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EXECUTIVE SUMMARY

Equity-Indexed Annuities: Fundamental Concepts and Issues

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This paper is on Equity-Indexed Annuities (EIAs), also known as Indexed Annuities and (more recently) Fixed Indexed Annuities. A category of relatively new and increasingly popular annuities, EIAs are a type of fixed annuity whose credited interest rate depends on the performance of an external market index, with a guaranteed minimum return. EIAs offer the potential for larger interest credits than traditional fixed annuities, without the downside risk of direct equity investing. Many risk-averse buyers want protection against equity market declines while retaining an opportunity for long-term growth, and EIAs help buyers achieve these objectives. Nearly all EIAs bought today are deferred (versus immediate) annuities, most with a single premium (although sales of flexible premium EIAs are growing).

EIA products, and certain sales and marketing practices, are being scrutinized from within and outside the insurance industry. This paper addresses key EIA product features, the current EIA marketplace, and issues and criticisms surrounding EIAs. The paper recommends changes.

Equity-Indexed Annuity Product Design

The paper briefly contrasts EIAs with variable annuities and mutual funds. A non-registered EIA is an insurance company "general account" product, like traditional fixed annuities and non-variable life insurance. As such, insurer assets that back these products are commingled in the insurer's general account, and all general account assets support any and all claims from these contracts. General account products always include insurer guarantees—most notably, guarantees of principal and a minimum rate of return.

The paper generally describes the main features of EIAs. Some variations are not permitted in some states. Key features include:

- **Tied Index**—the external market index used by the EIA (e.g., S&P 500, for 95 percent of EIAs sold).
- **Indexing Method**—the method used to measure change in the tied index. Nearly all new EIAs use Annual Reset interest-crediting methods.
- **Index Term**—the period over which index-linked interest credits are measured and corresponding interest credits are added to the EIA's accumulation value. Annual Reset methods generally use a term that corresponds to a policy year.
- **Participation Rate, Yield Spread, and Interest Rate Cap**—The interest rate credited may be lower than the gain in the tied index over the interest-crediting period, usually by one or more of: (1) applying a "participation rate" (e.g., 90 percent) to the total index gain; (2) deducting a "yield spread" (a stated percentage, e.g., 2 percent), from the otherwise-calculated interest-crediting rate; and/or (3) placing a "cap" on the interest-crediting rate.

- **Simple or Compound Interest**—the EIA can credit interest on the principal amount only (i.e., simple interest) or on principal and interest credited in earlier time periods (i.e., compound interest).
- **Surrender Charges**—EIAs, like most traditional fixed-rate annuities and variable annuities, assess a charge against the accumulation value if the contract is surrendered before the end of a surrender charge period. Surrender charges help the insurer recover contract-issuance costs that would be recoverable in other ways in future years had these policies stayed in-force.
- **Minimum Guarantees**—As in all fixed annuities, the principal under EIA contracts is guaranteed against a decline in the market value of the (general account) assets that underlie EIA contracts. Uniquely to EIAs, however, the owner is protected if the tied index declines between an initial date and a later point defined in the contract.
- **Other**—including premium bonuses, market value adjustments (MVAs), and riders.

Surrender Charges

Seventy percent of EIAs on the market have a surrender-charge period between seven and 12 years (inclusive), with modes at 10 years (22 percent) and seven years (20 percent). After the first year, most EIAs permit annual withdrawals—with no surrender charge—of 10 percent of either the premium or the accumulation value. Few EIAs assess a surrender charge if the EIA is cashed in due to the contract owner's death.

Most EIA sales today credit a "bonus" (e.g., five or 10 percent) to the contract's accumulation value, based on only the initial premium or, for example, on premiums paid during the first five contract years. Annuities that pay a premium bonus may have lower participation rates, lower interest rate caps, or other restrictions compared to EIAs that do not offer a bonus.

The imposition of the surrender charge might result in a forfeiture of some or all of premium bonuses and index-linked interest credits and possibly some loss of principal (i.e., premium). EIA products with longer surrender-charge periods and/or higher surrender charges often provide additional benefits that enhance the EIA's financial performance for those who keep their EIA until the end of the surrender period.

Also, if the contract is surrendered during the surrender-charge period, roughly one in four insurers currently issuing EIAs (including many of the largest writers) apply a market value adjustment (MVA) to the accumulation value; the adjustment can be up or down. MVAs are not unique to EIAs. Traditional fixed annuities that guarantee an interest rate over a prescribed period often apply an MVA to withdrawals made before the rate-guarantee period ends. If market interest rates at the time of withdrawal/surrender are below those at issue, the MVA will increase the cash surrender value. However, if interest rates at withdrawal are higher than at issue, the MVA will decrease the cash value but not below a guaranteed minimum. MVAs are designed to protect the insurer against financial disintermediation that might occur if the contract did not contain an MVA.

Participation Rate, Yield Spread, and Interest Rate Cap

EIAs with yield spreads account for only a small percentage of total EIA sales. An interest rate cap may be expressed as a monthly limit (e.g., 3 percent), an annual limit (e.g., 7 percent) or as a ceiling on the total amount of index-linked interest credited over the entire contract term (e.g., 50 percent). Insurers generally reserve the right to change the participation rate or the cap rate, but not both, annually. Changing the participation rate or the cap rate annually under an EIA contract is similar to how, in traditional fixed annuities, on each policy anniversary insurers declare the interest rate to be credited on accumulation values during the next contract year.

EIAs use participation rates, yield spreads and caps to create a source of funds with which to pay for sales and marketing costs, policy issuance costs, taxes, general overhead, and profit (or return on invested capital). These features also provide funds that cover the cost associated with guarantees in annuity and insurance contracts. Insurer guarantees of principal and a minimum rate of return are not “free,” nor is a guarantee of a minimum lifetime payout amount in the event of annuitization. Despite investment results or insurance outcomes inferior to what was expected (e.g., people living longer), the insurer must fulfill its contractual guarantees. Under traditional fixed annuity and non-variable life insurance contracts, insurers aim to cover the costs of these risks from returns on their (general account) investment portfolio that exceed the amounts credited to their in-force annuity and life insurance contracts.

Unlike traditional fixed annuities, issuers of EIAs typically invest only a portion of the premium in fixed-income instruments such as bonds and mortgages. Another portion is typically used to purchase options on the tied index. The part of the EIA premium that the insurer invests in fixed-income instruments is used to “cover” the principal and interest guarantees. Both market interest rates and the cost of index options fluctuate daily. For these and possibly other reasons, it is not uncommon for insurers to change key provisions (e.g., increase/reduce the participation rate by 5 percent) in newly issued EIAs from one month to the next. Thus, the insurer offering the most attractive EIA product today may not be the one with the most attractive EIA product tomorrow. Similarly, two people who buy an EIA on consecutive months from the same insurer may experience different rates of return—not only as a result of differing starting (and ending) index values but also possibly due to different participation rates, caps or yield spreads.

Minimum Guarantees

EIAs offer a guaranteed minimum value upon cash surrender, including the promise that the cash value at the end of the surrender-charge period will equal at least all paid premiums. So even if the tied index declines over the entire surrender-charge period, the EIA owner is entitled to receive at least the premiums paid, plus possibly some interest. The guaranteed rate rarely exceeds 3 percent per year and is usually smaller. Often it is applied to an amount less than the full premium (such as 90 percent), thereby reducing the effective interest rate below the stated rate. As such, the guaranteed interest-crediting rates in EIA contracts are generally lower than those in traditional annuities, but this enables higher participation in the tied external index than if a “greater guarantee” were provided.

Index-Linked Interest-Crediting Structures

There are two steps in the calculation of index-linked interest: measuring the percentage gain in the tied index and using the participation rate, yield spread, and/or rate cap to determine the portion of the gain to be credited to the accumulation value.

There are three main categories of methods for measuring the percentage gain in the tied index: *Point-to-Point*, *High Water Mark*, and *Annual Reset*. The Point-to-Point method measures the change in the index from the purchase of the EIA to an end point two or more years later. The High Water Mark method is a variation of the Point-to-Point method; it determines the “ending” index value as the highest value the index reaches on any “sampling date” throughout the term. The sampling frequency may be daily, monthly, or annually on each policy anniversary. Under the Annual Reset structure (the most commonly used method), an interest-crediting rate is determined at the end of each policy year.

Under all methods, the value of the tied market index at the end of each term is compared with the index value at the beginning of the term. In periods where gains in the tied index are negative, a “0” is recorded. Although there can be years with no index gains under Annual Reset EIAs, it is impossible to have a “down” year. Accumulation values will either grow or remain steady from one year to the next, regardless of the volatility in the tied index. Gains are divided by the index value at the beginning of the term to determine a percentage. This percentage may be reduced by a participation rate, a yield spread, and/or a cap in determining the index-linked interest-crediting rate. Once interest is credited to the accumulation value, it is locked-in and the accumulation value will never decrease from that level regardless of the future performance of the tied index.

The paper provides hypothetical examples that illustrate the operation of the Point-to-Point, High Water Mark, and Annual Reset methods.

The Equity-Indexed Annuity Marketplace

From 1999-2004 the annual sales growth rate ranged from 10 percent to 74 percent. In 2004 alone EIA sales were $23.1 billion, 60 percent over 2003. As of November 2005, 47 insurers offered indexed annuities—14 carriers offered only one EIA product; 7 insurers offered 10 or more products; the largest number of EIA products issued by a single insurer was 19.

Table A
Equity-Indexed Annuities as a Percent of Total (Individual) Annuity Sales, 1999-2004

Year	1999	2000	2001	2002	2003	2004
Percent	3%	3%	4%	5%	7%	11%

Source: LIMRA

- ***Average Premium***: The average premium of indexed annuities sold during the 3rd Quarter 2005 was $50,585, compared to approximately $34,000 five years earlier (3rd Quarter 2000). The average EIA premium of $50,585 exceeded the average premium on traditional fixed annuities by approximately $9,400.
- ***Surrender-Charge Periods***: Table B shows EIA market shares (for 3rd Quarter 2005 sales) by surrender-charge period. Only 3 percent of EIA premiums went into contracts with a surrender period shorter than 7 years. 74% of EIA premium volume went into contracts that had 10 or more years of surrender charges or required that the accumulation value be annuitized.

Table B
Surrender-Charge Periods and Market Shares

Surrender-Charge Period	5 Yrs	6 Yrs	7 Yrs	8 Yrs	9 Yrs	10 Yrs	11 or more Yrs	Annuitize
Market Share*	2%	1%	12%	2%	9%	14%	38%	22%

Source: LIMRA

- ***Distribution Channels***: Independent agents (PPGAs, life brokers and other independent producers) sell the vast majority of EIA products, accounting for approximately 92 percent of 3rd Quarter 2005 sales of indexed annuities.

- ***Commissions***: Agent commissions averaged 8.4 percent of premium during 3rd Quarter 2005. This average has fluctuated around 7.5 – 8.5 percent during the past several years. Table C shows 3rd Quarter EIA sales (i.e., premium volume) by commission rate.

Table C
Commission Rates and Market Shares

Commission Rate	5%-6%	7%-8%	9%-10%	11% or more
Market Share	13%	20%	63%	4%

Source: LIMRA

Issues Surrounding Equity-Indexed Annuities—Assertions and Analysis

Proponents of equity-indexed annuities claim that these financial products enjoy a number of advantages over other savings and accumulation vehicles. Advocates often contrast EIA characteristics with certificates of deposit (CDs) and mutual funds.

Some criticisms leveled against EIAs and individuals marketing these products come from individuals within the insurance industry, while others come from consumerists, regulators and individuals from other sectors of the broader financial services industry. Some of the criticisms leveled against EIAs are really criticisms of a broader category of financial products of which EIAs are merely a part.

Protection/Return of Principal

Compared to equities (including mutual funds), EIA proponents correctly claim that principal (i.e., premiums) and credited interest are protected against downside market risk inherent in the equities that comprise the tied index. And despite the presence of surrender charges, EIA owners are, at least, always entitled to the contract's guaranteed cash (surrender) value, as required by state law.

However, this does not mean that an EIA owner cannot lose money with an EIA, or is always entitled to a full return of principal. "Protection against downside market risk" is not the same as a "full guarantee (or return) of principal," for two reasons. The main reason is that, in order to benefit from the EIA's principal guarantee, the policy must stay in force at least until the end of the contract's surrender-charge period. Although the principal guarantee starts at contract issue, surrender of an EIA during the surrender-charge period will create a financial loss (i.e., a partial loss of principal) if the surrender charge exceeds index-linked interest and premium bonuses previously credited to the policy's accumulation value (assuming no upward MVA adjustment).

This result isn't unique to equity-indexed annuities. Other annuity products, including traditional fixed-rate and variable annuity contracts, generally also impose surrender charges during an initial period, and their imposition might also create a partial loss of principal to purchasers in an early-surrender scenario.

Upside Potential

Proponents correctly claim that, in contrast to products whose returns are derived from prevailing interest rates, EIAs have the potential to generate higher returns in a rising stock market. Furthermore, Annual Reset EIAs even have "upside potential" in a "choppy" or volatile equities market that spans multiple policy years because each beginning-of-year index value is reset to the ending-index-value of the preceding year. For example, if the tied index declines 10 percent in one year and rises eight percent in the following year, at the end of two years the Annual Reset EIA will have a total gain of 8 percent (0 percent in year 1 and 8 percent in year 2), whereas an investment made two years ago directly in a "tied index" fund would still be "under water."

However, the "upside potential" in EIAs is not as great as that of the typical variable annuity or mutual fund. This stems from the EIA's exclusion of dividends and the "haircut" that occurs from action of the participation rate, yield spread, or rate cap.

High Sales Commissions

The size of agent commissions paid on cash value life insurance and annuity products, in general, have been the subject of much debate and criticism for many years. On an industrywide basis, commissions paid to selling agents on EIA products possibly are higher than agent commissions paid on the sale of other annuity products, but this observation might not be an "apples to apples" comparison. Higher commissions could result from the distribution channels used. Independent agents [personal-producing general agents (PPGAs), life brokers, and other independent producers] sell more than 90 percent of EIAs. First-year commissions on the sale of life insurance and annuity products through the PPGA channel have traditionally been higher than, for example, commissions paid to the selling agent under the "career agency" system. Several reasons underlie this differential in first-year commissions, including:

- The PPGA system has no separate "override" commission that typically is payable to a "general agent" or branch manager under the career agency system.
- The PPGA system has little or no recruiting/training costs and office expense support, which may be substantial in the career agency system. The career agency system has significant "agency building" and ongoing "agency support" costs that either do not exist, or exist at much smaller levels, under the independent agent distribution channel.
- Many insurers using the career agency system are licensed in the New York which restricts the size of first-year commissions (and other distribution costs).

However, it may be that PPGA commissions for selling EIAs, in fact, are greater than PPGA commissions for selling other annuity products. The data examined in the report do not definitively demonstrate that this is true, but they suggest this possibility. Moreover, even if average commissions on EIA products are higher, this does not necessarily mean that commissions paid on every EIA product are higher than commissions paid on all variable and traditional fixed-rate annuity products. In fact, this is unlikely to be the case.

Furthermore, arguably, the most important aspect of agent commissions is not their size, but rather their disclosure to prospective purchasers. Consumers should know if there is a potential "conflict of interest" where an agent's recommendation might be based, at least partly, on the size of the commission paid on the purchase of a recommended product. Currently, no state or federal law requires the disclosure of agent commissions on the sale of annuity (or life insurance) contracts.

The conflict of interest issue isn't confined to annuity purchases. Prospective buyers of these contracts and/or competing non-annuity investments are encouraged to ask their sales representatives about commissions payable (and other forms of compensation), especially in those situations where the purchaser is deciding between two or more competing products that might pay different levels of agent compensation. However, absent a "conflict of interest" issue, consumers and others are cautioned against focusing too much attention on the size of the sales commission as they might lose sight of one of the most important attributes of any annuity or similar instrument—that is, its anticipated financial performance. EIAs that might offer the best financial performance may or may not be the products that pay the lowest commissions. Besides, many factors, in addition to agent commissions, underlie the cost structure of any specific equity-indexed annuity product.

Product Suitability

The suitability of an annuity for a buyer is an issue that should apply equally to all forms of annuities and competing investments as well as to buyers of all ages. However, recent regulatory and media attention has been directed specifically to examples of alleged unsuitability of EIAs bought by older customers. The actual extent of such practices is unclear.

The Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD) have guidelines for the suitability of variable annuity sales as part of their overall regulation of these investment products, but these guidelines do not apply to fixed annuity products, including EIAs (except registered EIAs), since they are regulated by the states. To encourage uniformity among the states and to address suitability criticisms, in 2003 the National Association of Insurance Commissioners (NAIC) adopted the Senior Protection in Annuity Transactions Model Regulation. The model defines seniors as individuals aged 65 and over. Several (though not all) states have enacted suitability legislation patterned after this model regulation.

At a minimum, every annuity product suitability assessment should ask:

1. Does the purchaser fully understand the major product characteristics?
2. Does the buyer have sufficient liquidity so that it is highly unlikely that the annuity will have to be surrendered for its cash value during the surrender-charge period?
3. Are the product's characteristics consistent with the buyer's risk tolerance and return objectives?

Product Understanding

Many financial products have complex elements that may pose obstacles to consumers' ability to fully understand the features and nature of these products. Annuities in general, and EIAs in particular, are no exception. Research shows that deferred annuities have features that consumers often misunderstand. "Comparison shopping"—whether by prospective buyers or by their advisors—is made more difficult by the proliferation of differing index-linked interest-crediting structures, varying levels of minimum guarantees, and differing surrender-charge penalties.

For all deferred fixed annuity products (including EIAs), at a minimum, prospective buyers should understand:

- Minimum guarantees as to principal, interest and annuitization.
- When surrender charges will be assessed.
- Whether, and under what circumstances, a market value adjustment (MVA) will be applied to the contract's accumulation value.
- Riders (e.g., Long-Term Care) attached to the contract and the conditions under which benefits are payable under these riders.

In addition, EIA buyers should also understand:

- What tied index is used, and that index-linked interest crediting rates do not include any dividends paid on the underlying stocks contained in the index.
- The specific indexing method used to measure change in the tied index.
- The contract's participation rate, interest rate cap, and/or yield spread, and the extent of any guarantees that apply to these features.

Liquidity

It is difficult for many people to forecast their financial needs accurately for more than five to seven years in the future. Yet some EIA products impose surrender charges that start out as high as 15 to 20 percent and gradually decline over a surrender-charge period that is rarely less than seven years. Moreover, surrender during this period might also trigger forfeiture of premium bonuses and interest credits. To provide some liquidity and avoid the effects of early surrender, many EIAs provide for "free withdrawals" (up to an overall maximum) and these contracts also typically contain loan provisions that allow owners additional penalty-free access to accumulation values. Nonetheless, because of the significant penalties that might be imposed at an early surrender of an EIA contract, EIAs should not be bought as a short-term savings or accumulation vehicle.

Marketed as an "Investment"

Some EIA detractors claim that EIAs are marketed as an equity investment and, as such, should be regulated in the same way as other investments that entail stock market risk. Any evidence to support this claim appears to be anecdotal in nature, with no published formal research into this issue having yet appeared.

When EIAs are bought with a single premium, the funds frequently come from the liquidation of CDs, mutual funds, or individual stocks and bonds. One senses that the criticism (the marketing of EIAs as an equity investment) comes mainly from those marketing or regulating competing equity investments. Although it is beyond the scope of the paper to consider the effectiveness of disclosure requirements for equity investors today, it seems reasonable to suggest that investors in individual stocks, bonds, and mutual funds might not always understand the risks, expense and transaction charges, and tax implications of those investments as well as they ought to, and that any changes to improve the decision-making of prospective EIA purchasers should apply to competing financial products as well. It is hoped that whatever regulatory process emerges will be one that puts the interests of consumers above the interests of broker-dealers, sales representatives, insurers, and the regulatory agencies themselves. The most important issue is not "who regulates" EIAs but, rather, that the regulatory process ensure that EIA purchasers be provided with appropriate, clear and accurate information about these products and that the regulation not be unduly burdensome.

Specific Recommendations

Recommendations for Insurers/Insurance Industry

1) ***Eliminate, where possible, the word "equity" in all future references to "indexed annuities."*** Call them Indexed Annuities (IAs).

2) ***Ensure that all IA product-performance claims and related statements in marketing brochures, sales literature, and sales presentations are accurate, complete, and not misleading.*** Avoid statements such as "no downside risk," "principal is guaranteed," or "guaranteed minimum return of 'x' percent." Materials should clearly identify the circumstances under which surrender charges are applied and, in these instances, how it is possible that the purchaser will receive some amount less than the full principal. Guarantees expressed as " 'x' percent on 'y' percent of the premium" are likely to confuse prospective IA buyers. Instead, guaranteed minimum values should be stated in dollar terms or expressed as multiples of the paid premium at selected policy anniversary dates throughout the potential life of the contract. Also, to improve understanding of minimum values, both sales illustrations and contract wording could show those values on various policy anniversaries under two separate scenarios—(1) assuming cash surrender, and (2) assuming no cash surrender.

3) ***Reassess the rationale underlying excessively long surrender-charge periods.*** "Excessively long" can be defined differently by different individuals, so the report does not suggest a maximum number of years for surrender-charge periods. Macroeconomic forces alter the financial landscape over time, individual economic circumstances change, and new and possibly more attractive products appear on a fairly regular basis. Any of these developments could easily create a logical rationale for surrendering an IA or other financial product if not for the presence of surrender charges.

4) ***Simplify the index annuity marketplace.*** The IA marketplace needs movement toward standardization in IA product design. This recommendation isn't meant to stifle development and innovation; its objective is to reduce misunderstanding that currently exists in the IA marketplace.

5) ***Consider increasing the portion of total agent compensation that comes from trail compensation.*** This recommendation, made in the context of indexed annuities, applies equally to other annuity and life insurance products. Not only might this soften some of the criticism that first-year commissions on IAs are too high, but it could provide other benefits as well. Higher trail compensation could offer agents a financial incentive to maintain ongoing client contact and to be alert to service needs of the client, which may lead to greater persistency and profitability to insurers on their IA product portfolios.

Recommendations for Regulators

Regulation of index annuities is not a primary focus of the paper; the recommendations for regulators relate specifically to issues addressed in the paper.

1) ***Examine further the issues relating to market conduct in the preceding section.*** For example, in June 2005 New Jersey capped the length of the surrender-charge period in tax-deferred annuities, including index annuities. And, absent significant simplification in the marketplace, states might require agents selling indexed annuity (or indexed life insurance) products to meet additional licensing requirements. Alternatively, an independent (non-regulatory) organization could offer a credentialing program to attest to an agent having sufficient knowledge about indexed annuities and the IA marketplace. Without such additional

licensing or credentialing, how will prospective IA buyers know who is knowledgeable and who is not?

2) ***Develop a new NAIC Buyer's Guide to Index Annuities.*** The current National Association of Insurance Commissioners' (NAIC) Buyer's Guide to Equity-Indexed Annuities should be revised to better reflect current market conditions.

Recommendations for Prospective Index Annuity (IA) Purchasers/Consumers

1) ***Identify, and rely on, a knowledgeable and trustworthy advisor.***

2) ***Consider only IA products issued by highly rated insurers.***

3) ***Follow a step-by-step process in making and implementing a buying decision.*** Buyers should use a decision-making process that focuses on important IA product features and other critical decisions. The process described in the report assumes that the person planning to buy an Index Annuity has already determined that such a purchase belongs in his or her long-term financial plans, and that the only issue remaining is deciding which IA features to buy, and from which annuity company.