
- Next, call options are purchased to support the growth in the index
- Then, options give the company the right to purchase an index at a specific price, if current prices are lower, we can choose not to purchase the index, if the price is higher, we can choose to purchase the index and participate in the gains
- Finally, bonds + expenses/profit + call options = premium invested in the fixed index annuity

Note: Fixed Index Annuities are not investments in the stock market or in the applicable indices.

GUARANTEES

All fixed annuities offer a minimum guaranteed return. For fixed index annuities, this minimum guarantee promises an Accumulation Value usually equal to a percentage of the original premium, less any withdrawals, accumulated at a minimum guaranteed interest rate by the end of the surrender period. To provide this minimum guaranteed return, the insurance company invests in bonds or other conservative instruments.

A fixed index annuity contains guarantees that protect and maximize retirement dollars. The customer is GUARANTEED the greater of the following values:

| The Index Account Cash Value Plus the Fixed Account Value | OR | The Minimum Surrender Value |
|--|----|--|
| <p>The Index Account Cash Value equals 100% of premiums, plus the premium bonus (if applicable), allocated to the index account, adjusted for any transfers in or out of the account, plus index credit, less withdrawals and applicable surrender charges, plus or minus Interest Adjustment.</p> <p>The Fixed Account Cash Value equals 100% of premiums, plus the premium bonus, allocated to the fixed account, adjusted for any transfers in or out of the account, plus interest earned at the current rate, less withdrawals and applicable surrender charges, plus or minus Interest Adjustment.</p> | | <p>The Minimum Surrender Value equals 87.5% of premiums (excluding premium bonus), less withdrawals, accumulated at the Minimum Guaranteed Interest Rate.</p> <p>This rate will vary based upon the issue date of the contract. Upon issue, this minimum rate will be guaranteed for the entire term of your customer's contract. The Minimum Guaranteed Interest Rate is determined by averaging a daily external index.</p> <p>Guarantees will vary by product. See brochure and product highlight sheet for details.</p> |

Fixed Index Annuity Example: Annual Reset

For this example assume a customer puts \$100,000 into an annual reset fixed index annuity. With a fixed index annuity there are 2 distinct calculations that take place independently of one another. The first column shows the Minimum Surrender Value of 3% growth on 87.5% of the premium. The other chart illustrates 100% of initial premium plus index growth. This chart details how two values grow independently over 3 years. Notice in the year where no index growth was credited, only the Minimum Surrender Value grew by 3%.

| Minimum Surrender Value Example | | | |
|---------------------------------|--------------|---|--|
| Year | Index Return | Minimum Surrender Value | Accumulation Value |
| 1 | 6% | \$87,500.00 + \$2,625.00 (3%) = \$90,125.00 | \$100,000 + \$6,000 (6%) = \$106,000 |
| 2 | 0% | \$90,125.00 + \$2,703.75 (3%) = \$92,828.75 | \$106,000 + \$0 (0%) = \$106,000 |
| 3 | 9% | \$92,828.75 + \$2,784.86 (3%) = \$95,613.61 | \$106,000 + \$9,540 (9%) = \$115,540 |

At the point where the contract holder receives the payout, the two values are compared, and the customer will get the greater of the two values. Please remember that each North American product is different, so there may be surrender charges applied to either the Minimum Surrender Value or the index value or both. Please see the product brochure for specific information.

North American must invest to meet not only the Minimum Surrender Value, but also to guarantee that the contract will not lose value due to market fluctuations on a yearly basis. In order to do that bonds are the primary investment, similar to what would be invested for a traditional fixed annuity. For every \$1 of premium, North American has to guarantee \$1 will be available at the beginning of the following year. For example, if the bonds purchased today are paying 7%, North American would have to purchase \$.93 in bonds to get back to that dollar.

| | |
|---------------------------|---------------|
| Guarantees (Bonds) | \$.93 |
| Expenses/Profit | \$.03 |
| Options | \$.04 |
| | ----- |
| Total | \$1.00 |

What if Bond Yields Change?

To generate \$1.00 in one year:

- If 7% is earned, it would take \$.93.
- If 5% is earned, it would take \$.95.
- If 9% is earned, it would take \$.91.

Each of these scenarios either gives the insurance company more or less money to purchase options, and ultimately will effect the Participation Rates and/or Margins/Spreads.

What if Option Costs Change?

It is important to remember that the change in the price of the options will affect the Participation Rate and/or Margin/Spread that the company can offer. The following is an example assuming \$.04 per dollar invested is available for the insurer to purchase options.

If one "full" option costs \$.04 = 100% Participation Rate

If one "full" option costs \$.08, then we can only buy 1/2 option = 50% Participation Rate

If one "full" option costs \$.02, then we can buy 2 options with our \$.04 = 200% Participation Rate

Setting Participation Rates

As illustrated in the examples above, the Participation Rate depends on the amount of options that can be purchased after covering the minimum guaranteed return and expenses. If the insurance company only has enough money left over to buy 80% of a "full" option, then the annuity participates in 80% of any growth or has a Margin greater than zero. The insurance company doesn't get "the other 20%" of the option because there was no money to buy the other 20% - the seller of the option keeps it.

In summary, both bond rates and option costs have an effect on Participation Rates on newly issued contracts.

On newly issued contracts, as bond rates go up, the company has more money remaining to buy more options and therefore can set higher Participation Rates on an annual basis. If option prices go up, the money does not go as far, and the company must set lower Participation Rates. If option prices fall, the company can afford more options, thus crediting a higher Participation Rate.

VARIATIONS IN PRODUCT DESIGN ELEMENTS

Although there are a multitude of product designs and variations within them, the most popular variations are the use of Averaging or Point-to-Point crediting methods, having a Participation Rate or an Index Margin/Spread and offering different index options from which to choose.

Averaging vs. Point-to-Point - Each index annuity contract will have either a Point-to-Point or an Averaging element, and some will incorporate both. Averaging usually takes the form of either a Daily Average or a Monthly Average. In either instance, it will smooth out the highs and lows of the index movement. Point-to-Point products measure the index movement from a starting date to a final date.

Participation Rate vs. Spread/Margin - Most products will have either a Participation Rate or an Index Margin/Spread. **The Participation Rate** is the percentage of index movement credited to the annuity. The **Index Margin/Spread** is the percentage deducted from an index increase prior to crediting the index gain to the annuity. Although these appear to be very different elements, both are necessary methods of reducing the contract owner's participation in the gain of the index.

Multiple Index Options - As discussed in module one, there are numerous indices to base the measure of growth for the contract. In addition, North American also offers a fixed rate account with a declared rate of return that the customer can put all or a portion of their money into. Contracts that offer multiple indices may or may not have transfer options available.

THREE ANNUAL RESET FIXED INDEX ANNUITY DESIGN EXAMPLES:

- Daily Averaging
- Annual Point-to-Point
- Monthly Point-to-Point

Example of Daily Average Crediting Method:

The Daily Average Crediting Method can be beneficial to the customer because it can smooth out the peaks and valleys of a volatile market. This gives the customer's index annuity the possibility of earning index-linked interest under market conditions when there is uncertainty. This is done by comparing the difference between the index on the first day of the contract year and the index's Daily Average during the year (usually 252 trading days). Using this type of calculation minimizes the extreme peaks and valleys that can occur during any given year. It also helps reduce volatility by providing a more consistent gain over the life of the annuity.

The following example illustrates how the Daily Average Crediting Method is calculated. The numbers used in this calculation are examples only and can be viewed in the [sample pdf](#).

Contract begins 1/5/04

For the next contract year, North American will record the closing value of the chosen index each day the market is being traded. The last day recorded being 1/4/05.

Next we add all of those closing numbers, from 7950 to 8909, listed on the [sample pdf](#), together.

$7950 + 8077 + 8129 + 8223 + 8382 \text{ (etc.)} \dots 9054 + 8873 + 8909 = 2,247,578$

Divide that total by the number of days the market was open (typically 252 days).

$2,247,578 / 252 = 8919$

This produces the **average** closing value of the index in that contract year.

Average index closing: 8919

The beginning index closing value is then subtracted from the average index closing value.

$8919 - 7950 = \text{difference of } 969$

This difference is divided by the beginning index value of the previous year, thus giving us the percentage of index change using the **Daily Average Crediting Method**.

$$969 / 7950 = 0.12188 = 12.18\% \text{ * Gain}$$

* **Note:** Please keep in mind that after the percentage change has been determined, an Index Margin, Participation Rate and/or Index Cap Rate may be applied.

Finally, the gain may be subject to a Cap or Participation Rate.

What If The Market Was Down In Year Two?

- . Beginning index closing value = 1125
- . Average closing value = 900
- . Participation Rate=75%
- . Cap=0%

$$\frac{900-1125}{1125} = -20\% \text{ change in index}$$

Since the calculation is negative, the customer receives a zero return for that year. They do not participate in the loss of the index. Because this is an annual reset design, the customer would still keep the 8.5% that was earned in the first year— it is "locked-in". In the second year, no interest would be credited and no Participation Rates would be applied. The positive in this scenario is that the customer does not lose money in a down year, and the customer's starting point for year three is at a lower number. This means the customer has the opportunity to participate in market corrections!

Example of Annual Point-to-Point Crediting Method

Annual Point-to-Point measures market index growth using two points in time, the beginning index value and the ending index value. Index-linked interest is credited based on the difference between these two values. The following is an example how the Annual Point-to-Point Crediting Method is calculated on a North American fixed index annuity.

Contract begins 1/5/04

First, the index value on the previous day's close becomes the beginning index value for the equation.

Beginning Value: **7950 (close of index on 1/4/04)**

Second, the ending value of this equation is the value of the chosen index one contract year later on 1/4/05.

Ending Value: **8909**

Next the beginning value is subtracted from the ending value.

$$8909 - 7950 = \text{difference of } 959$$

The difference is then divided by the beginning value giving us the percentage of index change using the **Annual Point-to-Point Crediting Method**.

$$959 / 7950 = 0.12062 = 12.06\% \text{ * Gain}$$

* **Note:** Please keep in mind that after the percentage change has been determined, an Index Margin, Participation Rate and/or Index Cap Rate may be applied.

It is important to note that in the Daily Average design, the closing value is taken into account on each day. But in an Annual Point-to-Point design, the only numbers used are the closing values from one contract anniversary to the next contract anniversary.

What If The Market Was Down In Year Two?

As in the Daily Average example, the customer would keep the 7% interest earned in the first year. No interest would be credited and no Participation Rate would be applied for year two.

Example of Monthly Point-to-Point Crediting Method

The Monthly Point-to-Point Crediting Method is calculated by first using a Point-to-Point calculation over a one-month period, rather than an annual period, to determine a gain or loss for that period. The upside potential of each month is subject to a Cap, however negative monthly returns have no downside limit. The change in the index value over a one-month period is then recorded for later use.

After all of the twelve month-long periods have been calculated and recorded, the index growth, if any, is determined by adding together all of the monthly percentage increases (subject to cap) and decreases (no cap limit). If the sum of all of the twelve month-long periods is greater than zero the index credit due will be added to the contract's Accumulation Value. If it is less than zero, no index credit will be added to the account.

Step 1: Calculate monthly change

The following example shows how a one-month period is calculated.

| | |
|---------------------------|---------------------------|
| Beginning of period | Close of period |
| Sept. 10, 2004 | Oct. 10, 2004 |
| Index Value = 1000 | Index Value = 1050 |

Closing Value - Beginning Value = Difference

$$1050 - 1000 = \mathbf{50}$$

Index Change divided by the Beginning Value = Percentage of Change.

If the percentage of change is a gain then it is subject to a cap!

$$50 / 1000 = \mathbf{5\% \text{ gain}} \text{ subject to cap of } \mathbf{3\%} = \mathbf{3\%}$$

Step 2: Record monthly change

| MO | GROSS RETURN | AFTER CAP | MO | GROSS RETURN | AFTER CAP |
|-----|--------------|-----------|-----|--------------|-----------|
| Jan | 5% | 3% | Jul | 6% | 3% |
| Feb | 1% | 1% | Aug | 1% | 1% |
| Mar | -4% | -4% | Sep | -2% | -2% |
| Apr | -1% | -1% | Oct | 8% | 3% |
| May | 2% | 2% | Nov | -1% | -1% |
| Jun | 1% | 1% | Dec | 2% | 2% |

Step 3: Add monthly changes together, both positives and negatives.

3%+ 1%+ -4%.....+ 3%+-1%+2%= 8% credited for the contract year.

Hypothetical Example of Monthly Point-to-Point Crediting Method

BELOW AVERAGE:

| MONTH | ASSUMED S&P 500[®] INDEX VALUE | MONTHLY POINT-TO-POINT 3.00% MONTHLY CAP |
|----------------------------|--|---|
| JANUARY | 950 | — |
| FEBRUARY | 910 | -4.21% |
| MARCH | 860 | -5.49% |
| APRIL | 860 | 0.00% |
| MAY | 880 | 2.33% |
| JUNE | 900 | 2.27% |
| JULY | 850 | -5.56% |
| AUGUST | 880 | 3.00%* |
| SEPTEMBER | 900 | 2.27% |
| OCTOBER | 850 | -5.56% |
| NOVEMBER | 860 | 1.18% |
| DECEMBER | 870 | 1.16% |
| JANUARY | 900 | 3.00%* |
| INDEX RETURN | | -5.61% |
| ACTUAL INDEX CREDIT | | 0.00% |

Please note: Index credit cannot be negative.

AVERAGE:

| MONTH | ASSUMED S&P 500[®] INDEX VALUE | MONTHLY POINT-TO-POINT 3.00% MONTHLY CAP |
|---------------------|--|---|
| JANUARY | 850 | — |
| FEBRUARY | 850 | 0.00% |
| MARCH | 860 | 1.18% |
| APRIL | 880 | 2.33% |
| MAY | 920 | 3.00%* |
| JUNE | 930 | 1.09% |
| JULY | 940 | 1.08% |
| AUGUST | 980 | 3.00%* |
| SEPTEMBER | 1000 | 2.04% |
| OCTOBER | 1010 | 1.00% |
| NOVEMBER | 950 | -5.94% |
| DECEMBER | 930 | -2.11% |
| JANUARY | 920 | -1.08% |
| INDEX CREDIT | | 5.59% |

ABOVE AVERAGE:

| MONTH | ASSUMED S&P 500® INDEX VALUE | MONTHLY POINT-TO-POINT 3.00% MONTHLY CAP |
|--------------|------------------------------|--|
| JANUARY | 880 | — |
| FEBRUARY | 850 | -3.41% |
| MARCH | 825 | -2.94% |
| APRIL | 845 | 2.42% |
| MAY | 905 | 3.00%* |
| JUNE | 890 | -1.66% |
| JULY | 910 | 2.25% |
| AUGUST | 910 | 0.00% |
| SEPTEMBER | 930 | 2.20% |
| OCTOBER | 940 | 1.08% |
| NOVEMBER | 970 | 3.00%* |
| DECEMBER | 1000 | 3.00%* |
| JANUARY | 1010 | 1.00% |
| INDEX CREDIT | | 9.94% |

*Not to exceed hypothetical Index Cap Rate of 3.00%.

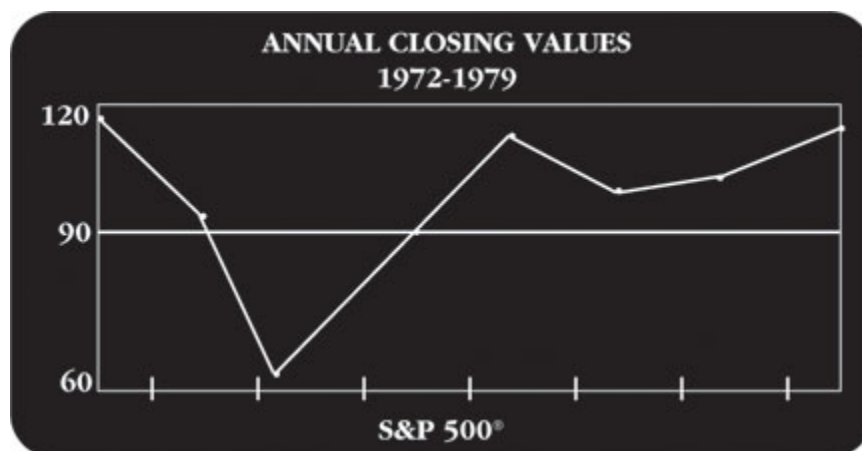
It is important to remember that each crediting method performs differently in different market scenarios. Historically, none of the aforementioned crediting methods have consistently outperformed the others.

ADVANTAGES/DISADVANTAGES OF ANNUAL RESET

Advantages

- Gains credited and "locked-in" annually
- Ability to profit in years in which the index is recovering from a prior down year
- Liquidity
- Compounding

The chart below illustrates the advantages of "locking-in" gains annually and the ability to profit in recovering years.



Although the first two years were down, a customer in an annual reset index annuity would not have experienced any loss. Furthermore, they would have a gain in years 3, 4, 6 and 7. In other market-linked investments, the investor would never have fully recovered their losses during this 7-year period, but the index annuity contract holder would be earning interest!

Disadvantages

- Costly for insurance company to hedge increases in the index
- Cap and/or Averaging is often imposed to reduce above cost