

## Introduction

The Kentucky Department of Insurance is pleased to offer this “Annuity Buyer’s Guide” as an aid to assist you in determining your insurance needs and the products that will fill those needs. This guide contains only a brief description of various annuity products. For specific information about a particular type of annuity, you should consult an agent. This guide is not meant to offer legal, financial or tax advice. You may want to consult independent advisors for those specific questions. This guide does not endorse any company, agent or policy type.

### What is an Annuity?

An annuity is a contract where an insurance company promises to make payments to an annuitant over a specified period of time or for life. One of the purposes for an annuity is to make sure a person does not outlive his income. An annuity is a type of insurance to protect against the risk of financial hardship during retirement.

There are three participants in an annuity contract: the owner, the annuitant and the beneficiary. Most of the time, the annuitant and the owner are the same person, but it is not required. The owner is the purchaser of the annuity, pays the premiums and has the right to surrender the annuity. The owner also is responsible for any taxes due upon surrender or payout and is usually the person who names the beneficiary of the contract. The annuitant is the person whose age and life expectancy is going to be used to calculate the benefits of the annuity and who will receive the annuity payments. The beneficiary receives the death benefit upon death of the annuitant or the owner.

### Various Types of Annuities

**Fixed annuity** – This type of annuity accumulates interest on the funds deposited into the annuity on a fixed rate basis. Every fixed annuity has a current interest rate and a minimum guaranteed interest rate. The current interest rate will always be equal to or higher than the minimum guaranteed interest rate. Although this varies from company to company and contract to contract, the current interest rate is declared on an annual basis, usually after an initial guarantee period. With a fixed annuity, the insurance company assumes the risk of paying at least the minimum guaranteed interest rate.

**Variable annuity** – Different than a fixed annuity, a variable annuity pays varying rates of interest on the funds placed inside the annuity based upon the investment options chosen by the annuity owner. If the investment choices do well, the annuity will do well. If the investment choices do poorly, the annuity will not grow as well or even could lose value. Because the

growth of a variable annuity is not guaranteed by the insurance company, the contract holder assumes the risk.

**Immediate annuity** – This type of annuity begins paying a benefit very soon, usually within 30 days to one year after it is purchased, and usually requires a lump sum payment.

**Indexed annuity** – This is a fairly new product in the annuity market. Indexed annuities pay an interest rate that is tied to the performance of a common or well-known index such as the S&P 500, the Russell 1000 or the S&P 100. The growth of an indexed annuity is based upon the participation rate of the index it is tied to. For example, if an indexed annuity has a defined participation rate of 70 percent and the index it follows goes up by 10 percent, the annuity's accumulation value will increase by 7 percent (10 percent increase times the 70 percent participation rate). On the downside, most indexed annuities specify a "floor" that the annuity growth rate cannot go below or offer a minimum interest rate. Typically this minimum rate is 1 percent to 3 percent.

## Things Common to all Annuities

There are two distinct phases to an annuity - the accumulation phase and the payout phase. The accumulation phase is the first phase where all the premiums are paid into the annuity and the money grows tax-deferred. The second phase is the payout phase, which is when the annuity actually starts to pay the benefits to the annuitant. There are several payout options; a few of these options will be discussed in the following section. Make sure your agent goes over each option with you thoroughly so that you choose the one most appropriate for your needs. It is very important to understand that once a payout option is chosen and you start receiving payments, that option cannot be changed.

### Examples of Payout Options (Settlement Options)

- Life income (no refund) – Pays an income as long as the annuitant is alive. Payments stop when the annuitant dies.
- Life income with period certain (10, 15 or 20 years) – Pays an income as long as the annuitant is alive. If the annuitant dies before the period certain has expired, payments are made to the beneficiary for the balance of the period.
- Life income with installments (refund) – This option provides a monthly annuity payment during the lifetime of the annuitant with a guarantee that payments will be made for a certain number of months (not necessarily for the annuitant's full lifetime). The number of months is determined by dividing the accumulated amount of the annuity by the amount of the first monthly annuity payment. Only the number of months is guaranteed so there is no guarantee of a full refund.

**The following payout options assume there are two individuals that will be receiving benefits from the annuity.**

- Joint and full to survivor (no refund) – This option pays an income as long as one or more annuitant is living. Payments stop when both annuitants are deceased.
- Joint and 2/3 to survivor (no refund) – This option pays an income while both annuitants are alive. When one dies, 2/3 income payments continue during the survivor's lifetime. Payments stop when the second annuitant dies.
- Joint and full to survivor with period certain (10, 15 or 20 years) – Pays an income while at least one annuitant is alive. If both annuitants die before the specified period expires, payments of the balance of the period certain continue to the beneficiary.
- Joint and full to survivor with installments (refund) – This option pays a monthly payment during the lifetime of the annuitant with a guarantee that payments will be made for a certain number of months. The number of months is determined by dividing the accumulated amount of the annuity by the amount of the first monthly annuity payment. Only the number of months is guaranteed so there is no guarantee of a full refund.
- Joint and 2/3 to survivor with period certain (10, 15 or 20 years) – Pays an income while both annuitants are living. When one dies, 2/3 of the income payment continues during the survivor's lifetime. If the second annuitant dies before the period certain expires, the 2/3 payment amount continues to the beneficiary for the balance of the period.

## **Guaranteed Living Benefits**

Guaranteed living benefits may be found as a provision in an annuity contract or added by rider endorsement or amendment to an annuity contract. There are 3 different types and can be very complicated. One important thing to consider is whether or not the particular contract you are considering purchasing allows these benefits to be assignable or not. Be sure to read your contract carefully before purchasing. These different guarantees provide a downside protection to an annuity contract. They are tools to aid in the management of risk by transferring different risks from the buyer to the insurer. There are different types of guarantees defined as follows:

1. **Guaranteed Minimum Withdrawal Benefits (GMWB)** – guarantees the return of at least the owner's investment, or that investment plus an interest component (the benefit base) through periodic partial withdrawals of a certain percent or less of the benefit base, even if the annuity cash value falls to zero. There is usually no waiting period.

2. **Guaranteed Minimum Income Benefit (GMIB)** – guarantees that, regardless of actual policy performance, the buyer is assured a certain minimum future income, but only in the form of a regular annuity payout. It does not guarantee a lump sum.
3. **Guaranteed Minimum Accumulation Benefit (GMAB)** – unlike the other guarantees the GMAB guarantees a minimum lump sum at the end.

## **Will You be Penalized if You Withdraw Money From Your Annuity?**

In most cases “Yes.” However, some annuities have a provision that permits you to withdraw a certain amount each year, usually 10 percent of the annuity value, without having to pay a surrender charge. Please remember, even though you may not have to pay a surrender charge, there may be taxes to be paid on some or all of the money you withdraw. It is recommended that you consult a tax advisor or your annuity insurance company regarding the tax consequences before you make the withdrawal.

## **Important Things to Consider**

1. Review your own insurance needs and circumstances. Choose the kind of contract that has benefits that most closely fit your needs. Ask an agent or company to help you.
2. Be sure that you can handle the premium payments. Ask about any possible increases in premium amounts and what may cause an increase.
3. Don't sign an application until you review it carefully to be sure all the answers are complete and accurate.
4. Don't drop one contract and buy another without a thorough study of the new contract and the one you have now. Replacing your insurance may be costly.
5. Read your policy carefully. Ask your agent or company about anything that is not clear to you.
6. Periodically review your insurance program with your agent or company to keep up with changes in your income and your needs.
7. Do not buy a contract until you have a good understanding of how it works.

## **Are You Considering Dropping or Replacing an Existing Annuity Contract?**

If you are thinking about dropping or replacing an annuity contract, here are some things you should consider:

- If you decide to replace your contract, do not cancel your old contract until you have received the new one. You usually will have a minimum of 30 days to review your new contract to decide if it is what you want.

- It may be costly to replace a contract. There may be substantial surrender charges that you will incur. Remember that if you have held your existing contract long enough and no longer have to pay surrender charges, purchasing a new contract may start a new period of surrender charges.
- Consider consulting a tax advisor to see if dropping your contract could affect your income taxes.
- You may have valuable rights and benefits in your existing contract that are not in the new contract.
- If the annuity contract you have now no longer meets your needs, you may not have to replace it. You might be able to adjust your existing contract or purchase an additional contract to get the coverage or benefits you now need.
- In all cases, if you are thinking of buying a new contract to replace your existing one, check with the agent or company that issued your existing contract. Before replacing, ask your agent or company for an updated illustration (in-force illustration). Check to see how the contract has performed and what you should expect in the future based on the guarantees.

## **How Can You Find Missing Contracts?**

If the deceased's estate went through probate, there is a chance that the contract might have been listed as an asset.

Begin by contacting insurance companies. Try to narrow your search as much as possible. For example, start with those companies most prominent where the deceased lived or worked. Contact the benefits coordinator at the deceased's place of employment. Remember, unless you are the beneficiary, the company is not required to offer any information. Try to provide as much information as possible, including the deceased's name and any aliases, Social Security number, date of birth, etc.

Ask the estate's executor to request copies of all bank statements and other records. If a check has been written or an automatic payment has been made to an insurance company, this might provide a lead.

Contact the deceased's insurance agent for homeowners, renters, or auto insurance. Although he may not have sold your friend or relative an annuity contract, many agents keep records of their client's insurance purchases.

## **Final Points to Consider**

Remember to read your annuity contract carefully when you receive it. Ask your agent or insurance company to explain anything you don't understand. If you have a specific complaint

or can't get the answers you need from the agent or company, contact your state insurance department.

## Insurer Rating Organizations

Other sources of information related to the financial strengths of companies are insurance rating organizations. Some of these are A.M. Best, Fitch Ratings, Moody's Investors Service, Standard and Poor's, and Weiss Ratings Inc. You can use these sources to help you research and determine which companies you would like to contact about your insurance needs. The Kentucky Department of Insurance can provide you with ratings from A.M. Best or you can contact the companies directly to get information about their ratings.

A.M. Best  
www.ambest.com  
Telephone: 908-439-2200

Standard and Poor's  
www.standardandpoors.com  
Telephone: 212-438-2000

Fitch Ratings  
www.fitchratings.com  
Telephone: 800-893-4824

Weiss Ratings LLC  
www.weissratings.com  
Telephone: 877-934-7778

Moody's Investors Service  
www.moodys.com  
Telephone: 212-553-0377

## Other Important Terms

**Amendment, Endorsement or Rider** – forms that are used to effect contract changes requested by an owner to an individual annuity contract.

**Annuitize** - This is a term used when the owner elects to convert the lump sum of the accumulated value of the annuity contract to begin receiving a series of payments.

**Assignment** – transfer of rights under an annuity contract to another person or business in exchange for partial or total ownership rights to the contract.

**Guaranteed Living Benefits** - a contract provision or added to a contract by rider. These different guarantees provide a downside guarantee to an annuity contract. They are tools to aid in the management of risk by transferring risk from the owner to the insurer. There are different types of guarantees, as follows:

- 1. Guaranteed Minimum Withdrawal Benefit (GMWB)** – the benefit guarantees the return of at least the owner’s investment, or that investment plus an interest component (the benefit base) through periodic partial withdrawals of a certain percent or less of the benefit base, even if the annuity cash value falls to zero. There is usually no waiting period.
- 2. Guaranteed Minimum Income Benefit (GMIB)** – the benefit guarantees that, regardless of actual contract performance, the owner is assured a certain minimum future income, but only in the form of a regular annuity payout. It does not guarantee a lump sum.
- 3. Guaranteed Minimum Accumulation Benefit (GMAB)** – unlike the other guarantees the GMAB guarantees a minimum lump sum at the end.

**Long-Term Care Riders** - a provision which may or may not require an extra premium that allows for the reduction of the annuity value based upon long term care expenses without applying surrender charges. A benefit above the value of the annuity also may be purchased for an additional cost.

**Market Value Adjustment** – increase or decrease in the surrender charge of the annuity contract depending on the current financial markets. The cash value is adjusted upward if the policy interest rate is greater than the current interest rate on new money and thus, if interest rates decline after the date the annuity contract is purchased, the surrender charge decreases. However, if the cash value is adjusted downward if the policy interest rate is less than the current interest rate on new money and thus, if interest rates rise after the purchase date of the annuity contract, the surrender charge increases.

**Tax-Free Exchange (1035 Exchange)** – under Section 1035 of the Internal Revenue Code stipulations that the exchange of one life insurance policy for another life insurance policy generally will not result in a recognized gain for the purposes of federal income tax purposes to the policy owner. The insured must be the same on both policies. Life policies can be exchanged for life policies, life policies can be exchanged for annuities and annuities can be exchanged for annuities. Annuities

cannot be exchanged for life policies. With annuities, the annuitant must be the same on both contracts.

**Ten Day Free Look** – a contract provision notifying purchasers of new insurance that they have ten days after delivery of the annuity contract to inspect it and if not satisfied, return it to the agent or company for a full refund of all premiums paid.