

# Randy's Annuity Notebook



## Fixed Indexed Annuities

### Part 2: Mechanics of Fixed Indexed Annuities

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*This article assumes the reader has a general understanding of annuities and how they work.*

#### What is a fixed indexed annuity (FIA)?

A fixed indexed annuity is a fixed annuity that has an interest rate formula linked to an external index. The annuity owner chooses the interest crediting strategy for their annuity. And, depending on the chosen strategy, they will know exactly how the interest on their annuity will be calculated and the potential interest they may receive on the annuity for that year. Like a fixed annuity, the value of the underlying fixed indexed annuity can never decrease due to index performance.

Fixed indexed annuities have interest crediting strategies linked to market indexes. However, money in the actual fixed indexed account is not invested directly in the market, as is the case with variable annuities. Therefore, you should **never** state that a prospective buyer is making an investment when purchasing a fixed or fixed indexed annuity. The customer is simply purchasing a fixed or fixed indexed annuity for the purpose of accumulating or saving dollars for retirement with the option to turn those dollars into a future stream of income via annuity payments or withdrawals.

Fixed indexed annuities offer the following core benefits:

- Tax-deferred Interest
- Lifetime Income Options
- Taxation on Withdrawals Using “Last In, First Out” Method
- Minimum Guaranteed Returns
- Possibility of Avoiding Probate

There are three parties to an annuity contract: the producer, the customer, and the insurance company. The insurance company assumes all investment risk and financial obligation of the annuity. They are also responsible for performing maintenance on the contract and carrying out requests made by the policy owner. In the event of a death claim, the insurance company is also responsible for paying the claim upon receipt of the necessary claim paperwork.

The application process for a fixed indexed annuity is much like the process for other types of annuities. A licensed insurance professional completes the required application and accompanying forms with his or her client. He or she then submits the completed application to the insurance company with the initial premium or transfer paperwork. Upon receipt, the insurance company processes the application, issues the contract, and sends the contract to the insurance producer. The customer reviews the annuity contract for errors, and if none are found, accepts the policy.

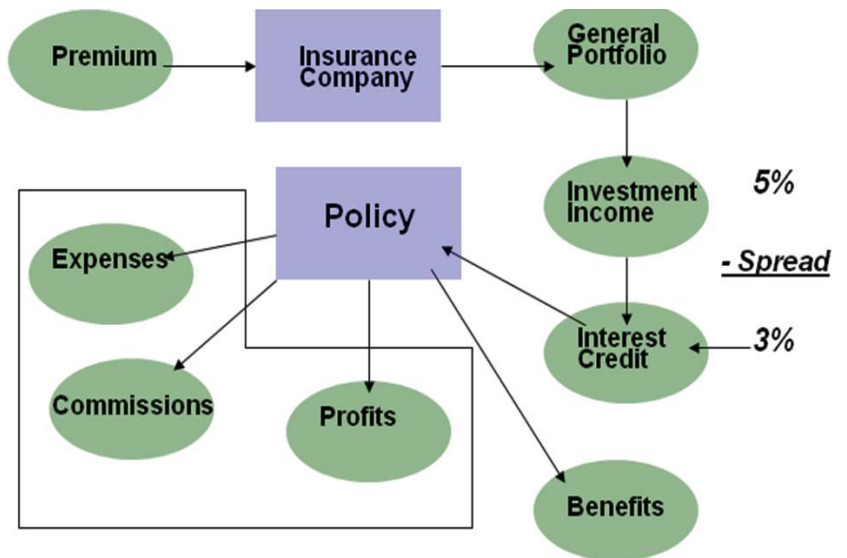
#### What happens when the insurance company receives the FIA contract?

Around the issue date of the policy, the insurance company invests the customer's premium and buys call options to cover the risk obligation created by the contract and premium allocation.

## Fixed Annuity Premium Flow

To the right is a diagram of a traditional fixed annuity demonstrating how the premium flows through an insurance company. The premium is deposited into the general portfolio of the company. Most companies put the majority of the dollars into bonds. The company then earns an interest coupon, or investment income, on these bonds for 10 years. In example below we'll assume a 10-year bond with a 5% interest on the investment income.

Each year the company uses dollars from their investment income to pay expenses, commissions, and to allocate a portion for their profit. To accomplish this, the company needs a hypothetical 2% spread and 3% to credit interest in the customer.

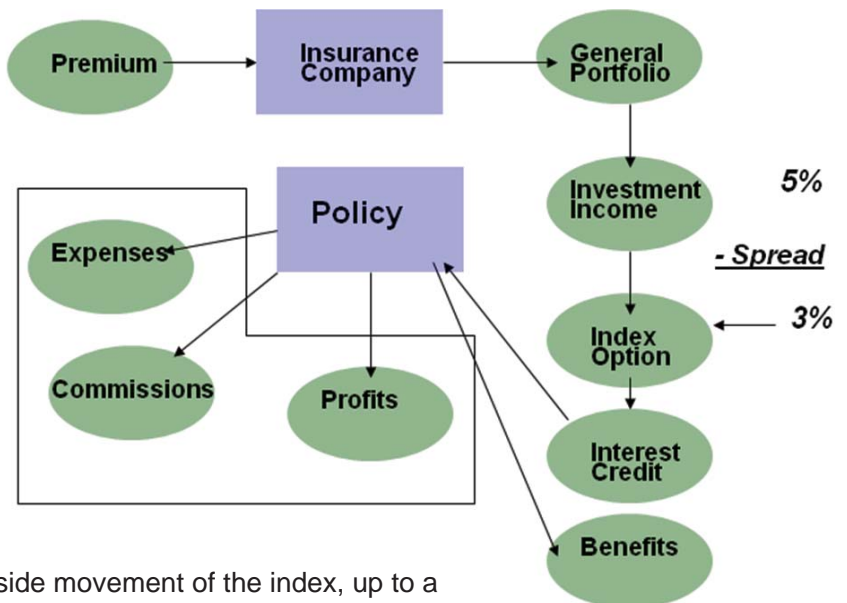


## Fixed Indexed Annuity Premium Flow

To the right is a diagram of a fixed indexed annuity. Everything is the same with a fixed indexed annuity except the company uses the 3% to buy a call option based on the selected index.

Each year, the insurance company uses a portion of the investment coupon from the bond to purchase the call option. The cost of the option can increase or decrease from year to year and because of this, companies reserve the right to adjust the crediting formula criteria each year.

For example, the policy might provide an interest crediting formula in the first year where the customer is credited interest based on the upside movement of the index, up to a 6% annual cap. In years when the index decreases the company doesn't receive any dollars from their call option purchase and the customer doesn't receive credited interest for that year. If the market goes up by 6% the company receives 6% from the call option and they credit the 6% interest to the customer. The policy may also provide some type of underlying minimum interest rate guarantee in addition to this crediting formula. The guarantee would come into use if the index formula didn't credit any interest over a period of years.



The annual dollar amount available to the company for the call option purchase is dependent on several factors including the amount of investment income available, interest rate levels, call option cost, market volatility, and the spread needed for the annuity product sold. Bonus products generally have a higher required profitability spread which results in a lower cap, higher spread on selected strategies, or lower participation rates.

### From the customer's perspective:

- The customer decides to purchase a fixed indexed annuity with an initial premium of \$100,000.
- The customer and producer discuss the different crediting strategies available and allocate 100% of the premium to the annual point-to-point index with cap.
- The customer is credited the full \$100,000 to their annuity.
- The customer does not bear any investment risk.

### From the insurance company's perspective:

- The company received \$100,000 from the customer along with instructions to allocate 100% of the premium to the annual point-to-point index with a cap strategy.
- Using hypothetical numbers, the insurance company (not the customer) invests approximately \$97,000 in its investment portfolio (primarily bonds).
- The company then spends \$3,000 to purchase call options to ensure they can pay upside interest credited on the premium allocated to the indexed strategies.
- The company credits the full \$100,000 to the customer's annuity.

### Why a fixed indexed annuity (FIA)? Because loss hurts.

Remember, with a fixed indexed annuity the customer gives up a guarantee of an annual declared interest rate to gain more potential. Let's look at an example I call, "loss hurts."

This example shows \$100,000 in a financial vehicle not protected from market loss. The value declines 15% in year one and the balance falls to \$85,000. In year two, the value declines another 12%, decreasing the balance to \$74,800.

If it earned 6% interest each year the customer would have over \$179,000 in 10 years. Because of just two years of loss this hypothetical account only has \$119,220 at the end of 10 years. These types of losses are especially troublesome for people close to retirement who may not have enough time to recover. Many customers are averse to a loss on the value of their retirement savings. A fixed indexed annuity is a strong alternative.

#### Loss Hurts

Year	Interest	Balance
1	-15%	\$85,000
2	-12%	\$74,800
3	6%	\$79,288
4	6%	\$84,045
5	6%	\$89,088
6	6%	\$94,433
7	6%	\$100,099
8	6%	\$106,105
9	6%	\$112,472
10	6%	\$119,220

Let's look at a fixed indexed annuity using the same example. The index was down in the first two years, the customer is credited with a zero interest for those years, but the \$100,000 balance remains stable. Since the value did not fall on the fixed indexed annuity at the end of 10 years the customer would still have over \$159,000 in the annuity, versus less than \$120,000 in an account that participates in market losses. The example of the fixed indexed annuity is to the right.

Power of a Fixed Indexed Annuity		
Year	Interest	Balance
1	0%	\$100,000
2	0%	\$100,000
3	6%	\$106,000
4	6%	\$112,360
5	6%	\$119,102
6	6%	\$126,248
7	6%	\$133,823
8	6%	\$141,852
9	6%	\$150,363
10	6%	\$159,385

Stay tuned for the next part 3 of this series, **Mechanics of Fixed Indexed Annuities**. In the next part we will discuss moving parts of Fixed Indexed Annuities. If you need help finding possible product solutions for your next client, please call us at Brokers International, Ltd. 1-800-362-1097

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