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## NATIONAL ASSOCIATION FOR FIXED ANNUITIES

### WHITE PAPER ON FIXED INDEXED INSURANCE PRODUCTS INCLUDING “FIXED INDEXED ANNUITIES” AND OTHER FIXED INDEXED INSURANCE PRODUCTS

#### INTRODUCTION

##### Popular Appeal

Fixed indexed insurance products are increasingly popular with the public. As with all cash value insurance products, fixed indexed insurance products offer a combination of insurance and investment features.

Fixed indexed insurance products are a natural evolution of the traditional fixed insurance product which offers one method of crediting interest. Fixed indexed insurance products are nothing more than a traditional fixed insurance product that offers owners an opportunity, often on an optional basis, to receive interest based on positive changes in a financial markets index coupled with *insurance* guarantees of purchase payments and minimum rates of interest. In other words, fixed indexed insurance products offer guaranteed preservation of purchase payments coupled with guaranteed growth in value, even when indexed-based interest is small or non-existent.

More specifically, benefits under fixed indexed insurance products can increase in amount depending on the changes in financial market indexes. At the same time, benefits have guaranteed floors that protect against loss of principal if the performance of financial market indexes is not favorable. The result is that an owner has limited downside risk while *potentially* realizing a greater (or lesser) amount of credited interest than a life insurance company could declare and guarantee in advance as a fixed rate.

Fixed indexed insurance products generally provide all of the *insurance* coverages of traditional insurance products, including death benefits, withdrawal options, payout options and benefits triggered by disability or incapacitation.

These insurance guarantees mean that only life insurance companies can issue fixed indexed insurance products. Life insurance companies are subject to strict regulation by the states. State regulation is designed to assure that life insurance companies will have sufficient assets to make good on their guarantees, even if the general economy and the business fortunes of an individual life insurance company fall. Moreover, fixed indexed insurance products are backed by state guarantee funds. These funds provide the money to compensate owners if a life insurance company defaults.

Because of these features, fixed indexed insurance products are receiving a lot of attention from journalists, financial planners, competitors, academicians, regulators and others.

## **Some Short-hand Terms**

These products are sometimes called “equity index annuities” or “EIAs.” However, some products involve indexes other than equity indexes (such as bond indexes), and some products are life insurance policies rather than annuities. So, “FIPs” refers to all insurance products for which benefits may vary in relation to a financial market index.

This White Paper refers extensively to financial market indexes – or “indexes” for short. That’s because a distinguishing characteristic of FIPs is the fact that the rates of interest credited to owners are derived by reference to indexes. We have tried to make clear that an index is solely a *benchmark* or a *measuring stick* for the interest rate that the life insurance company credits to the owner. The owner, in no way, “participates” in the performance of the index or in the performance of a specified group of stocks, bonds or other financial instruments in the market that the index measures. The index is a reference point outside the control of a life insurance company, which provides an objective standard from which a life insurance company can derive an interest rate to be credited to an owner.

We have attempted to write this White Paper in plain English. Consequently, we may have sacrificed some technical precision for easy readability. For example, this White Paper focuses on fixed indexed *annuities*, as an example of indexed products, rather than fixed indexed *life insurance*.

On a technical point, this White Paper uses the term “owner” to include the “annuitant” when the annuitant is not the owner. And this White Paper refers to a life insurance company as simply an “insurance company.”

Finally, some FIPs offer the indexing feature as the only means of crediting interest, and other FIPs offer the indexing feature along with traditional means of crediting declared rates of interest. This White Paper does not distinguish between these two types of FIPs.

## **BACKGROUND**

### **Investor’s Knowledge Level**

Financial products contribute to the well-being of the public in general and individual persons in particular. They provide methods for saving for large purchases like houses, major expenditures like college, unexpected contingencies like medical needs, and important life changes like retirement.

It’s critically important that the public understand financial products – whether issued by insurance companies, banks, mutual funds or other financial service companies. Understanding financial products helps assure that an individual buys a product that is suitable for his or her needs at the time and into the future. Suitability of a product depends on a match between the particular circumstances of an individual and the features of a product. An individual’s circumstances include, for example, financial experience, other assets, income sources and needs and tax status. The

characteristics of a product, for example, includes risk of loss, growth potential, liquidity and tax implications.

Financial products are like medicines. A particular financial product, like a particular medicine, can help many people, but it may not be suitable for some people. What is crucial is not only the financial product or the medicine itself, but the fit of the financial product or the medicine to the user. Figuring out the fit takes some effort. In short, you have to read the label.

Competition and technology fuels the creation of new financial product features on a continuous basis. The American public can hardly be expected to keep pace with the development or have sufficient knowledge of financial products, including insurance products generally and FIPs in particular, to make informed decisions without assistance. The need for the manufacturers, issuers, distributors, regulators and the media to contribute to the flow of information can not be over-estimated. This need is equal to the public's need for financial products that will address savings and retirement needs.

### **Demand for Diversity and Flexibility**

Just as the public demands a wide range of car models and options, the public demands a wide range of financial products and options. This wide range of financial products and options is a great advantage to the investing public, because it allows a person to find a product that can be micro-fitted to his or her individual needs. At the same time, a wide range of financial products and options can make it difficult for a person to understand and assess a product and compare it to other similar and different financial products.

Issuers of financial products – including insurance companies – could make financial products more uniform, simpler and easier to understand, assess and compare with other financial products. Or, the government could paternalistically control and restrict design in an attempt to protect investors by keeping things simple. But, doing so would hamper the evolution of designs that could benefit investors. It would sacrifice the diversity and flexibility that a diverse public needs. It would handicap a person in finding the most suitable product and choosing among that product's options that allow the person to fit the product to his or her individual needs.

One way to balance the tension between desirability of unhampered product evolution and consumer protection is investor education. Information acts as the lubricant in a free enterprise engine, benefiting its performance and reducing the friction of bad investment decisions or unsuitable sales. Journalists, academicians, sales persons, analysts, financial planners and others serve critical roles in educating investors. This White Paper is intended to contribute to that effort.

### **Scourge of All Financial Products**

As explained above, diversity and complexity of financial products can benefit the public. Unfortunately, however, diversity and flexibility can also lend themselves to abusive sales practices including fraud. All financial products are vulnerable to the contemptible tactics of the unscrupulous.

The United States Securities and Exchange Commission - SEC for short – held its first Senior Summit on how regulators and others can better coordinate efforts to protect older Americans on July 17, 2006. The SEC announced that the purpose of the Seniors Summit was “to examine investment fraud and abusive sales practices.” ([www.sec.gov/news/press/2006/2006-109.htm](http://www.sec.gov/news/press/2006/2006-109.htm).)

The Seniors Summit released a new NASD Investor Education Foundation Fraud Study (<http://www.nasd.com>). Some of the Study’s key findings are the opposite of what one would expect.

The Study finds that “[i]nvestment fraud victims are more financially literate than non-victims.” The Study also finds that fraud victims, compared to the general population, are more educated, have high levels of income, and are more often married. The Study further finds that fraud victims, compared to non-victims, are more optimistic, tend to have a personality that is more self-reliant and self-deterministic, and are more likely to rely on their own experience and knowledge to make financial decisions. The Study concludes – counter to common perception – that “traditional financial literacy education alone will not inoculate investors from being defrauded.”

The Study demonstrates an important need to rethink how we can teach investors to protect themselves against abusive sales practices and fraud. The Study makes clear that factors *other* than the diversity and complexity of financial products contribute significantly to investment fraud. So, it’s not enough simply to educate the public as to the characteristics and operation of financial products. Education must also address what the Study calls the “psychological profile” of investors – the demographic and personality indicators.

This, however, is easier said than done. As the Study recognizes, attempts to understand these psychological factors are still “early,” and “social workers, researchers and law enforcement personnel” must do further work in order for us to have a fuller picture.

### **Focusing on Fixed Indexed Insurance Products**

Fixed indexed insurance products – or FIPs – are relatively new. They first became available around 1995. They offer a unique combination of insurance and investment opportunities. The products have evolved rapidly. They now offer a wide variety of features.

Consequently, there is a growing need for information about FIPs. This need is increased by the public’s general lack of understanding of financial products. Journalists, financial planners, competitors, academicians, as well as regulators, have turned their attention to FIPs in an effort to understand and explain them.

As with many new products that grab the public’s interest, FIPs have sparked discussion. Many statements made about the products have been valid and accurate. Other statements have been unfounded, inaccurate and of dubious purpose. Some statements have praised FIPs, and some statements have criticized the idea of indexing in a guaranteed insurance product. .

The purpose of this White Paper is to contribute to the public’s knowledge about FIPs through careful but simple analysis. This White Paper presents information in a summary form in the beginning and in more detail later on.

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## **FIXED INDEXED INSURANCE PRODUCTS**

### **Nutshell Summary**

FIPs are issued by life insurance companies. FIPs generally offer the same array of benefits as non-indexed products. Indexed *annuity* products offer accumulation (or “pay-in”) benefits, annuity (or “pay-out”) benefits and death benefits. Indexed *life insurance* products have the same general features, but offer death benefits significantly in excess of the pay-in and pay-out benefits.

FIPs differ from other insurance products in that part or all of the appreciation in benefits are determined by reference to independent indexes.

Generally, the dollar value of benefits can vary up or down as derived from the increases and decreases in the performance of the indexes. However, the dollar value of benefits cannot fall below specified levels guaranteed by the insurance companies.

With today’s products, the dollar value of benefits on an interest determination date cannot be lower than the value of the preceding determination date. In other words, the dollar value of benefits cannot move downward, but only upward relative to the index.

So, FIPs offer owners an opportunity to benefit from rates of interest derived from favorable changes in the financial markets, while assuring that the owner’s value will not decrease at all in most designs and will not decrease below specified levels in any design.

This White Paper focuses below on fixed indexed *annuities*. But much of the information would be true for fixed indexed *life insurance* as well.

### **Fixed Indexed Annuities as Deferred Annuities**

Currently, most fixed indexed annuities are *deferred* annuities.

All annuities offer an owner the opportunity to receive, usually after retirement, periodic annuity payments guaranteed for life. Deferred annuities offer an owner the additional opportunity to *accumulate* purchase payments with interest, before retirement, on a tax-deferred basis.

Deferred annuities offer death benefits and withdrawal benefits during the accumulation or pay-in period.

There are two kinds of annuities – fixed and variable. Fixed indexed annuities are a kind of fixed annuity.

The terms “fixed” and “variable” refer to the rate of interest or return that an owner earns on purchase payments and accumulated interest earned on purchase payments, as follows:

Under fixed annuities with *declared* rates of interest, the insurance company credits the owner with a rate of interest that the company declares in advance and guarantees for a period of usually one year. The owner bears no investment risk that the insurance company will fail to credit the declared interest rate. The company credits the owner with a rate of interest that the

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company may be said to bear the risk that subsequent declared rates may be reduced, but never below a minimum rate. The dollar amount of annuity payments is set in advance and remains the same during the pay-out period. The owner bears no investment risk that the insurance company will fail to continue making annuity payments in that dollar amount.

Under fixed annuities with *indexed* rates of interest, the insurance company credits the owners with a rate of interest that the company calculates by reference to a formula that includes a factor for changes in an independent index specified by the company. As under other fixed annuities, the owner bears no investment risk that the life insurance company will fail to pay the interest rate calculated with reference to the index. The owner may be said to bear the risk that subsequent indexed rates may be reduced, but never below a minimum rate. Also, as under other fixed annuities, the dollar amount of annuity payments purchased by each dollar of contract value is set in advance and remains the same during the pay-out period. The owner bears no investment risk that the insurance company will fail to continue making annuity payments in that dollar amount.

Under *variable* annuities, the owner earns a rate of return that the insurance company derives from the investment performance of a pool of assets invested by the company and managed by an investment adviser. The dollar amount of annuity payments also varies up and down with the performance of a pool of assets. The owner bears all of the investment risk that the pool will earn less than the owner could earn elsewhere and that the owner's accumulated value or dollar amount of annuity payments will drop. However, the owner bears no investment risk that the insurance company will fail to continue making annuity payments of some dollar amount.

### **Fixed Indexed Annuity Benefits**

A typical fixed indexed annuity guarantees the following amount to the owner:

- a specified percentage of total purchase payments (ranging between 87.5% and 100% of purchase payments, thereby generally reflecting the deduction of expenses and less any withdrawals), which is referred to as “principal”; plus
- a guaranteed rate of interest in the form of a minimum rate of interest required under applicable state insurance non-forfeiture laws (historically and currently, 3% annually, but, at times, ranging between 1% and 3% depending on the then-current yield curve as indexed to five-year Treasury yields), which becomes part of the principal; and plus
- an additional rate of interest (sometimes referred to as the “excess rate interest”) that is calculated under a guaranteed formula by reference to an index, which becomes part of the principal.

During the accumulation or pay-in period, fixed indexed annuities, like other annuities, provide death benefits and withdrawal and surrender benefits.

As with all annuities, fixed indexed annuities provide death benefits in the form of taxable life insurance coverage. The insurance company pays the death benefit to the owner's beneficiaries on the owner's death. Fixed indexed annuities differ regarding the dollar amount of the death benefit. Some fixed indexed annuities provide a dollar amount of death benefit equal to total purchase payments less expenses and withdrawals. Typically, fixed indexed annuities provide a dollar amount of death benefit equal to purchase payments less expenses and withdrawals and plus credited interest, as listed above. A minority of annuities require beneficiaries to annuitize (convert to an income stream) the values listed above or to pay surrender charges upon full cash out on the owner's death.

As with all annuities, fixed indexed annuities provide withdrawal and surrender benefits. The insurance company allows the owner to withdraw all or some of the owner's money and to surrender the owner's fixed indexed annuity. However, most fixed indexed annuities impose a charge if the owner withdraws or surrenders during the first several years of an annuity. Fixed indexed annuities typically impose a surrender charge that declines to zero over a specified period. The amount and duration of the surrender charge varies among contracts as permitted by applicable state laws. At the same time, most fixed indexed annuities waive any surrender charges for partial withdrawal of up to 10% of accumulated purchase payments annually, interest only or upon the owner's disability, confinement to a nursing home or becoming terminally ill or upon any "required minimum distribution" as mandated by federal income tax law.

As with some non-indexed annuities, a few fixed indexed annuities impose a market value adjustment ("MVA") on surrenders and withdrawals prior to the end of the period noted above. MVAs adjust the amount surrendered or withdrawn to reflect the effect of then current economic conditions on the value of the insurance company's invested assets (generally bonds) supporting the guaranteed crediting rate of fixed indexed annuities. Under some fixed indexed annuities, the MVA adjustment can be "positive," in which case, in actuarial parlance, the withdrawal or surrender proceeds will be reduced, or "negative," in which case, in actuarial parlance, these proceeds will be increased to reflect asset gains. In every case, however, an MVA adjustment will not be allowed to reduce product values below the minimum guaranteed values required by state insurance law. This maintains the insurance status of the product by limiting the degree of investment risk that the insurance company transfers to the owner.

From the inception of the income tax, the general rule has been that accumulations of income under an annuity contract are not subject to current income tax. This annuity tax deferral rule has also been applied to accumulations under new forms of annuity contracts, such as variable and indexed annuities, as they have been developed.

Congress has specifically recognized the importance of annuity tax deferral as an incentive for retirement and other long-term savings by individuals. In order to encourage savings and discourage inappropriate uses of annuity tax deferral, the Internal Revenue Code taxes partial withdrawals and loans from annuity contracts on an "income first basis," generally imposes a 10% penalty on withdrawals from annuity contracts prior to the attainment of age 59½, or death or disability and generally denies annuity tax deferral to corporations, partnerships, and other nonnatural persons.

## HOW INDEXED INTEREST IS CREDITED IN FIPs

### General

This section is a high level summary of the method of crediting interest in an FIP. A more complete description appears in the Appendix.

The distinguishing feature of FIPs is that the owner earns a rate of interest derived by reference to an index. This section describes the process of how insurance companies credit *indexed* interest. This process is not to be confused with another form of interest crediting that occurs in most FIPs in the calculation of a guaranteed minimum cash value. The guaranteed minimum cash value is usually an independent and secondary calculation that involves guaranteed minimum, non-indexed interest,

The index is solely a *benchmark* or a *measuring stick* for the interest rate that the insurance company credits to the owner. The owner, in no way “participates” in the performance of any index or owns in any sense the underlying stocks, bonds or other financial instruments in the market that the financial index measures. The index is a reference point, outside the control of an insurance company which provides an objective standard from which an insurance company can derive an interest rate to be credited to an owner.

The insurance company derives the interest rate to be credited to an owner by using the index performance as a *starting-point*, *not* the final result. The insurance company does not necessarily credit an interest rate equal to the index performance. Instead, the insurance company derives an interest rate to be credited with reference to the index performance *and* other factors in accordance with the terms of the FIP.

These factors include:

- what is the **period** of the interest credit
- **what index** is used?
- how are **index value percentage changes calculated?**
- **what adjustments** are made to the index value percentage changes?
- **when and for what benefits is the** indexed interest applied?

The Appendix to this paper contains more detailed description, examples and comments on current product designs.

### Period of the Interest Credit

The period or “term” of the interest credit establishes the point at which interest will be credited to the owner. The most common term today is one year. Since interest is typically credited on not only purchase payments but past interest earned, these interest credits “compound,” *i.e.*, interest is

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earned on previously credited interest. The credits “lock in” and cannot be lost. This is often referred to as “ratcheting.” In contracts with periodic ratcheting, future interest cannot be negative, and contract values cannot decrease due to interest credits.

Some FIPs have multi-year terms for interest crediting, ranging from two years to the entire surrender charge period. Products with terms over three years usually make some provision for an interim interest calculation should a benefit calculation be necessary (upon annuitization, death, surrender or withdrawal).

Sometimes this will take the form of a calculation from “inception to date of benefit,” using the index on that date rather than the end of term index which would not be available at that point. Sometimes it will take the form of the highest of (often called a “high water” calculation) prior anniversary calculation.

### **Financial Index**

An index value is a number measuring the value of a specified group of stocks, bonds or other financial instruments. Many indexed products specify the S&P 500 Composite Stock Price Index, which does not reflect dividends (the “S&P 500 Index”). Currently, insurance companies use less than a dozen other indexes. Some FIPs specify only one index, but some permit an owner to choose among several approaches and reallocate among indexes at the end of interest crediting terms.

**Indexed Value Percentage Change** There are a variety of methods of determining the percentage change. Currently most methods fall into three categories. The Appendix describes the methods. For any of these methods, the term is usually annual but may be any number of years.

- Point to Point – percentage change of starting index value to end of term index value, including Point to Point with Final Averaging - percentage change of starting index value to an average of a series of index values at the end of the term
- 
- Averaging – percentage change of starting index value to the average of an evenly spaced series of index values
- Additive Serial Point to Point (sometimes referred to as monthly point to point) - percentage change of a starting index value to the sum of a periodic series of index changes, usually with positive changes capped at a maximum

There are three other methods that are not used as frequently and have been available at various times.

- High Water – percentage change of starting index value to the highest of a periodic series of index values
- Low Water, – percentage change of the lowest of a periodic series of index values to the end of term index value

- Binary or Triggered – a version of Point to Point where a specified interest percentage is credited only if the Point to Point Index Value Percentage Change is achieved (usually 0%).

At the end of a crediting term, the insurance company credits the owner with interest. Therefore, most products start anew with an interest crediting term of the same length. For example, if a product has an annual term and the ending index value of the prior term becomes the beginning value of the next term, the product is said to be an “annual reset” calculation, because the beginning index value is reset at the beginning of the next term to where the index finished in the last term.

### **Adjustments**

Nearly all fixed indexed annuities make provision for an adjustment factor to modify the index value percentage change. The purpose of the adjustment is to allow the insurance company to balance the amount that it has available to spend for an interest credit with what it costs the company to provide the index percentage change method.

For example, if an insurance company would normally credit a fixed interest rate of 4% per year, this roughly becomes the budget for purchasing or constructing a financial liability hedge that is intended to provide the interest credit promised in a particular indexed interest approach. It will be rare that, say a hedge for a point to point strategy would cost the company exactly 4%. Perhaps it costs 5%. The insurance company needs some way to provide the owner with an interest credit that costs the company only 4% to provide. It must reduce the cost of the liability hedge to 4% while still providing interest under the basic method promised in the contract. Moreover, hedging is an art based on science, and there are a variety of hedging strategies which may or may not be effective.

**Floor or Minimum** – The first and nearly universal adjustment is a floor or minimum of 0% on the index value change percentage.

**Participation rate** – This method credits a percentage or proportion of the index value change percentage as interest. For example, an 80% participation rate applied to an index value change percentage of 10% will yield a credit of 8%.

**Spread, Margin or Fee** – These are all terms for a deduction from the index value change percentage. For example, if the spread is 2% and the index value percentage change is 10%, then interest credit would be 8%.

**Cap** – A cap adjustment is a maximum limit on the index value change percentage. For example, if the index value change percentage is 8% and the cap is 10%, then the interest credit is 8%. However, if the change percentage is 12%, the credit would be capped at 10%.

Insurance companies always declare adjustments in advance for the interest credit term. Insurance companies declare adjustments for subsequent interest terms, if not guaranteed, based on then current investment yields, required spreads and cost of hedging. The new adjustments may not exceed maximum spreads or be less than any minimum participation or cap levels specified in the contract. The new adjustment level is then maintained for the next interest credit term.

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### **Availability of Indexed Interest Credits for Benefits**

In most fixed annuities today, including most FIPs, interest credits are available for all benefits, including death benefits, surrenders, partial withdrawals and annuity payouts. There are several contract types under which interest credits are not immediately available, or are available only for certain benefits, e.g. annuitization.

### **Investment Risk: Relative Risks of Insurance Company and Owner**

Under FIPs, the insurance company, and not the owner, assumes the investment risk regarding payment of the rate of interest derived by a formula with reference to an index.

The financial index is created and maintained by a source outside of the insurance company. The insurance company has no control or influence over changes in the values of an index.

The insurance company guarantees the owner a rate of interest derived from the index. The insurance company then invests its own assets with the objective of earning a rate of return at least equal to that derived from the index. If the insurance company earns a rate of return less than that derived from the index, it nevertheless must credit the owner the rate of interest derived from the index and make up the shortfall from its general account.

The owner is not assured that the index will increase. However, the owner is assured that the insurance company will credit the owner a rate of interest equal to that derived from whatever the rate the index earns. This means that the insurance company assumes the investment risk that it will have to credit the owner a rate of interest higher than the rate of return that the insurance company earns investing its own assets.

Investment risk affects the insurance company and the owner differently under a FIP, as explained below.

### **Insurance Company's Risks**

The insurance company has to invest and cover two types of risks: the guarantee of the floor and the guarantee of the excess interest resulting from positive changes in the applicable index.

An insurance company invests the premiums received from FIPs in its general account. All general account assets support the insurance company's obligations under the FIPs, as well as all other contracts issued through the general account. To fund the obligations under the FIPs, the general account includes an investment portfolio of options and futures or a reinsurance contract. The insurance company seeks to structure the options and futures purchases so that their payoff or value will produce whatever interest rate the insurance company guarantees to credit. As many options and futures investors are well aware, hedging is not a perfect science. The insurance company is at risk as to its ability to accurately hedge its obligations to credit index-derived interest.

The insurance company invests the bulk of premiums in fixed income securities to support the guaranteed rate of interest. Although the insurance company invests the premiums with the FIPs'

indexed obligations in mind, the company has no guarantee that the markets will meet its expectations. Moreover, the insurance company in no way segregates the assets to meet the FIPs obligations. More importantly, the interest rate that the insurance company credits under the FIPs has no relationship to the investment returns that the insurance company earns on these assets. State insurance law generally requires the insurance company to establish reserves for the FIPs for the guaranteed rates based on a cumulative floor over the term of the FIPs.

The insurance company generally believes that its hedging, reserving and investment methods will reduce the investment risks it bears with respect to the FIPs. Nevertheless, the insurance company still bears other risks related to the investments, including: (i) liquidity risk, (ii) credit risk, (iii) market risk, (iv) pricing risk, (v) legal risk, and (vi) operational risk. As a final note, the insurance company must manage its investment risk against the backdrop of strict state insurance law limitations on the total percentage of assets that it can invest in equity securities and in options and futures.

### **Owner's Risk**

The owner, as discussed above, is protected by a guaranteed value that must grow over time and result in return of principal within a short period of time. The owner is always assured of receiving at least these guaranteed values and more if credited excess interest raises then current value above guarantees. This is true because a true interest credit cannot be undone or lost in a fixed annuity. Thus, while the owner can not be sure of what future values will be (nor can the owner in an annually declared fixed interest rate approach) the owner does know guaranteed minimum values in advance and can use these to compare to other products, as well as whether the guaranteed minimum values approximate his or her minimum needs. Measured against a variable product or a mutual fund product, the owner is in a very different posture due to the guaranteed minimum values.

In summary, regardless of the specific product features by which an insurance company balances its assets and liability for interest credit, the owner is guaranteed the return of principal and a minimum rate of credited interest regardless of the insurance company's investment management skills. The insurance company accepts the risk, for example, that the S&P 500 Index or the bond market will perform well enough, and/or the company will manage its hedges well enough, to eliminate the insurance company's need to provide the guaranteed values.

## **ANNUITIES MORE GENERALLY**

### **The Annuity Option**

Annuities protect a person against living too long. More specifically, annuities protect against the risk that someone will live so long that he or she will use up the assets that he or she has saved for retirement and not have enough assets to live on in the later years.

The insurance company guarantees that, if and when the owner chooses, the company will make payments to the owner for as long as the owner lives. So, annuities guarantee that a person cannot outlive all of his or her assets.

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## **Immediate and Deferred Annuities**

An owner of an *immediate* annuity can begin receiving income payments from the insurance company right after purchase. Generally, immediate annuities are purchased with sizeable initial or single premium payments, and frequently as a rollover from another source or retirement product.

An owner of a *deferred* annuity does not begin receiving income payments right away. Instead, the owner of a deferred annuity accumulates monies for a period of time and postpones or “defers” choosing whether to begin receiving income payments from the insurance company.

Deferred annuities offer accumulation benefits during a pay-in period and retirement benefits during a pay-out period.

During the *pay-in* period, owners make purchase payments to an insurance company. Owners generally have the option of making purchase payments when and in amounts they choose. Owners earn a rate of interest on their purchase payments and do not pay taxes on the interests until the owner withdraws money.

At retirement, the owner can take the accumulated money in either a lump-sum or a system of periodic payments for life or some other period of time.

During the *pay-out* period, the owner receives income payments from the insurance company. As under other fixed annuities, the dollar amount of the payments are specified and, unlike variable annuities, do not vary up and down in dollar amount. As under other annuities, owners have the flexibility of receiving these income payments for various periods, such as life, life of the owner and spouse and a specified number of years.

## **Benefits Under Annuities**

There are basically two kinds of annuities – fixed and variable. The terms “fixed” and “variable” refer to the way contract values and benefits can change. FIPs have been referred to as a third kind of annuities. However, FIPs are fixed annuities that offer some indexed interest formula. All other features and guarantees are those of a fixed annuity.

## **Fixed Annuities**

Benefits under *fixed* annuities are the amount of purchase payments that the owner pays to an insurance company, plus interest. Fixed annuities differ, but essentially the interest rate that the insurance company credits is declared by the company in advance each year. The interest rate declared depends on many factors, including the minimum rate required by state insurance law and the rate that the insurance company expects to earn on the assets available to fund all of its liabilities.

“General account” is the term used in the insurance world to identify the insurance company’s assets that are not earmarked as funding any one set of contractual obligations. By contrast, assets supporting variable products are held in “separate accounts” that insulate those assets from the general claims of creditors and obligations under any other contracts issued by the insurance company.

So, under fixed annuities, the owner's rate of interest on accumulated premiums is fixed in the sense that the insurance company declares the rate in advance and the rate can never be negative. The life insurance company guarantees that the owner will receive the rate of interest declared. This means, from a value perspective, that the owner is not risking original principal. Interest once vested under the terms of the design cannot be taken away and owner principal value cannot drop or be invaded (surrender charges are a different issue and apply to all types of contracts, fixed or variable). The insurance company assumes the risk that it will be able to pay the owner the rate of declared interest *regardless* of the rate of return that the insurance company actually earns investing its assets. If the insurance company earns a lower rate of return than the rate of interest that it has promised to credit to the owner, the insurance company must make up the shortfall out of its own pocket. The owner, therefore, bears no investment risk as to the rate of interest that the insurance company promises to credit to the owner.

### **Fixed Indexed Annuities**

Fixed indexed annuities, as noted above, are fixed annuities that offer at least one indexed interest approach.

Benefits under fixed *indexed* annuities are linked to the amount of purchase payments that the owner pays to an insurance company, plus an amount derived from the performance of an independent index. Fixed indexed annuities offer an indexed interest strategy approach. As with all fixed annuities, the insurance company guarantees to credit the owner a minimum rate of interest. The insurance company undertakes to credit an additional, or "excess," rate of interest within any indexed interest approach. As in fixed interest approaches, all interest parameters are fixed in advance except for the index change which is external to and uncontrolled by the insurance company. In addition, as a second guarantee, the insurance company promises that, regardless of how the index performs, the company will credit a minimum specified rate of interest. In all cases, the interest rate credited can not be less than, but may be more than, the rate that applicable state insurance law requires.

So, under FIPs, the rate of interest credited to the owner on accumulated premiums derives from the investment performance of a specified index. The insurance company must guarantee a minimum rate of interest required by state insurance law and may guarantee some minimum excess rate of interest. But the insurance company guarantees that the owner will receive a rate of interest derived by a formula that references the specified index.

The nature of FIPs as a kind of fixed annuity is apparent. Under FIPs, as under other fixed annuities, the insurance company assumes the risk that it will be able to credit to the owner a specified rate of interest *regardless* of the rate of return that the insurance company actually earns investing its assets. If the insurance company earns a lower rate of return than it has promised to credit to the owner, the company must make up the shortfall from its own general account. Therefore, under FIPs, as under other fixed annuities, the owner bears no investment risk as to the rate of interest that the insurance company promises to credit to the owner.

## **Variable Annuities**

Under *variable* annuities, benefits are linked to the amount of purchase payments that the owner pays to an insurance company adjusted to reflect a direct participation in underlying investments managed by the insurance company or outsourced to third party managers. The value of benefits in most variable annuities varies up and down with the investment performance of a pool of assets. The rate of earnings depends on the management of the assets by the insurance company or a third party manager.

So, under variable annuities, the owner's rate of return on accumulated premiums varies up and down with investment performance. The insurance company shifts to the owner most of the risk as to the rate of return to be earned. The owner, therefore, bears the risk of what the rate of return will be.

Some variable annuities feature optional riders that provide some level of guarantees. These guarantees usually provide some minimum level of benefit that the insurance company must provide upon death, annuitization or withdrawal. However, the guarantees do not usually apply for surrender, generally have some restrictions in their election, and are optional. The presence of these features does not prevent variable annuities from being treated as securities due to their partial, restricted and optional nature. Should an owner not elect these riders or terminate them at any time, the owner will be exposed to the entire risk of investment.

## **Comparison of How Contract Values Change Under Annuities**

Under fixed annuities, including FIPs, state insurance law requires insurance companies to guarantee some minimum rate of interest. This guaranteed minimum rate of interest historically was at least 3%, but, under current state law, the rate can range from 1% to 3% as a function of the five-year constant maturity Treasury yield. Variable annuities do not have any state mandated minimum interest crediting rate or minimum guaranteed surrender value requirements.

Under fixed annuities the owner has assurance of earning a declared or specified minimum rate of interest, in other words, *some* rate of interest. Under variable annuities, the owner's rate of return is linked to the earnings realized on a pool of assets, and the owner has no assurance that the pool will experience a high, low or, indeed, any increase in investment performance. In fact, investment performance may result in a decrease of the assets and the benefits to which the owner is entitled or under some circumstances the lapse of the policies.

Under FIPs, the owner's rate of excess interest is calculated by reference to an index, and the owner has no assurance that the index will experience a high, low or, indeed, any increase in investment performance. When the index increases, depending on how the interest formula is calculated, there may be high, low or no interest credited. If the index experiences no increase or drops, depending on how the interest formula is calculated, there may be high, low or no interest credited. But, in either case, interest credited is no less than 0%, thus never invading previously credited interest. Moreover, the owner receives a minimum rate of interest sometimes expressed as a guaranteed minimum surrender value equal to premium payment accumulated at the specified

guaranteed rate of interest. It is this secondary guarantee of minimum value and benefits that clearly distinguishes FIPs from variable annuities.

So, under fixed annuities, the owner has assurance of earning *some* rate of interest. But, under variable annuities the owner has no assurance of earning *any* rate of return and generally is not protected against losses and lapse of the contract.

### **Suitability of Fixed Indexed Insurance Products**

Any financial product – whether issued by an insurance company, bank, mutual fund or other financial service company – should fit the particular needs of the person buying it. Like other financial products, FIPs meet the needs of many, but not all, people at all times. And like other financial products, FIPs are suitable for a person depending on the circumstances of that individual.

FIPs, for example, like most insurance retirement products are designed for persons in a position to hold the products for a number of years. Accordingly, FIPs may not be suitable for persons, regardless of age, who could not be expected to keep their products for the long term, or are looking for a product that will produce a stream of income in the near future. This is because surrender in the short term could be subject to surrender charges and tax consequences that could decrease the dollar value of benefits otherwise available. However, many contracts mitigate the apparent disadvantage of pairing an owner’s short-time horizon with a long-term surrender charge by waiving charges on death or upon annuitization. Thus, while seniors as a class of investors are thought of as requiring a stream of income, any person, including seniors, may be purchasing the annuity for accumulation purposes and any individual senior may not have all of his or her assets tied up producing an income stream.

At the same time, FIPs can be suitable for many persons who can use the unique combination of insurance and investment features that FIPs offer. FIPs can be a useful retirement planning tool for unsophisticated purchasers and even seniors who, probably more than others, cannot risk losing their principal and need some predictable guarantee of increases. The minimum guarantee results in a predictable asset to fund the future liabilities of a person’s retirement years. Assuming the insurance company is financially stable, a minimum dollar value is guaranteed. This floor is coupled with the upside potential of additional credited interest based on increases in an index.

### **QUESTIONS RAISED ABOUT FIXED INDEXED PRODUCTS**

As discussed above, journalists, financial advisers, competitors, academicians, regulators and others are seeking to learn about FIPs indexed insurance products and educating the public about them. This process has developed some misconceptions and mischaracterizations addressed below.

## Annuitization

If the annuity option is an important feature, why don't all owners elect to receive annuity payments?

Because of the insurance nature of the annuity option, annuities provide for what amounts to a trade-off. When an owner chooses to receive the *certainty* of annuity payments for life, the owner must generally give up the *flexibility* of withdrawing accumulated money that is available during the accumulation or pay-in period.

Owners may prefer to keep this flexibility, especially where their annuities permit them to withdraw accumulated money as the result of other features. For example, many annuities – including indexed annuities – allow the owner to withdraw, *without charge*: 10% of the accumulated value each year, interest earned (as distinguished from principal), or amounts in the event of disability, nursing home confinement or terminal illness. Index annuities are also exploring the addition of optional income payout benefits to the available riders.

## Category

Are fixed indexed annuities a third kind of annuity in addition to fixed and variable annuities?

No. Fixed indexed annuities are not a third kind of annuity. Fixed indexed annuities are a type of fixed annuities. Fixed annuities have merely evolved from their traditional approach of crediting interest to approaches that credit interest derived by reference to an index.

During the accumulation or pay-in period, the insurance company, under fixed indexed annuities and other fixed annuities, guarantees to pay a declared or indexed rate of interest. In all cases, there is a minimum guaranteed rate below which the declared rate may not fall. This guaranteed rate applies if the indexed rate yielded by the applicable indexes is less than the guaranteed rate. The insurance company bears the investment risk that the company will earn enough investing its assets to pay that rate or else make up the shortfall out of its own pocket. The insurance company makes no such guarantee under variable annuities.

During the annuity or pay-out period, the insurance company, under FIPs and other fixed annuities, guarantees to pay a dollar amount of annuity payment that is set in advance and remains the same during the pay-out period. The insurance company bears the investment risk that the company will earn enough investing its assets to pay that dollar amount of annuity payments or else make up the shortfall out of its general account. The insurance company makes no such guarantee under variable annuities.

## Spread

If a financial index earns 9% and the owner's interest rate under a fixed indexed annuity is 7%, does the insurance company pocket the 2% difference?

The insurance company does not pocket the difference between 9% and 7%.

This is because the insurance company does not invest its assets in the financial instruments making up the financial index. Instead, the insurance company invests its assets in bonds and other financial instruments and engages in hedging techniques that may or may not be effective.

As a result, it is conceivable, but unlikely that the insurance company could happen to earn a rate of return equal to that of the index, but this would in fact be evidence of poorly constructed hedging.

### **Alternative**

Is a person better off if he or she forgoes a fixed indexed annuity to buy a zero coupon bond, plus an indexed mutual fund?

The features and benefits of a fixed indexed annuity have a very different profile from this proposed alternative. A fixed indexed annuity differs dramatically in the areas of guarantees, preservation of principal, insurance benefits, taxation and liquidity.

The zero coupon bond plus mutual fund alternative is a do-it-yourself approach. It may yield a higher ultimate return, though there is no ultimate guarantee of that. Both instruments are subject to current taxation with no cash flow to assist the owner in paying those taxes. Zero coupon corporate bonds are subject to default risk, jeopardizing a client's potential retirement income. Indexed mutual fund values are subject to significant swings in value, but so are zero coupon bonds, perhaps even more so. While both instruments are liquid in the sense they can probably be sold quickly and sooner than the term they are structured for, they could result in significant losses because there is no guaranteed minimum value.

Some studies have purported to show that the owner theoretically could receive a higher rate of return if the owner holds the assets to bond maturity. However, the owner would not have either a death benefit or emergency partial liquidation rights without loss of value, as the owner would have under a fixed indexed annuity. In addition, the owner would be liable to pay income taxes every year where the zero coupon bond provides no cash flow to help cover the taxes due. This would not be the case with a fixed indexed annuity.

Fixed annuities may have one of the most extensive sets of guarantees and liquidity features of any financial instrument today, such as minimum interest guarantees, adjustment guarantees, and full value liquidation benefits on death, annuitization, 10% withdrawal, required minimum distribution, terminal illness, and nursing care.

### **Surrender Charges**

If purchase payments are considered to be the owner's assets, why does an insurance company charge the owner for withdrawing those assets?

Insurance companies – like other financial service companies – incur costs that must be recovered for developing, administering and marketing annuities, especially at the outset and during the early years. In addition, they must effectively match assets and liabilities. They cannot use long-

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term, higher yielding bonds to back a low or no surrender charge annuity, which would be a very short-term liability.

If the owner holds an annuity for the longer term, the insurance company stands to recover those costs through charges imposed over the life of the annuity. If the owner withdraws or surrenders an annuity during the first several years, the insurance company cannot earn sufficient returns under the annuity to cover those costs. The insurance company could price the annuity in a manner that permitted rapid recoupment. However, the only source would be by reducing the benefits to all owners and not just those that surrender. So, surrender charges enable insurance companies to help recoup their up-front costs and impose those costs on the persons who would otherwise not bear their fair portion. Should a large percentage of owners elect to surrender their annuities early due to lack of surrender charges, the insurance company's solvency could be jeopardized.

## **REGULATION OF FIXED INDEXED INSURANCE PRODUCTS**

### **General**

It is a fact of business life that financial products – including stocks, bonds, money market instruments, mutual fund shares, bank products and many other instruments – are regulated by state authorities, federal authorities or both.

Insurance products have traditionally been regulated by state insurance authorities. However, life insurance products that transfer a substantial investment risk to investors are regulated by federal, as well as state, authorities.

Insurance products regulated by both state and federal authorities include principally variable annuities and variable life insurance. Certain guaranteed interest contracts are also regulated by both state and federal authorities. Fixed indexed products are regulated by state authorities, but, with a handful of exceptions, are not regulated by federal authorities.

### **State Regulation**

Fixed indexed products are regulated by state insurance authorities under state insurance laws.

Insurance laws vary from state to state, but generally involve review and clearance of indexed products themselves and oversight of advertising and other aspects of marketing the products.

Insurance laws also provide for various protections designed to assure that insurance companies remain in a financial position to make good on their promises to pay benefits under indexed products. These protections, for example, require insurance companies to maintain dollar amounts of reserves, keep books and records, file periodic financial reports, cooperate in inspections and examinations, and, under certain circumstances, make product owners whole.

The National Association of Insurance Commissioners – “NAIC” for short – is an organization of state insurance authorities. NAIC provides a means for the insurance authorities from all of the

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states to discuss common regulatory issues and develop model laws and regulations that individual states can then adopt.

The NAIC is currently focusing on FIPs. In addition, the states of Iowa and Minnesota are the domiciliary states for the vast majority of insurance companies issuing the bulk of FIPs. Those states have come together to address the major regulatory issues affecting FIPs and their representatives have articulated their confidence in providing the full extent of necessary regulation.

### **Federal Regulation**

The SEC regulates life insurance products that are subject to federal regulation. These regulated products include principally variable annuities and variable life insurance. These regulated products also include some guaranteed interest contracts and FIPs where surrender features or marketing methods makes the insurance status of the products unclear.

The SEC regulates variable annuities and variable life insurance as a result of the following. Purchase payments and earnings under these products are invested, usually through separate accounts of life insurance companies, in funds of stocks, bonds or money market instruments. Benefits under the variable annuities and variable life insurance vary up and down in dollar value with the increases and decreases in the investment performance of these stocks, bonds or money market instruments. Owners bear the investment risk that the value of their benefits will decrease rather than increase under management of their money through the insurance companies. The federal securities laws apply to protect owners in light of this investment risk.

FIPs, very generally speaking, resemble variable annuities and variable life insurance to the extent that they offer benefits that can increase or decrease in dollar amount. However, FIPs differ significantly from variable annuities and variable life insurance with regard to transferring investment risk to owners. Under FIPs, investor benefits increase in varying amounts, but not based upon the investment performance of pools of money managed by insurance companies, but with indexes maintained by entities other than insurance companies. In other words, under FIPs, insurance companies do not manage the owners' money. Instead, insurance companies promise to pay owners dollar amounts of benefits derived from any positive changes in indexes wholly beyond the influence and control of the companies.

The SEC has examined FIPs and has not required that they be regulated under the federal securities laws. Of course, the SEC may take action in the future based on further experience with differing forms of FIPs.

A very few insurance companies have registered their FIPs with the SEC. Very generally speaking, these insurance companies have designed their registered FIPs to be sold as securities. The FIPs have design features or marketing methods that make the products more like securities or that make the insurance status of the products highly uncertain.

## Supreme Court

The background of SEC regulation of some insurance company products is as follows.

The U.S. Supreme Court has determined that certain life insurance products (“products”) can have investment elements, in addition to insurance elements, that make the products subject to SEC regulation under the federal securities laws.

The Supreme Court made its determination in two cases involving variable annuities in 1959 and 1967. The SEC and other courts have relied on the Supreme Court determinations in assessing the status of other life insurance products, such as variable life insurance, under the federal securities laws.

The Supreme Court, in a nutshell, said as follows. Whether or not a product is a security under the federal securities laws is a federal question for federal courts and agencies to decide. The decision depends on a handful of factors, with the assumption of *investment risk* being the most important factor. If the product results in the insurance company’s assuming a meaningful investment risk, the product is insurance. Conversely, if the product results in the insurance company’s shifting a meaningful investment risk to the owner, the product is a security.

The Supreme Court said that an insurance company assumes a meaningful investment risk by making payout guarantees in the form of promised floors under benefits. The greater the guarantees and the higher the promised floors, the better the chance that the product is insurance. Conversely, the lesser the guarantees and the lower the promised floors, the better the chance that the product shifts the investment risk from the insurance company to the owner and, therefore, is a security.

Virtually all life insurance products include both insurance and investment elements. This is basically because insurance companies must collect and invest premiums in the early years in order to be in a position to meet its guarantees in later years. But the mix of insurance and investment elements – that is, the mix of guarantees and the absence of guarantees – varies among companies, products and product designs.

The Supreme Court did not lay down a clear-cut way for determining what mix of insurance and investment elements constitutes insurance and what mix constitutes a security. More specifically, the Supreme Court did not lay down a numerical or other objective test for determining whether or not a particular product results in the insurance company’s or owner’s assuming a meaningful investment risk. The Supreme Court’s test is more *qualitative* than *quantitative*. Consequently, courts and the SEC have often struggled to assess the status of other life insurance products under the Supreme Court’s test.

## APPENDIX

### CREDITING INTEREST UNDER FIPs

#### General

The distinguishing feature of FIPs is that the owner earns a rate of interest derived by reference to an index.

The index is solely a *benchmark* or a *measuring stick* for the interest rate that the insurance company credits to the owner. The owner, in no way, “participates” in the performance of the index or in the performance of a specified group of stocks, bonds or other financial instruments in the market that the financial index measures. The index is a reference point, outside the control of an insurance company, that provides an objective standard from which an insurance company can derive an interest rate to be credited to an owner.

The insurance company derives the interest rate to be credited to an owner by using the index performance as a *starting point*, *not* the final result. The insurance company does not necessarily credit an interest rate equal to the index performance. Instead, the insurance company derives an interest rate to be credited with reference to the index performance and to other factors in accordance with the terms of the FIP.

These factors include:

- what is the period of the interest credit?
- what index is used?
- how are index value percentage changes calculated?
- what adjustments are made to the index value percentage changes?
- when and for what benefits is the indexed interest applied?

#### Period of the Interest Credit

The period or “term” of the interest credit establishes the point at which interest will be credited to the owner. The most common term today is one year. Since interest is typically credited on not only purchase payments but past interest earned, these interest credits “compound,” *i.e.*, interest is earned on prior credited interest. The credits “lock in” and cannot be lost. This is often referred to as “ratcheting.” In contracts with periodic ratcheting, future interest cannot be negative, and contract values cannot decrease due to interest credits.

Some FIPs have multi-year terms for interest crediting, ranging from two years to the entire surrender charge period. Those products with terms up to three years (including annual terms) usually have no provision for any interim interest credit. Only monies in the contract for the entire term receives indexed interest at the end of the term.

FIPs with terms over three years usually make some provision for an interim interest calculation should a benefit calculation be necessary (upon annuitization, death, surrender or withdrawal). Sometimes this will take the form of a calculation from “inception to date of benefit,” using the index on date of calculation of benefit rather than the end of term index which would not be available at that point. In other contracts, the highest of a calculation done on every prior anniversary is used (often called a “high water” calculation). This requires a calculation on every anniversary of total interest to date in order to determine which is the highest. The provision for interim interest in longer-term, multi-year interest crediting formulas makes the interest crediting term flexible depending on the need for a benefit calculation, including interest, upon surrender, withdrawal, death or annuitization.

One recent approach to indexing creates variable length crediting terms. This approach is a form of the Triggered Indexed Value Percentage Change. When a certain level of increase in the index value occurs, it triggers an interest credit and the beginning of a new term of interest crediting.

### **Financial Index**

An index reflects the investment performance of a specified group of stocks, bonds or other financial instruments in a market or a segment of the market. Most indexed products specify the S&P 500 Composite Stock Price Index, which does not reflect dividends (the “S&P 500 Index”). That index is popular because it is widely recognized by the public and reflects the investment performance of the stock of 500 companies that Standard & Poor’s Inc. has selected as representing a broad segment of the stock market. Some FIPs specify only one index, but others permit an owner to choose among several approaches and reallocate among strategies at the end of interest credit terms.

Approximately a dozen other indexes are used by insurance companies today in their FIPs. However, the future variety seems limited only by:

- the ability of a company to find appropriate hedges, as explained below,
- the ability of a company to develop the volume of purchases to make it cost-effective
- and market acceptance of the index.

Other indexes used in products today include equity indexes such as the Dow Jones 30 Industrials, the NASDAQ 100, and Russell 2000. Indexes do not have to be based on groups of equity instruments. A few products have used interest crediting formulas linked to Treasury Bills interest rates and published and independently maintained bond indexes.

### **Indexed Value Percentage Change**

There are a variety of methods of determining the percentage change. The term of the interest credit is usually annual but may be any number of years. In this section, the Indexed Value Percentage Change is abbreviated as IVPC.

- Point to Point – percentage change of starting index value to end of term index value. For example, if starting index is 1000 and ending index is 1200, then IVPC is 20%.
- Point to Final Average, - percentage change of starting index value to average of a series of index values. This approach can be used in a one year interest crediting term, e.g., starting point to final 3 month average at the end of the year. For example, if the interest crediting term begins January 2 with an index of 1000, and the average of index values on November 2, December 2 and the following January 2 is 1100, then the IVPC is 10%. This approach tends to reduce the volatility of the IVPC due to the averaging. This approach is more common in multi year crediting, where much more ultimate interest is dependent on a final series of index values, e.g., final six month average over a five year crediting term.
- Averaging – percentage change of starting index value to the average of an evenly spaced series of index values. This approach is most commonly manifested in a point to 12 month average over a one year term. For example, if the crediting term begins January 2 with an index of 1000, and the average of index values on the 2<sup>nd</sup> of every month for the next 12 months is 1100, then IVPC is 10%. This approach tends to reduce volatility of IVPC even more than Point to Final Average, and presents a greater potential for significant positive index changes at any point or points to be more than offset by negative index changes at other points.
- Additive Serial Point to Point (sometimes referred to as monthly point to point) - percentage change of a starting index value to the sum of a periodic series of index changes, usually with positive changes capped at a maximum. Negative changes are not adjusted or floored. This approach is used in interest crediting periods of one to three years and the frequency of the period is monthly. This method is somewhat unusual in that the adjustment is applied *within* the IVPC calculation rather than *after*. A quarterly example is shorter and simpler. Assuming the crediting term begins January 2 at an index value of 1000 and the declared quarterly cap for the year is 5% and the index values result in a series of quarterly percentage increases and monthly capped percentage increases as follows:

| Date    | Index Value | Percentage increase | Capped              |
|---------|-------------|---------------------|---------------------|
|         |             |                     | Percentage Increase |
| Jan – 2 | 1000.00     |                     |                     |
| Apr – 2 | 1050.00     | 5.00%               | 5.00%               |
| Jul – 2 | 1155.00     | 10.00               | 5.00                |
| Oct – 2 | 1212.75     | 5.00                | 5.00                |
| Jan – 2 | 1139.99     | -6.00               | -6.00               |
|         |             |                     | Sum 9.00%           |

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- High Water – percentage change of starting index value to the highest of a periodic series of index values. This approach is almost always used over multiple years with the high water period being annual. For example, assume a 10 year Point to Point interest term begins January 2 with an index value of 1000. On January 2, five years later, the index value is 1100, however, the highest index value of the last five years was 1400. The IVPC is 40%.
- Low Water, – percentage change of the lowest of a periodic series of index values to the end of term index value. This approach is rare, but usually used for a one year interest term. For example, assume a one year Point to Point interest term begins January 2 with an index value of 1100 and one year later on January 2, the index value is 1200. If the lowest index value of the beginning January 2 index value and the next 11 month’s index values through December 2 is 1000, then the IVPC is 20%.
- Binary or Triggered – a version of Point to Point where a specified interest percentage is credited only if the Point to Point Index Value Percentage Change is achieved (usually 0%). For example, assume an interest term begins January 2 with an index value of 1000, the trigger point is 0% increase and the specified interest rate is 6%. The index value one year later is 1100. Because the index value increased by greater than equal to 0%, the IVPC is 6%.

Indexed interest approaches use various methods of determining what index value is used for any particular date. For example, some insurance companies use the first available index value after the policy anniversary if there is not one available, because the date is a holiday or non-market day.

At the end of a term, a credit is made. Therefore, most products start anew with an interest crediting term of the same length. For example, if a product has an annual term and the ending index value of the prior term becomes the beginning value of the next term, the product is said to be an “annual reset” calculation, because the beginning index value is reset at the beginning of the next term to where the index finished in the last term.

### **Adjustments**

Nearly all fixed indexed annuities make provision for an adjustment factor to modify the index value percentage change. The purpose of the adjustment is to allow the insurance company to balance the amount that it has available to spend for an interest credit with whatever it costs the insurance company to provide the index percentage change method.

For example, if an insurance company would normally credit a fixed interest rate of 4% per year, this roughly becomes the budget for purchasing or constructing a financial hedge which will provide the interest credit promised in the policy, regardless of what index changes occur. It will be rare that, say a hedge for a point to point strategy would cost the company exactly 4%. Perhaps it costs

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5%. The insurance company needs some way to provide the policyholder with an interest credit that costs the company only 4% to provide. The company must reduce the cost of the liability hedge to 4% while still providing interest under the basic method promised in the contract, subject to the risks inherent in virtually all hedging techniques.

**Floor or Minimum** –The first and nearly universal adjustment is a floor or minimum of 0% on the index value change percentage. This prevents a negative interest credit from ever occurring. It effectively locks in prior interest credits by keeping them from being invaded by a future negative credit. Indexed approaches with this feature are referred to as “ratchet” approaches, because policy values can go in only one direction (up) as a result of interest credits. A few products have a higher floor than 0%.

**Participation rate** – This term may be an unfortunate misnomer in that a fixed annuity cannot “participate” in any equity, market, or index. A FIP can only credit interest as declared or promised by the insurance company. A fixed annuity has no direct participation in any other investment. Regardless of how an insurance company hedges or assures itself of having funds available to provide the interest credit, it is guaranteed to be paid by the company. This method credits a percentage or proportion of the index value change percentage as interest. For example, an 80% participation rate applied to an index value change percentage of 10% will yield a credit of 8%. When interest rates are low or hedge costs are high, participation rates will usually be less than 100% and vice versa. Should the product allow the insurance company to change participation rates for future interest terms, they must state a minimum guaranteed level of participation rate, *e.g.*, 25%.

**Spread, Margin or Fee** – These are all terms for a deduction from the index value change percentage. For example if the spread is 2% and index value percentage change is 10%, then interest credit would be 8%. That is, the first 2% percent of the index value change percentage is not credited as interest. Most products have a zero floor. If the index value percentage change is 0%, and the index value percentage change is less than the spread, interest credit will be 0%, not negative. A few insurance companies have referred to these terms as administrative fees. However, this is a misnomer, because it makes this adjustment approach sound similar to fees for variable annuities or mutual funds, which they are not. These fees are not to pay for administrative or investment services rendered but rather, like all adjustments, to provide the company a “lever” to balance the hedging budget with the cost of hedging or reduce the risks inherent in hedging.

**Cap** – A cap adjustment is a maximum limit on the index value change percentage. For example, if the index value change percentage is 8% and the cap is 10%, then the interest credit is 8%. In no case would a credit for any interest term be higher than 10%, no matter what the index value change percentage is.

**Binary or Triggered Specified Rate** – The specified rate is the specific interest credit which will be paid if the trigger or hurdle IVPC is reached. For example, if the trigger is 0% and the IVPC is 10% and the specified rate is 6%, then the interest credit will be 6%.

Within a given index interest formula, any floor is always guaranteed for the life of the product. Similar to fixed interest rate strategies, the other adjustments for indexed strategies may be guaranteed for only one interest rate period or for multiple periods. Adjustments are always declared in advance for the interest credit term. Adjustments for subsequent interest terms, if not guaranteed are declared by the insurance company based on then current investment yields, required spreads and cost of hedging. The participation rate and caps must generally have a guaranteed minimum below which an insurance company may not reduce in subsequent interest terms. Margin adjustment must generally have a declared maximum above which an insurance company may not increase in subsequent interest terms.

### **Availability of Indexed Interest Credits for Benefits**

In most fixed annuities today, including most FIPs, interest credits are available for all benefits, including death benefits, surrenders, partial withdrawals and annuity payouts. There are several contract types under which interest credits are not immediately available.

**Not available for certain benefits** – Some products, often referred to as “two-tier,” never (or not for a long period of time) make the accumulated current interest credits (both declared rate and indexed rate) available for surrender or partial withdrawal. Guaranteed interest, of course, must be provided for these benefits.

**Available according to a guaranteed schedule over time** – A few products will calculate the interest credits according to the methods specified in the product, and they become available for inclusion in benefit payments pro-rata over a period of time. This is sometimes referred to as a “vesting schedule.”

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This White Paper was contributed to NAFA by Joan E. Boros, a Director and Gary O. Cohen of Jorden Burt LLP with the active participation of Michael Tripses, Chairman, and direction by the other members of NAFA's Board of Directors and Kim O'Brien, Executive Director. This White Paper does not necessarily reflect the views of all of the NAFA members.

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