Annuities for Income – Overview

# What is it?

An annuity is a systematic liquidation of principal and interest over a given period of time. A commercial annuity is a product offered by an insurance company. For a purchase price or premium, an insurer agrees to pay a stream of payments (an annuity) to an annuitant for a term of years or for life. There may be other guarantees, such as to refund unrecovered premiums if the annuitant dies before premiums have been recovered through annuity or other payments. Such guarantees generally reduce the amount of the regular annuity payment.

Regular annuities generally provide payments based on the crediting of a fixed guaranteed interest rate. Variable annuities can be invested in various investment accounts that may produce higher returns, but the annuity holder bears much of the risk that the value of the investment account may go up or down.

Annuities generally provide tax deferral until annuity payments or other amounts are received from the annuity. However, the amount includable in income is treated as ordinary income for income tax purposes.

# When is the Use of this Tool Indicated?

1. When the retiree would like to provide for a fixed stream of retirement income that the retiree (or perhaps, the retiree and the retiree’s spouse) will not outlive.

2. When the retiree would like to provide for a fixed stream of retirement income that can be used to relieve the stress on providing income from other assets.

3. When the retiree would like to have an investment that provides for payments that include the systematic liquidation of principal.

4. When the retiree would like to transfer some investment and risk management to another (the insurance company).

5. When a tax-deferred accumulation of interest is desired.

# Advantages

1. An annuity can provide an income stream that is guaranteed for life.

2. An annuity can provide for income tax deferral.

3. A regular annuity can moderate investment risk. If the retiree is interested in higher returns and finds the risk acceptable, variable annuities should be considered.

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# Disadvantages

1. A fixed income annuity may not keep pace with inflation.

2. If the annuity must be liquidated in the early years, expenses are likely to be substantial.

3. The amount includable in income is ordinary income for income tax purposes.

4. With a variable annuity, much of the investment risk is assumed by the annuitant.

# What are the Tax Implications?

1. The part of an annuity distribution that is includable in income is treated as ordinary income (even if, e.g., the underlying investment might have qualified as capital gain property.)

2. A distribution from an annuity that is received as part of an annuity is generally treated as partly excludable from income as basis (or return of investment) and partly includable in income as earnings, on a prorated basis.

3. A distribution from an annuity that is received as other than a part of an annuity is generally treated first as earnings (which are taxable), and then as basis or return of investment (which is excludable from income). However, investment in a contract before August 14, 1982 can generally be recovered first.

4. An annuity can be exchanged for another annuity in a Section 1035 tax-free exchange.

5. A loss can be claimed if investment in the contract has not been fully recovered when annuity payments end.

# Annuities for Income

Searching For Certainty in an Uncertain World

It is *The Age of Annuities*! The baby boomers again have created a wave of change. As the baby boomers search for a palatable way to secure their retirement income, and the insurance industry tries to accommodate, annuities are adapting at warp speed. No matter what a person’s mind-set regarding annuities may have been in the past, it is time to rethink their application as a way to solve the long-term income needs of the boomers. Understanding the basics of annuities is the first step in building a framework of understanding so that the rapid fire development of risk management features within annuity contracts can be appropriately applied to meet individual client needs.

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Typically, annuities are thought of as payoutannuities because, very often, they are used in payout mode and have the ability to pay out a systematic monthly income as retirement income to an annuitant. In fact, even the dictionary definition tends to define the payout phase of an annuity as “an amount payable yearly or at other regular intervals for a certain or uncertain period.” It defines the annuitant as one who receives benefits or payments from an annuity, or who is entitled to receive such benefits. Employers frequently pay pension and retirement benefits as an annuity. They offer the retiree varying monthly incomes depending upon the guarantees made as to what will happen to the payment should the annuitant die.

The other side of annuities, however, is their ability to act as vehicles to accumulate capital for future use, without current income taxation on interest, dividends, or capital gains earned within the annuity contract. Deferred annuities have become increasingly popular, not only to accumulate capital, but also to distribute retirement income without annuitization, using the various guarantee features to give annuitants confidence that they will not run out of income during their lifetimes.

An annuity contract is not a particular investment in and of itself. The annuity contract is, so to speak, a wrapper around investments. The owner of an annuity contract may wrap it around many types of investments ranging from very conservative investments, such as insurance company guaranteed-principal, guaranteed-interest accounts, to relatively aggressive investments within variable annuities, such as aggressive stock accounts, high-yield bond accounts, or anywhere in between. Variable annuities contain families of subaccounts, also called variable investment options (VIO), and these subaccounts are similar to mutual funds. How the contract owner allocates money between the various investment options available within the contract (general and separate account) will determine whether the annuity contract is conservatively or aggressively invested. An annuity contract is not inherently risky or safe, aggressive or conservative; contract owners have the ability to tailor it to what they want. The primary functions of annuity contracts, then, are to assist contract owners in accumulating investment capital in a tax-deferred contract, and to dole out accumulations of capital over a specific period, an individual’s lifetime, or more than one individual’s lifetime.

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What Is An Annuity?

The dictionary defines *annuity* as:

* The annual payment of an allowance or income
* The right to receive this payment or the obligation to make this payment
* An investment on which a person receives fixed payments for a lifetime or a specified number of years.[[1]](#endnote-1)
* A contract or agreement under which one or more persons receive annuities in return for prior set payments made by themselves or another (as an employer).[[2]](#endnote-2)

Why People Use Annuity Contracts

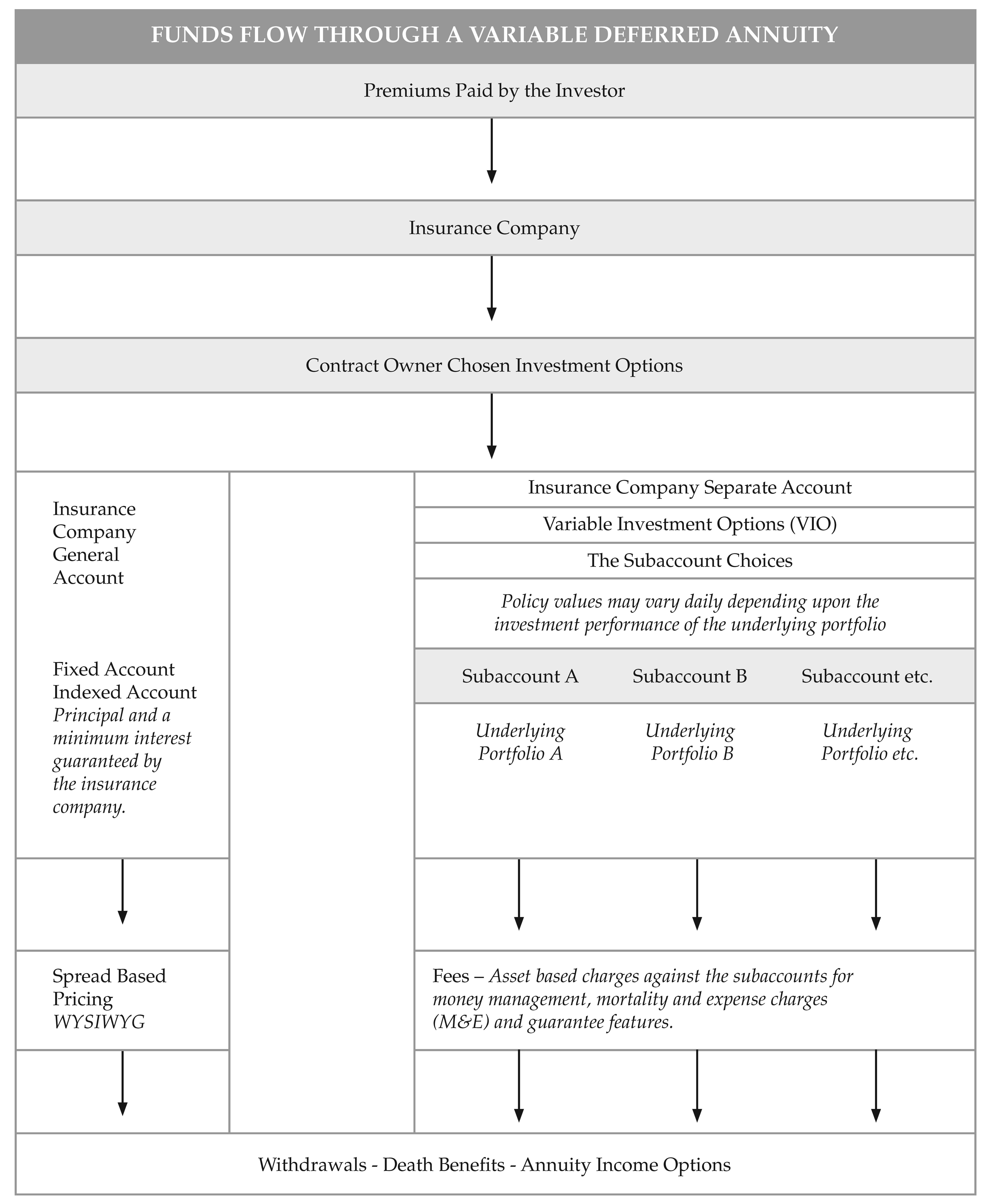
It is all about risk management. Individuals and institutions can tolerate having their capital exposed to only so much risk. After that point, they will seek a way to transfer some risks to others who are willing to accept those risks for a fee (or alternatively, will simply avoid any further risk exposure). The annuity contract offers different degrees of risk relief for people with varying levels of risk tolerance, applied to the money that is very important to their family’s financial security.

Focus On Annuities To Generate Income

The focus here is on annuities as a financial tool, manufactured by commercial insurance companies, and about the techniques that can be used to have them generate income for contract owners. It is not about all annuities. It will not deal with the basics of annuity contracts which have been covered so well in John Olsen and Michael Kitces’ excellent book on annuities, *The Annuity Advisor*, published by The National Underwriter Company. It will address the various techniques of turning the capital within an annuity contract into an income stream for those needing income to pay bills.

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**Figure 8.1**

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Immediate and Deferred Annuities

The dictionary definitions of annuity focus on how money is paid out of an annuity contract and that will be the focus here, as a tool for retirement income, rather than the deferred annuity used to accumulate funds for retirement. Annuities that provide current payments to an annuitant may be called payout annuities, income annuities, immediate annuities, or single premium immediate annuities (SPIA).

Deferred annuities are annuity contracts holding and investing capital for eventual distribution. Anyone who owns a deferred annuity is concerned about what is going on with the capital within the contract while awaiting the contract owner’s choice of distribution method that will be made some time in the future.

What Does An Annuity Do?

Annuity contracts offer an investment alternative for consumers seeking to accumulate funds for retirement and to manage distribution of funds during retirement. Annuities are competition for two kinds of capital. They compete for investment funds that would otherwise be invested in taxable investments, and for the capital invested in the various types of tax-deferred retirement plans.

Taxable capital, whose earnings are subject to income taxes each year as it accumulates, may be placed inside of non-qualified annuities and enjoy the advantage of not having to pay taxes on the investment earnings until withdrawal. There are fixed, deferred annuities, guaranteeing principal and some level of interest earnings, competing for money that otherwise would be invested in instruments like savings accounts or certificates of deposit. There also are variable annuities that compete for money that might otherwise be invested in stocks, bonds, or taxable mutual funds.

The other equally important reason people put money inside of annuity contracts is to obtain the various types of insurance – risk protection – that are contained in the contractual provisions and features provided by the contract.

The National Association of Securities Dealers, Inc. (NASD) Notice to Members 99-35 of May 1999, which reminds NASD members of their responsibilities regarding the sale of variable annuities, describes variable annuities in the following fashion.

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“Although variable annuities offer investment features similar in many respects to mutual funds, a typical variable annuity offers three basic features not commonly found in mutual funds:

* tax-deferred treatment of earnings;
* a death benefit; and
* annuity payout options that can provide guaranteed income for life.”[[3]](#endnote-3)

This NASD notice also reminds member firms that, when a registered representative recommends the purchase of an annuity for any tax-qualified retirement account (e.g., 401(k) plan, IRA), the registered representative should disclose to the customer that the tax-deferred accrual is provided by the tax-qualified retirement plan and that the tax-deferred accrual feature of the annuity is unnecessary and redundant. Registered representatives should recommend annuities for qualified money only when there are benefits other than income tax deferral that support the recommendation and when the fees for such benefits are disclosed and acceptable. These benefits may be such things as lifetime income payments, protections provided by death benefits, guaranteed minimum withdrawal benefits (GMWB), guaranteed minimum withdrawal benefit for life (GWBL), guaranteed minimum income benefits (GMIB), and guaranteed minimum accumulation benefits (GMAB).

Qualified And Non-Qualified Annuities

Non-qualified annuities are annuity contracts into which investors put their after-tax funds that otherwise would reside in a taxable environment. For that reason, they are also referred to as after-tax annuities.

Non-qualified or after-tax annuities will provide:

* Tax-deferred treatment of earnings
* Death benefits
* Other contractual features that can provide peace of mind in dealing with an uncertain future, and
* Annuity payout options that can provide guaranteed income for life or a specified period of time

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On the other hand, qualified annuities – those purchased with funds that are already qualified (i.e., funds in retirement accounts) – provide value with only the following features:

* Death benefits
* Other contractual features that can provide peace of mind in dealing with an uncertain future, and
* Annuity payout options that can provide guaranteed income for life or a specified period of time

This distinction of what qualified and non-qualified annuities provide is important because some consumers have been led to believe that the annuity wrapper is necessary for the qualified money to maintain its tax-deferred nature, which, of course, is not true. Qualified money, by definition, is tax-deferred in its own right. Many people also have been under the impression that insurance companies charge for the tax-deferral feature, which would mean that qualified money would be exposed to an unnecessary fee. This also is not the case. The tax deferred nature of annuities is as a result of the nature of the contract and Internal Revenue Code Section 72, Annuities; Certain Proceeds of Endowment and Life Insurance Contracts, which defines when and how income from annuity investments will be taxed. Section 72 provides that taxation is generally an issue only when money comes out of an annuity contract. The tax deferral benefit for investments while held inside of the contract is a part of the generic nature of annuities, and not something for which insurance companies can (or do) charge.

Primary Objective Of An Annuity Contract

The primary objective of the annuity insurance contract is to pay financial benefits *to the annuitant*, as opposed to the life insurance contract which is to pay death benefits *to beneficiaries*. Under current law, the next generation beneficiaries of annuity contracts have to pay taxes on the gain in the contract. Therefore, annuities generally are not an income-tax-efficient way to pass assets on to the next generation, whereas life insurance, which generally passes to the next generation without income tax liabilities, is much more tax-efficient for this purpose.

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The distinctions between the annuity contract and the life insurance contract are:

* The annuity contract has no significant mortality charges (but could vary with certain guarantees).
* Annuities have no net amount at risk (pure insurance), whereas life insurance does have a net amount at risk and the associated charges for the insurance element.
* The annuity contract is not efficient in paying benefits to non-spousal beneficiaries at the annuitant’s death.

Annuities can be passed to a non-spousal beneficiary but any income tax liabilities in the contract go with it, and become income tax liabilities for the beneficiary of the contract. The deferred annuity contract is used to accumulate money to be used at some future date by the contract owner before the annuitant’s death. It is most efficiently used for the accumulation of money that will be used as retirement income for the purchaser. Annuitization is the safest (and, in many cases, the most cost effective) way (particularly, with respect to relatively smaller amounts of capital) for a specific sum of money to provide systematic payments, over a specified period, or over the duration of a single life, or over the lives of two people.

An annuity contract is not an investment. It is an insurance contract around investments. The owner of an annuity contract may wrap the annuity insurance contract around many different types of investments. The wrapper says, among other things, that this investment is now tax-deferred, and must not be invaded without income taxes to the extent of gain. In addition, an IRS imposed 10 percent penalty will apply to the extent of gains distributed prior to age 59½; this age-based restriction is effectively a trade-off for the tax-deferred benefit of the non-qualified annuity.

Generally speaking, there are two basic investment media that annuities are wrapped around in order to impart the annuity insurance features to the investment.

* A fixed annuity – An annuity wrapped around an interest bearing account, and
* A variable annuity – An annuity wrapped around variable investment options or subaccounts similar to mutual funds.

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Agent/Registered Representative /Advisor Qualifications to Sell

Annuities are insurance products and, therefore, the sale of these products comes under the jurisdiction of the various state insurance departments. Each state has its own set of rules, regulations, and licensing requirements designed to protect its citizens. Anyone selling annuities must be licensed and must maintain the qualifications required by each of the states in which they do business. Some states require a representative to be licensed even if they are only advising on the product. The objective of state licensing is to ensure that only people of good character, and who are knowledgeable about the products they sell, are licensed to do business in the state. Generally speaking, before an individual can qualify to go through the licensing process with the state, the individual must have a written statement, known as an appointment, from an officer of a licensed insurance company indicating that the insurer names the applicant as an agent to sell a particular line or lines of insurance for the insurance company. The state will do its background checks once all of the paper work has been submitted and, if everything is in order, the applicant will be instructed when and where to appear for the written examination. Upon passing that exam, the individual is qualified and approved to sell fixed and most indexed annuities in that state.

In order to sell variable annuities, the licensed insurance agent also must be a registered representative, a person who engages in the securities business on behalf of a broker-dealer who has registered with the National Association of Securities Dealers (NASD), and who has submitted the required background information and passed NASD examinations. The broker-dealer is responsible for the person’s registration process and also responsible for the continued supervision of that individual for compliance with Securities and Exchange Commission (SEC) and NASD rules and regulations. People who sell registered products, such as variable annuities, also are accountable to the various state securities departments. The individual may take either the Series 6 or the Series 7 examination for the NASD. The latter is preferable in that it is more extensive and qualifies the individual to sell stocks and bonds, as well as mutual funds and variable annuities. The Series 6 examination limits a registered representative to the sale of mutual funds, unit investment trusts, and variable annuities.

In many cases, the investment community has relabeled sales people of financial products as advisors. The consumer expects one thing from sales people and another thing from an advisor. Sales people are expected to have an allegiance to their company and its products, but an advisor is expected to have an allegiance to the consumer. The regulators are in favor of allegiance to the consumer, as are the companies who recognize that satisfied consumers are their most profitable product but,

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for the salesperson who now has been labeled an advisor, there is a new level of responsibility. An advisor is one who gives advice, who informs, who gives opinions and who offers counsel. This requires a broader base of knowledge in order to be able to give competent counsel ethically, for to give counsel without competency is unethical.

One of the first things to understand about annuities is how daunting the problem is that they are intended to solve, not just now, but throughout history.

The Early History Of Annuities

We tend to think that the annuity is a rather modern tax-driven financial tool; however, annuities were in use long before IRC Section 72. The need for annuities was not tax-driven. It was driven by the need for security in an uncertain world. It was, and is, driven by the need for the insurance features – the guarantees – provided within the annuity contract.

There is evidence of annuities as early as 2500 BC in Babylon. The Roman Empire issued “Annual,” payments made once a year over the person’s lifetime. In the middle ages in Europe, individuals would pay a lump sum of money to a hospital or church in exchange for lifetime payments in order to secure their futures.

In France in 1653, there was a system of annuities in which the benefits would pass to the surviving subscribers until only one person was left. This was developed by Lorenzo Tonti, a Neapolitan banker, and called a *tontine.* Each subscriber to the tontine paid a sum into the fund and, in return, received dividends from the capital invested. As each person died, the deceased’s portion of the income was divided among all of the survivors until only one person was left who reaped all of the benefits. Originally, the capital reverted to the state when the last subscriber died. The idea was taken up enthusiastically in France and later in Britain and the USA, where it was used to fund buildings and other public works. Later, there were private schemes in which the last survivor got the capital as well. These eventually were banned because there was too much incentive for subscribers to eliminate each other to increase their share of the fund.

In the United States, the concern for life income involved not only tontines but also the National Pension Program for Soldiers that was signed in 1776. By 1894, 37 percent of the federal budget was going for military pensions.

One of the first people in this country to propose a scheme for retirement security was the Revolutionary War figure, Thomas Paine. His last great pamphlet, published in the winter of 1795, was a controversial call for the establishment of a public system of

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economic security for the new nation. It was entitled *Agrarian Justice* and it called for the creation of a system whereby those inheriting property would pay a 10 percent inheritance tax to create a special fund. Out of this fund, a one-time stipend of fifteen pounds sterling would be paid to each citizen upon attaining age twenty-one, to give them a start in life, and annual benefits of ten pounds sterling to be paid to every person age fifty and older, to guard against poverty in old age.

Following the Civil War, there were hundreds of thousands of widows and orphans, and hundreds of thousands of disabled veterans. Immediately following the Civil War, a much higher proportion of the population was disabled or were survivors of deceased breadwinners than at any other time in America's history. This led to the development of a generous pension program, with interesting similarities to later developments in Social Security. It was with the creation of Civil War pensions that a full-fledged pension system developed in America for the first time.

The Civil War Pension program began shortly after the start of the war, with the first legislation in 1862 providing for benefits linked to disabilities “incurred as a direct consequence of … military duty.” Widows and orphans could receive pensions equal in amount to that which would have been payable to the deceased soldier, if he had been disabled. In 1890, the link with service-connected disability was broken, and any disabled Civil War veteran qualified for benefits. In 1906, old-age was made a sufficient qualification for benefits. So that by 1910, Civil War veterans, and their survivors, enjoyed a program of disability, survivors, and old-age benefits similar, in some ways, to the later Social Security programs. By 1910, over 90 percent of the remaining Civil War veterans were receiving benefits under this program. Civil War pensions were also an asset that attracted young wives to elderly veterans whose pensions they would inherit as the widow of a war veteran. Indeed, there were still surviving widows of Civil War veterans receiving Civil War pensions as late as 1999!

In the aggregate, military pensions were an important source of economic security in the early years of the nation. In 1893, for example, the $165 million spent on military pensions was the largest single expenditure ever made by the federal government. In 1894, military pensions accounted for 37 percent of the entire federal budget.[[4]](#endnote-4)

In 1875, American Express established the first private pension plan for its employees.

In 1889, the seventy-four year old German Chancellor, Otto Von Bismarck, instituted the concept of Social Security in Germany. A social insurance program was provided for retirees at age seventy that was funded by the employer, employees, and the government. The retirement age was dropped to age sixty-five in 1916.

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In April 1905, in the United States, Andrew Carnegie benefited two of his favorite causes, higher education and pensions, by giving ten million dollars to set up the Teachers Pension Fund for professors, which eventually became the Teachers Insurance and Annuity Association, commonly referred to as TIAA. Originally, no contributions were required from either employers or employees. However, in the years following World War II, the economy was suffering from rising inflation, which was decreasing the purchasing power of the dollar, as well as that of the TIAA Traditional Annuity, which is based on fixed-income investments. The College Retirement Equities Fund (CREF) evolved from a comprehensive economic study conducted by TIAA to determine how a combined fixed-income and variable annuity program would have worked in the past.[[5]](#endnote-5)

The study covered the years 1880 through 1950, and analyzed different periods of fund accumulation and benefit payment within those seventy years to determine the hypothetical annuity amounts that would have resulted. It examined common stock and fixed-income investment experience in comparison with the course of consumer prices, covering periods of depression, prosperity, war, peace, inflation and deflation, short and long working lifetimes, and short and long periods of retirement. Over time spans long enough to encompass both a normal working career and retirement years, the historical data consistently showed that an individual would have fared better from participation in a diversified annuity program than in a fixed-income annuity alone. Thus, in 1952, CREF was created to provide a variable annuity fund (CREF Stock Account) to complement TIAA.

Since then, the Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF) has introduced a number of additional investment accounts. The TIAA-CREF variable accounts complement the TIAA traditional component of the TIAA-CREF retirement system, broadening the range of investment choices available to participants and paving the way for possible additional funds in the future. The objective of the combined TIAA and CREF retirement system is to provide a pension income that is more responsive to economic change than one based solely on TIAA’s traditional annuity and more stable than a variable pension benefit based solely on the experience of any of the TIAA-CREF variable annuity accounts.

The Social Security Act was enacted in 1935. The first payment was made to Ida May Fuller in 1940 and was paid for thirty-five years. Ida May died in 1975, at age one hundred, after having paid $22.54 into the Social Security System and having received $22,888.92 in benefits.

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Why Annuities? – Why Now?

The history of annuities demonstrates that annuities are not about taxes or tax deferral; they are about a universal concern of running out of money before running out of breath. Annuities have been, and are, about retirement security. The need for retirement security and the many threats to retirement security have continued to grow as people continue to live longer and longer. As one financial advisor, Deena Katz, has been known to say, “The good news is that we are living longer, and the bad news is that we are living longer.”

Ken Dychtwald put it this way:

We have completed a century of incredible improvements in health care, which has dramatically elevated our life expectancy. While we have managed to increase our life spans by almost 30 years since 1900, we haven't yet focused properly on our health spans. We are now on the brink of mind-boggling breakthroughs in the areas of pharmacology, nutraceuticals, hormone therapeutics, organ cloning, miniaturization of biotechnology, stem cell research and the world of gene therapy that will have a radical impact on how we live.[[6]](#endnote-6)

In this new age of biology, experts say the most profound effect ultimately may be a stunning ability to slow the aging process, perhaps allowing the healthiest and strongest to one day live one hundred twenty-five years or more.

A leading Duke University demographer, James Vaupel, projects that half of the girls and one third of the boys born currently in developed countries will live more than a century. What's more, “many people alive now will live through the next century and on to the next one,” said Dr. Roy Walford, a researcher on aging at the UCLA School of Medicine.

# Financial Strength of the Insurance Company

The financial strength of the insurance company from whom a consumer buys an annuity is very important. If an annuitant is going to succeed financially, the insurance company from whom the annuity has been purchased must also succeed. Consumers and advisors will demand quality and will deal with large, well-known names in the insurance industry that have kept promises to policyowners over a significant number of years. The purchaser of an annuity may obtain information regarding insurance companies from the various rating services such as those in Figure 8.3:

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|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| INSURANCE COMPANY RATINGS | | | | | |
| Rating  Categories1 | A.M. Best2 | S&P3 | Moody’s4 | Weiss5 | Fitch6 |
| Superior | A++ | AAA | Aaa |  | AAA |
|  | A+ |  |  |  |  |
| Excellent | A | AA7 | Aa8 | A7 | AA7 |
|  | A- |  |  |  | A7 |
| Good | B++ | A7 | A8 | B7 | BBB7 |
|  | B+ |  |  |  |  |
| Fair | B | BBB7 | Baa8 | C7 | BB7 |
| (Adequate) | B- |  |  |  |  |
| Marginal | C++ | BB7 | Ba8 | D7 |  |
|  | C+ |  |  |  |  |
| Weak | C | B7 | B8 | E7 | B7 |
|  | C- |  |  |  |  |
| Poor | D | CCC | Caa8 |  | CCC7 |
| (Below |  | CC | Ca |  | CC, C |
| Standards) |  |  | C |  | DDD9 |
|  | E9, F10 | R9 |  | F | DD9, D9 |
| 1The comparative distribution of rating categories is approximate. Therefore, the ratings definitions of each agency should be consulted. The basic mission of all of these independent agencies is to assess an insurer’s financial strength in terms of its ability to meet policyholder and other contractual obligations, and to communicate those findings to the financial and investment communities. Due diligence requires not just a determination of the assigned rating, but an understanding of how each rating agency determines its published ratings.  2A.M. Best Company publishes Best’s Ratings of Life and Health Companies (has rated insurers since 1899).  3Standard & Poor’s (S&P) publishes Insurer Claims-Paying Ability Ratings (has rated debt issues for over 50 years and insurers for approximately 20 years).  4Moody’s Investor’s Service publishes Life Insurance Credit Report, which includes the *Life Insurance Handbook* (has rated bond issues since 1904 and insurers since the 1970s).  5Weiss Research, Inc. publishes Insurance Company Safety Ratings (has rated insurers since 1989).  6Fitch, Inc. publishes Insurer Financial Strength (Fitch was formed by the merger of Fitch IBCA and Duff & Phelps; Duff & Phelps had rated insurers since 1986). Ratings below AAA and above CC may be appended with a “+”or “–” to indicate relative position within the rating category.  7Includes three levels of ratings (i.e., AA-, AA, AA+; A-, A, A+; BBB-, BBB, BBB+; BB-, BB, BB+; B-, B, B+; CCC-, CCC, CCC+; D-, D, D+; E-, E, E+).  8Includes three levels of ratings (i.e., Aa1, Aa2, Aa3; A1, A2, A3; Baa1, Baa2, Baa3; Ba1, Ba2, Ba3; B1, B2, B3; Caa1, Caa2, Caa3).  9Under regulatory supervision.  10In liquidation. | | | | | |
| *Source:* Cady, *2007 Field Guide to Estate Planning, Business Planning, & Employee Benefits*, page 575 (Cincinnati, OH: The National Underwriter Company, 2007). | | | | | |

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Most insurance companies will report their ratings on their website; the relative level of their rating can be determined by consulting Figure 8.3.

It is particularly important for the purchaser of an annuity to choose a company that will last as long as the annuitant will, which is assumed by actuaries to be longer than the general population. Therefore, advisors should seek nothing less than investment grade companies, preferably with improving ratings. Inordinately high interest rates and “bonuses” should be viewed with suspicion. One need only recall the collapse of companies such as Baldwin United and Executive Life and the strains placed on those owning policies in those companies.

The primary risk is in the general account of the insurance company because that account is subject to the claims of the creditors of the insurance company. The separate account, which is the structure used for the subaccount investments of variable annuities, is not subject to those creditor claims. That creditor protection is a good argument for variable annuities, which give the annuitant the choice of using the general account or the separate account.

Conclusion

As quickly as insurance companies come up with features that either enhance the potential for increased return or reduce the exposure to loss, intermediaries find ways to use them to help clients satisfy current income needs while seeking to retain growth potential to meet future inflation-adjusted income needs. Insurance companies continue to say, with these features, that annuitants can take income up to X amount while the capital in the contract is exposed to market risk, the downside of which the insurance company will take. These features, which protect contract owners from various potential losses, are making consumers feel good, while the insurance regulators are becoming more and more concerned about the risks that are being assumed by the insurance companies. This type of risk may be classified as systematic risk. It is nondiversifiable and noncontrollable, and results from forces outside of a firm's control, such as a general stock market decline that would put many variable annuity guarantees “in-the-money” at that time. In such a situation, the insurance company would be at risk because the guarantee features would provide more value than the market diminished account values. Hedging is used to address systematic risk. Hedging involves making an investment to reduce the risk of adverse price movements in the stock market. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract. For example, an investor owns a stock. The investor then sells a futures contract stating that the investor will sell the stock at a set price, thereby avoiding market fluctuations. Insurance companies use this strategy to hedge their

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uncertainty as to what the market will do. Are they any good at it? Insurance buyers are used to the idea of buying insurance and hoping that they do not have to use it. However, it would be wise for all of us to heed the old adage, “There are no guarantees, only guarantors.” It has always been important to choose an insurance company carefully, and today it is even more important to choose wisely.

Life-contingent income annuities also are exposed to the systematic risk of increasing longevity. Life insurance policies are exposed to the risk of pandemics and terrorist attacks. A favorite quote from the reinsurance marketplace explains how to hedge these risks. “If you had a life insurance policy and an immediate annuity, you’d pay out only on one of them, either you live or you die, you aren’t going to do both.”[[7]](#endnote-7)

1. *The American Heritage Dictionary* (2nd College Ed.) (Houghton Mifflin Co. , 1985). [↑](#endnote-ref-1)
2. Webster’s Third New International Dictionary ( G. & C. Merriam Co., 1971). [↑](#endnote-ref-2)
3. NASD Notice to Members 99-35, May 1999, pp. 229-232. [↑](#endnote-ref-3)
4. Www.socialsecurity.gov/history/briefhistory3.html. [↑](#endnote-ref-4)
5. Greenough, *A New Approach to Retirement Income* (New York: Teachers Insurance and Annuity Association, 1951). [↑](#endnote-ref-5)
6. Ken Dychtwald, *Age Wave*. [↑](#endnote-ref-6)
7. Green, “Same Stage, New Roles,” *Best’s Review*, Feb. 2007, pp. 62-64. [↑](#endnote-ref-7)