Saving For Retirement

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Annuities can play a vital role in helping investors save for retirement. Unlike other investments, annuities provide a wide variety of benefit options that can protect against an untimely death, provide principal guarantees, assure a specified amount of income when the contract is annuitized, and guarantee withdrawals for life. This chapter discusses how a deferred annuity contract operates during the savings or accumulation period. The information does not apply to an immediate annuity which starts benefit payouts right away and does not have an accumulation period.

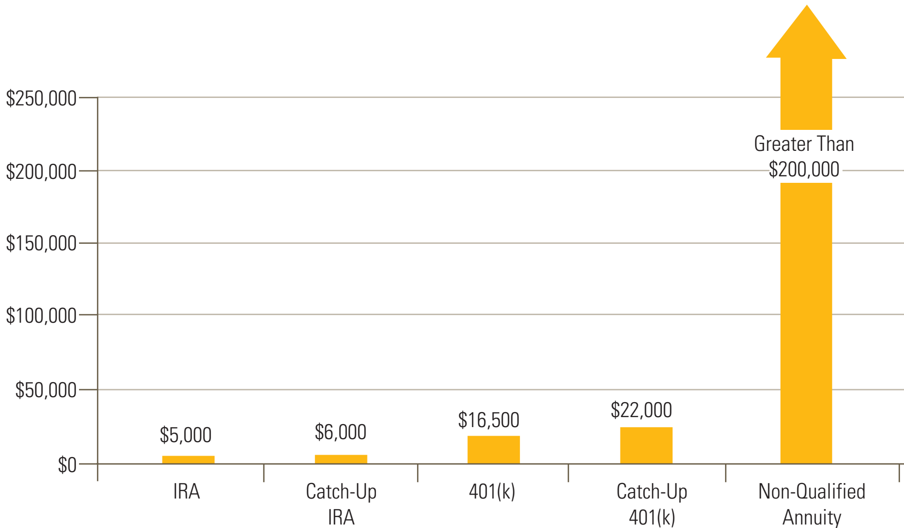
Getting Started

Premiums

The accumulation period begins when the initial purchase (or premium) payment is made by the contract owner and the contract is issued by the life insurance company. Gifts, an inheritance, or any other source of income can be used to initiate or add to a contract. Typically, insurance companies have minimum requirements for initial and additional premium amounts. However, sometimes a life insurance company will permit a smaller minimum initial payment, for example $1,000, if the purchaser agrees to pay premiums on a regular basis, e.g. through automatic payroll deduction. Insurers may also have lower minimum premium requirements for annuities in qualified retirement plans such as 403(b) or 401(k) plans. As is true for all qualified plans, contributions to annuities used to fund qualified plans must come from earned income.

Under a flexible premium annuity contract, varying premium payments may be made on a regular basis or depending on the contract owner's financial situation. Annuities used within qualified plans are subject to annual contribution limits. The government does not, however, limit the total annual amount of premium payments to non-qualified annuities. Insurance companies may impose maximum premium limits that are typically very high and do not affect most contract owners. Because of this feature, many people view non-qualified annuities as valuable personal retirement accounts to which they can contribute as much as they need for retirement.

Figure 3-1 *Contribution Limits to Retirement Savings Plans—2009*



Source: Internal Revenue Service, Publication 590, Individual Retirement Arrangements (IRAs)

Premium Payment Credits or Bonuses

Some companies offer bonuses or credits on variable annuity premium payments. By using this feature, the purchaser receives an immediate credit to his or her account equal to a percentage of the premium payment. Bonus amounts generally range from 1-6%. For example, with a 3% bonus feature, a contract owner paying $10,000 in premiums would have $300 credited immediately to the balance. Such bonuses may be credited to premiums paid only in the first year, or to premiums paid in any year. Variable annuities with bonus credits may have higher ongoing expense charges and longer surrender periods than variable annuities without bonus credits. Some contracts allow the insurer to re-capture all or part of the bonus if the contract is surrendered within the first few years. Approximately 28% of the variable annuity contracts available in 2008 offered bonuses.

Investment Options

As discussed in Chapter 1, annuities can be fixed or variable.

Fixed Investment Options

Fixed annuities offer a rate of return that is determined by the insurance company for a set period of time, subject to a specified minimum. When the applicable period is over, the company may offer a new rate for the next period, which can be for a different length of time. Fixed annuities generally specify a minimum credited interest rate for the lifetime of the contract.

There are many different types of fixed annuities available, with deferred products representing the majority of sales.

Types of deferred fixed annuities:

- *Book value deferred* products earn a fixed rate for a guaranteed period. The surrender value is based on the annuity's purchase value plus credited interest, net of any charges.

- *Market value adjusted* (MVA) annuities are similar to book value deferred annuities but the surrender value is subject to a market value adjustment based on interest rate changes.

- *Indexed* annuities guarantee that a certain rate of interest will be credited to premiums paid but also provide additional credited amounts based on the performance of a specified market index (such as the S&P 500).

Types of immediate fixed annuities:

- *Structured settlement* annuities are used to provide ongoing payments to an injured party in a lawsuit.

- *Single premium immediate* annuities (SPIAs) are usually purchased with a lump sum and payments begin immediately or within one year after annuities are purchased.

- *Deferred income* annuities allow people to purchase annuities that guarantee income at current market rates, but put off receiving the income until a later age, such as 85.

Variable Investment Options

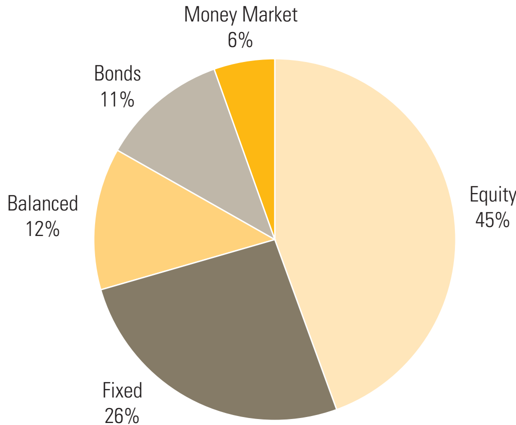
Variable annuities offer investment choices called subaccounts, a selection of funds similar to publicly-sold mutual funds, often managed by the same fund managers. (Many variable annuities also offer a fixed account, effectively an embedded fixed annuity, within the variable contract.) The value of the subaccounts will fluctuate over time, and the variable annuity's return will be based on the investment performance of these subaccounts.

A variable annuity contract will generally permit the owner to choose from a range of subaccounts with different asset classes and strategies. The choices may include equity funds, bond funds, balanced funds, money market funds, and specialty funds such as international and sector funds. The average number of funds per variable annuity contract in 2008 was 51.

The subaccounts are often managed by a variety of investment advisors, who may or may not be affiliated with the insurance company. In fact, a number of well-known mutual fund companies offer subaccounts that serve as investment options or provide professional fund management services for variable annuities.

In their basic form, there is not a minimum return guarantee which applies to these subaccounts; although in recent years insurers have begun to offer various forms of guaranteed return minimums.

Figure 3-2 *Variable Annuity Net Assets by Asset Class*
(percent of 2008 net assets)



Source: Morningstar, Inc.

Portfolio Allocation

Variable annuities offer investors a wide variety of funds to choose from to match their risk tolerance and views of the market. There are different types of asset allocation programs available to help variable annuity purchasers analyze their risk tolerance and decide on a specific mix of funds. Choosing the right mix can be a complex process.

Portfolio Rebalancing

Once a contract owner has decided on the investment mix best suited for his or her needs, premium payments are then allocated in accordance with those percentages. However, as time goes by, market performance may alter the percentage of the variable annuity's contract value held in certain subaccounts (either higher or lower). Many variable annuity issuers offer programs that automatically maintain a pre-determined investment diversification based on the specific needs of each investor. These programs, referred to as portfolio rebalancing programs, periodically reallocate variable annuity contract assets among fixed and variable investment options to reflect the proportions originally selected.

Dollar Cost Averaging

Contract owners who are wary of investing when the market is at a peak, can take advantage of dollar cost averaging programs that are offered under many variable annuity contracts. For example, an owner may choose to allocate a substantial portion of their premium payments to a particular stock fund. If the allocation is made all at once, it is possible that a single purchase price could be locked in when asset values of the stock fund are relatively high. With dollar cost averaging, the premium is systematically transferred (typically from the variable annuity's fixed account option or money market option) to a stock fund over a specified period of time, with the goal of investing at lower, as well as higher, prices. While dollar cost averaging does not ensure a profit or protect against a loss, it can be an effective investment technique.

Importance of Tax Deferral to Portfolio Allocation

The benefits of tax deferral are vital to rebalancing programs and dollar cost averaging. In a taxable account (e.g., a stand-alone mutual fund), each time an investor sells a stock, mutual fund, or other investment and replaces it with another in order to reallocate assets, the investor can be required to pay short- or long-term capital gains tax on any investment growth. With a variable annuity, an owner can rebalance between funds as desired without being taxed, thereby maximizing investment potential.

Transfers

While variable annuity contract owners may transfer money, tax free, from one investment option to another during the accumulation period, certain restrictions typically apply. For example, owners may be restricted to the number and amount of transfer payments allowed in any given year from a fixed account contained inside a variable annuity contract. Another restriction may also limit the number of transfers made among the variable investment options within a specified period of time. Excessive transfer transactions may be subject to nominal administration charges.

Guaranteed Minimum Death Benefit Riders

If a contract owner or annuitant dies in the accumulation phase, a deferred annuity contract will usually provide a death benefit rider protecting the account and payable to a named beneficiary. Sometimes the contract may name a new annuitant to take the place of the deceased annuitant. The contractual payout of this benefit varies by policy and can be payable as a lump-sum payment or as periodic annuity payments. (The tax treatment of death benefits is discussed in the chapter on *Regulation and Taxation of Annuities.*)

Variable annuity contracts have traditionally offered a guaranteed minimum death benefit (GMDB) during the accumulation period that is generally equal to the greater of (a) the contract value at death or (b) premium payments minus any prior withdrawals. The GMDB gives contract owners the confidence to invest in the stock market, important in keeping up with market inflation, as well as the security to

know their families will be protected against financial loss in the event of an untimely death.

The value and importance of the GMDB is proven when considering the market downturn between 2001 and 2003, where variable annuity investor beneficiaries received death benefits worth $2.8 billion more than the value of the annuities, making up for short-term market losses.

Over the past ten years, many insurers have offered enhanced GMDBs. Some type of enhanced death benefit is now available with 87% of variable annuity contracts. The different types of enhanced GMDBs are described below, some of which have additional associated charges.

Contract Anniversary Value or Ratchet (See also GMDB)

Some life insurance companies offer death benefits that step up or increase based on pre-determined criteria. Called contract anniversary value or ratchet, these enhanced GMDBs are equal to the greater of (a) the contract value at death, (b) premium payments minus prior withdrawals, or (c) the contract value on a specified prior date. The specified date could be a prior contract anniversary date, such as the date at the end of every seven-year period, every anniversary date, or even more often. A ratchet GMDB locks in the contract's gains on each of the dates specified.

The cost of this benefit typically ranges from 5-115 basis points annually. At the end of 2008, approximately 80% of variable annuity contracts offered some form of ratchet GMDB.

Initial Purchase Payment with Interest or Rising Floor

Some insurers offer a rising floor GMDB that is equal to the greater of (a) the contract value at death or (b) premium payments minus prior withdrawals, increased annually at a specified rate of interest.

The cost of this benefit typically ranges from 5-135 basis points annually. At the end of 2008, approximately 47% of variable annuity contracts offered some form of rising floor GMDB.

In some cases, a ratchet and a rising floor may be available within the same contract. Some contracts offer a choice of a ratchet or a rising floor.

Enhanced Earnings Benefits

Not all variable annuity death benefits are associated with protection against falling markets. Some more recent variable annuity contracts offer enhanced earnings benefits (EEB) that provide a separate death benefit to help offset federal income taxes payable upon death on any gains in the contract. With this feature, beneficiaries receive not only the base death benefit amount, but also an additional amount that is usually equal to a percentage of the contract's earnings at death (e.g., 40%).

The cost of this benefit typically ranges from 10-95 basis points annually. At the end of 2008, approximately 64% of variable annuity contracts offered some form of enhanced earnings GMDB.

Guaranteed Minimum Living Benefit Riders

Until recently, principal protection under variable annuity contracts was offered only in the case of death. Insurers now offer living protection against investment risks under variable annuity contracts by guaranteeing the level of a variety of different benefits. Some type of living benefit rider is now available with 71% of variable annuity contracts.

Various types of guaranteed minimum living benefit riders (GMLB) are described below. Besides being offered in new contracts, some companies allow them to be added to existing contracts. Charges typically are asset based (or, expressed as a percentage of account value, e.g., 15 basis points is the same as 0.15%).

Guaranteed Minimum Income Benefit

A guaranteed minimum income benefit (GMIB) rider is designed to provide the investor with a base amount of lifetime income when they retire regardless of how the investments have performed. It guarantees that if the owner decides to annuitize the contract (for life, life plus a certain period, or the lives of two people), income payments will be based on the greater of the amount invested credited with a pre-determined interest rate (typically 3-6%), or the maximum anniversary value of the account prior to annuitization. An investor must annuitize to receive this benefit and there is typically a ten-year holding period (in a few instances, a seven-year holding period) before it can be exercised. Age limits may also apply.

GMIBs are usually offered as riders to variable annuity contracts for an optional charge, typically ranging from 15-115 basis points annually. At the end of 2008, approximately 28% of variable annuity contracts offered some form of GMIB - and in the fourth quarter of 2008 the election rate for this rider was 36%.

Guaranteed Minimum Accumulation Benefit

A guaranteed minimum accumulation benefit (GMAB) rider guarantees that an owner's contract value will be at least equal to a certain minimum percentage (usually 100%) of the amount invested after a specified number of years (typically 7-10 years), regardless of actual investment performance. Many GMABs require some form of asset allocation.

The cost of the GMAB rider typically ranges from 15-150 basis points annually, often depending on the extent of asset allocation required. At the end of 2008, approximately 32% of variable annuity contracts offered some form of GMAB - and in the fourth quarter of 2008 the election rate for this rider was 5%.

Guaranteed Minimum Withdrawal Benefit

A guaranteed minimum withdrawal benefit (GMWB) rider guarantees that a certain percentage (usually 5-7%) of the amount invested can be withdrawn annually until the entire amount is completely recovered, regardless of market performance. (Reducing withdrawals in one year does not allow for increased withdrawals in subsequent years. However, if a contract owner defers withdrawals and the account value grows, the amount of subsequent withdrawals allowed may be larger.)

If the underlying investments perform well, there will be an excess amount in the policy at the end of the withdrawal period. If they perform poorly and the account value is depleted before the end of the withdrawal period, the investor can still continue to make withdrawals until the full amount of the original investment is recovered.

If the investor decides to terminate the contract before the end of the withdrawal period, they will receive the cash surrender value of the contract.

Recently a step-up feature has been introduced that periodically (e.g., annually or every five years) locks in higher guaranteed withdrawals if investments do well.

The cost of the GMWB rider typically ranges from 15-150 basis points annually. GMWBs, first introduced in mid-2002, have shown a steady gain in popularity. At the end of 2008, approximately 64% of variable annuity contracts offered some form of GMWB - and in the fourth quarter of 2008 the election rate was 5%.

Guaranteed Lifetime Withdrawal Benefit

Another type of GMWB rider that guarantees withdrawals for life was introduced in 2004. The guaranteed lifetime withdrawal benefit (GLWB) guarantees that a certain percentage (typically 2-8%, often based on age) of the amount invested can be withdrawn each year for as long as the contract holder lives. This percentage may vary depending on the person's age when withdrawals begin. New benefits, such as spousal continuation (which guarantees withdrawals for two lives), have recently been introduced.

The cost of the GLWB rider typically ranges from 25-150 basis points annually. At the end of 2008, approximately 51% of variable annuity contracts offered some form of GLWB - and in the fourth quarter of 2008 the election rate was 58%.

Standalone Lifetime Benefit

An innovative new annuity product, a standalone lifetime benefit (SALB), was introduced in 2008. The SALB provides protection that is similar to that provided by the GLWB, while adding flexibility with the various types of assets that can be protected.

Surrenders

Deferred annuity contracts permit the contract owner to surrender the annuity contract during the accumulation period and receive a cash payment from the insurance company. This amount is called the cash value or cash surrender value of the contract. It equals the sum of premiums paid plus any earnings, minus prior withdrawals and charges deducted. The owner may take partial withdrawals or fully surrender the contract during the accumulation phase. Penalties for early withdrawal may be incurred and federal income taxes will apply to any gain in the contract value.
The amount paid to the contract owner on surrender may be subject to surrender charges which generally range from 5-7%. Some deferred annuity contracts impose surrender charges only for an initial period after the contract is purchased; others start a new surrender charge period for each individual premium paid. Surrender charges usually decline to zero over a period of time, such as five or seven years.

A partial surrender is the withdrawal of an amount less than the entire cash surrender value of the contract. Partial surrenders can also be taken as a pre-scheduled series of payments under a systematic withdrawal plan. Many contracts permit annual withdrawals of an amount, such as 10% of the contract value, which is free of a surrender charge. Tax penalties may apply, however.

Long-Term Care Protection

Some annuity contracts have features designed to address aging Americans' concerns about long-term care (LTC). Many contracts permit owners to withdraw money from their contracts for long-term care needs without incurring surrender charges. Surrender charges may be waived if, for example, a contract owner has been confined to a nursing home for a minimum period or has suffered a critical illness. Additional benefits may be offered such as eldercare resources, referral and consultation services, and discounted long-term care services from a specified group of providers.

With the enactment of the Pension Protection Act of 2006, new hybrid products which combine annuities with LTC are being introduced. Beginning in 2009, tax-free distribution status will be given to both annuity assets and LTC rider benefits used for a qualified LTC purpose. Under prior law, withdrawals taken from the annuity to pay the LTC premiums were taxable and subject to a 10% penalty prior to age 59½.