NAFA
National Association for Fixed Annuities
Securing the Future!

NAFA White Paper on **Annuity Income Opportunities**

Annuity product innovations include a wide variety of ways to provide guaranteed income through annuitization choices, income riders called guaranteed lifetime withdrawal benefits (GLWB) or guaranteed lifetime income benefits (GLIB) and withdrawal benefits. These options provide retirees the amount of guaranteed income and flexibility and control over retirement savings.

Annuitization

Traditional income options from annuities include guaranteed income for life, for a specified period, or a combination of a lifetime payout with a guaranteed period. These options are typically referred to by the industry as "annuitization." Annuitization is available in both immediate (also called payout or income annuities) and deferred annuities. The selected income stream is guaranteed. Also, many products offer inflation adjustment features and more innovation is currently underway that will provide guaranteed inflation protection using the consumer price index and other inflation measurement indices. Here is a typical list of annuitization options available on fixed deferred and lifetime income (immediate) annuities:

- **Life Option**
  The life option typically provides an income stream for life, which is an effective hedge against outliving retirement income.

- **Joint-Life Option**
  This common option allows the spouse to continue to receive payments when the annuity recipient dies. The monthly payment is lower than that of the life option because the calculation is based on the life expectancy of both the husband and wife.

- **Period Certain**
  With this option the value of the annuity is paid out over a defined period of time that the owner chooses such as 10, 15 or 20 years. If a 15-year period certain payout is selected and the annuitant died at any time during those 15 years, then all remaining payments through the end of the 15th year would be paid to the beneficiary.

- **Life with Guaranteed Term**
  Many people like the idea of guaranteed income for life (which they get with the life option), but they are afraid to choose that option in case they die in the near future. The life-with-guaranteed-term option provides an income stream for life (like the life option), so it pays you for as long as you live. But this option also allows the payout recipient to select a guaranteed period, such as a 10-year guaranteed term, for which the annuity must pay to the estate or beneficiaries even if death occurs before that guaranteed period is over.

- **Systematic Withdrawal Schedule**
  This method allows the recipient to select the amount of payment that is desired each month and how many payments are needed. However, the insurance company will not guarantee that the recipient will not outlive income payments. How much is received and how many months payments are received depends on the annuity cash value at payout. The risk of outliving the income is borne by the recipient.

- **Lump-Sum Payment**
  Taking out all of the cash value is the least efficient payout method from a tax minimization perspective. Ordinary income taxes are due on the entire portion of the annuity (for IRAs and annuities in employer-sponsored plans) rather than spread out over time when the tax bracket may be lower in retirement.

- **Electing Not to Take Payments**
  With deferred fixed annuities you are not required to take the payments unless you choose to. This is beneficial in that the retiree doesn't need to make any payout decision until and if income is needed.

Income Riders

Income riders have become one of the most popular benefits ever added to fixed deferred annuities. NAFA members are reporting that over 50 percent of people who purchase fixed deferred annuities also elect to add an income rider. These income riders are called by names such as guaranteed lifetime withdrawal benefits (GLWB) or guaranteed lifetime income benefits (GLIB).

The first income riders were introduced on variable annuity products in 2003, and they became available on fixed and fixed indexed annuity products a few years later. Income riders provide consumers with a guaranteed income for life (similar to what can annuitization provide), but without giving up access to remaining principal – a feature that caused many consumers to shy away from annuitization. By purchasing an income rider on a fixed rather than a variable annuity, a consumer gets the benefits of the income rider while also being protected from investment risk.

An income rider on a fixed or fixed indexed annuity allows a retiree to build a secure retirement income. The payout provided by the income rider is guaranteed by the issuing insurance carrier for the life of the annuity owner. The issuing insurance carrier bears all of the investment and longevity risk on the guaranteed payout, which means that the consumer is completely protected from these risks. Some annuity carriers even provide for the income to substantially increase in the event that the annuity owner becomes confined to a nursing home, further sheltering the annuity owner from risk. In addition, the annuity owner retains access to the annuity's remaining value and also continues to reap the benefits of interest credits to the annuity's value.

How Income Riders Work

As previously noted, a guaranteed lifetime income or withdrawal benefit is typically optional on a fixed annuity, and it is added to the annuity by a rider. Whereas the annuity has an accumulation value to determine the death benefit or annuitization, the rider adds a second value, the income value.

The accumulation value works just as it always does on a fixed annuity. The annuity owner's premium earns additional interest that is declared and guaranteed in advance or guaranteed through a calculation of an index (or indices) performance while at all times promising a minimum guaranteed interest. The unique benefit of a fixed indexed annuity (FIA) is that it has a built-in inflation hedge because additional interest is calculated based on a formula tied to the designated index (e.g., S&P 500).

With income riders, the income value is completely separate from the accumulation value. It typically grows at a fixed rate of interest and when the retiree elects to start taking lifetime withdrawals,

* withdrawals in excess of the guaranteed annual withdrawal cause the income value and future guaranteed annual withdrawal amounts to decrease depending on the ratio of the excess withdrawal to the accumulation value.

a payout factor is applied to the income value to determine the guaranteed annual withdrawal. If the accumulation value is higher than the income value when the income is desired, then the accumulation value is used in the payout calculation instead. Once the amount of guaranteed withdrawal is calculated, the retiree may withdraw that amount from the annuity every year for life. While taking these withdrawals, the retiree is provided with two very valuable guarantees. First, although the annual withdrawals are deducted from the accumulation value, the additional interest (declared or indexed) continues to be credited to the accumulation value, and the retiree retains access to the remaining accumulation value at all times. Second, even if the annual withdrawals ultimately deplete the accumulation value, the issuing carrier must continue making the annual payments as long as the retiree lives.

Withdrawal Benefits

Most fixed annuities contain a provision to withdraw a portion of the annuity value without any surrender charge, usually after the first policy year. Many fixed annuities which are qualified contracts (IRAs) allow the stated withdrawal amount or the required minimum distribution (RMD), whichever is greater.

However, this benefit is not guaranteed and if you withdraw more than the amount specified by the benefit you may incur a withdrawal charge. The withdrawal benefit allows access to funds in an emergency or planned withdrawal for income or required distribution under qualified retirement fund rules. The amount usually allowed is 10% of the annuity's account once per year. Some policies let you accumulate the percentage allowed if you do not take a withdrawal in a given year with a maximum total accumulated percentage that is typically 50% of the account value. A few products limit penalty-free withdrawals to the interest earned during a year.

How Income Riders Work – At a Glance

Value	Accumulation Value	Income Value
How it is used	It is the basis for most benefit calculations, including the value to be paid upon death, surrender, or maturity	It has one purpose – it is the value that is used to determine the lifetime payments that can be taken from the annuity
How it grows	Interest is credited to this value using a choice of fixed and/or index-based methods	A separate fixed, guaranteed interest rate (usually in the 5% - 8% range) is credited to this value

Liquidity Available under an Annuity

Nursing Care Rider

This feature is a special form of penalty-free withdrawal. To qualify, you usually must be admitted to a qualified care facility (or receive home health care) after the first policy year, for a specified period of time (often 90 days). When you qualify you may usually elect a penalty free withdrawal of up to 75% or 100% of your account value.

Terminal Illness Rider

This feature is a special form of penalty-free partial withdrawal. To qualify you must be diagnosed by a doctor as terminally ill (death expected within one year) after the first policy year. When you qualify you may usually elect a penalty free withdrawal of up to 75% or 100% of your account value.

Tradeoffs of Income Choices

Annuitization or Lifetime Income Annuities

As we have discussed, the fixed immediate or lifetime annuity's most significant (and understood) benefit is that the customers are guaranteed a steady stream of income for the rest of their lives, a specific period or a combination of lifetime and period guarantees. Economists have suggested that individuals can achieve substantial gains to their welfare if they eliminate the uncertainty related to their lifespan by purchasing annuities.[1]

The first tradeoff for the guarantee that you cannot outlive your savings is that the customer may not change their election. Therefore, if the customer needs more money for unexpected expenses, they may not access the money they have chosen to annuitize. *But note: the insurance industry has recognized and solved for this need with GLWB income riders mentioned previously.*

In addition, many annuities do not owe the beneficiary any remaining value when the customer dies. Retires who would like a payout of the remaining value need only select from the products that offer this benefit and, in exchange for the benefit, accept a lower income stream than he or she would have received otherwise.

Charges for Income Riders

Income riders attached to a deferred annuity provide consumers with more flexibility to access their remaining annuity value if the consumer needs money for unexpected expenses. However, that flexibility comes at a cost. While the income riders guarantee lifetime income or withdrawal amounts that add a valuable benefit to the fixed annuity for retirees interested in a reliable retirement income, the riders are not free. Some carriers build the rider into the annuity product, so the cost is reflected in a lower interest rate on the accumulation value, the income value, or both. Other carriers charge directly by deducting a fee from the accumulation value of the annuity, usually based on the income benefit base. This charge may cause the accumulation value to fall in years in which no indexed interest is credited. Rider charges normally continue until the accumulation value of the annuity is depleted or the rider is removed from the contract.

[1] Julie R. Agnew, Lisa R. Anderson, Jeffrey R. Gerlach, and Lisa R. Szykman, The Annuity Puzzle And Negative Framing, (Center for Retirement Research at Boston College, July 2008), Page 1.