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- Equity-Indexed Annuities
- Tax-Deferred Annuities
- Fixed Annuity
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Equity-Indexed Annuities: A Complex Choice

Why an Alert on Equity-Indexed Annuities?

Sales of equity-indexed annuities (EIAs) have grown considerably in recent years. Although one insurance company at one time included the word “simple” in the name of their product, EIAs are anything but easy to understand. One of the most confusing features of an EIA is the method used to calculate the gain in the index to which the annuity is linked. To make matters worse, there is not one, but several different indexing methods. Because of the variety and complexity of the methods used to credit interest, investors will find it difficult to compare one EIA to another.

Before you buy an EIA, you should understand the various features of this investment and be prepared to ask your insurance agent, broker, financial planner, or other financial professional lots of questions about whether an EIA is right for you.

What Is an Annuity?

An annuity is a contract between you and an insurance company in which the company promises to make periodic payments to you, starting immediately or at some future time. If the payments are delayed to the future, you have a deferred annuity. If the payments start immediately, you have an immediate annuity. You buy the annuity either with a single payment or a series of payments called premiums.

i Information. Annuities come in two types: fixed and variable. With a fixed annuity, the insurance company guarantees both the rate of return and the payout. As its name implies, a variable annuity's rate of return is not stable, but varies with the stock, bond, and money market funds that you choose as investment options. There is no guarantee that you will earn any return on your investment and there is a risk that you will lose money. Unlike fixed contracts, variable annuities are securities registered with the Securities and Exchange Commission (SEC). To learn more about variable annuities, read our Investor Alert, *Should You Exchange Your Variable Annuity?*, www.finra.org/investor.

What Is an Equity-Indexed Annuity?

EIAs have characteristics of both fixed and variable annuities. Their return varies more than a fixed annuity, but not as much as a variable annuity. So EIAs give you more risk (but more potential return) than a fixed annuity but less risk (and less potential return) than a variable annuity.

EIAs offer a minimum guaranteed interest rate combined with an interest rate linked to a market index. Because of the guaranteed interest rate, EIAs have less market risk than variable annuities. EIAs also have the potential to earn returns better than traditional fixed annuities when the stock market is rising.

What Is the Guaranteed Minimum Return?

The guaranteed minimum return for an EIA is typically 90 percent of the premium paid at a 3 percent annual interest rate. More recently, in part because of changes to state insurance laws, the guaranteed minimum return is typically at least 87.5 percent of the premium paid at 1 to 3 percent interest.

However, if you surrender your EIA early, you may have to pay a significant surrender charge and a 10 percent tax penalty that will reduce or eliminate any return.

How good is this guarantee? Your guaranteed return is only as good as the insurance company that gives it. While it is not a common occurrence that a life insurance company is unable to meet its obligations, it happens. There are several private companies that rate an insurance company's financial strength. Information about these firms can be found on the Securities and Exchange Commission's website, www.sec.gov.

What Is a Market Index?


A market index tracks the performance of a specific group of stocks representing a particular segment of the market, or in some cases an entire market. For example, the S&P 500 Composite Stock Price Index is an index of 500 stocks intended to be representative of a broad segment of the market. There are indexes for almost every conceivable sector of the stock market.

Most EIAs are based on the S&P 500, but other indexes also are used. Some EIAs even allow investors to select one or more indexes.

How Is an EIA's Index-linked Interest Rate Computed?

The index-linked gain depends on the particular combination of indexing features that an EIA uses. The most common indexing features are listed below. To fully understand an EIA, make sure you not only understand each feature, but also how the features work together since these features can dramatically impact the return on your investment.

- ▶ **Participation Rates.** A participation rate determines how much of the gain in the index will be credited to the annuity. For example, the insurance company may set the participation rate at 80 percent, which means the annuity would only be credited with 80 percent of the gain experienced by the index.
- ▶ **Spread/Margin/Asset Fee.** Some EIAs use a spread, margin or asset fee in addition to, or instead of, a participation rate. This percentage will be subtracted from any gain in the index linked to the annuity. For example, if the index gained 10 percent and the spread/margin/asset fee is 3.5 percent, then the gain in the annuity would be only 6.5 percent.
- ▶ **Interest Rate Caps.** Some EIAs may put a cap or upper limit on your return. This cap rate is generally stated as a percentage. This is the maximum rate of interest the annuity will earn. For example, if the index linked to the annuity gained 10 percent and the cap rate was 8 percent, then the gain in the annuity would be 8 percent.

 **Caution!** Some EIAs allow the insurance company to change participation rates, cap rates, or spread/asset/margin fees either annually or at the start of the next contract term. If an insurance company subsequently lowers the participation rate or cap rate or increases the spread/asset/margin fees, this could adversely affect your return. Read your contract carefully to see if it allows the insurance company to change these features.

Indexing Methods

As described in the table below, there are several methods for determining the change in the relevant index over the period of the annuity. These varying methods impact the calculation of the amount of interest to be credited to the contract based on a change in the index.

Indexing Method	Description
Annual Reset (Ratchet)	<p>Compares the change in the index from the beginning to the end of each year. Any declines are ignored.</p> <p>Advantage: Your gain is “locked in” each year.</p> <p>Disadvantage: Can be combined with other features, such as lower cap rates and participation rates that will limit the amount of interest you might gain each year.</p>
High Water Mark	<p>Looks at the index value at various points during the contract, usually annual anniversaries. It then takes the highest of these values and compares it to the index level at the start of the term.</p> <p>Advantage: May credit you with more interest than other indexing methods and protect against declines in the index.</p> <p>Disadvantage: Because interest is not credited until the end of the term, you may not receive any index-link gain if you surrender your EIA early. It can also be combined with other features, such as lower cap rates and participation rates that will limit the amount of interest you might gain each year.</p>
Point-to-Point	<p>Compares the change in the index at two discrete points in time, such as the beginning and ending dates of the contract term.</p> <p>Advantage: May be combined with other features, such as higher cap and participation rates, that may credit you with more interest.</p> <p>Disadvantage: Relies on single point in time to calculate interest. Therefore, even if the index that your annuity is linked to is going up throughout the term of your investment, part or all of the gain can be lost if the index declines dramatically on the last day of the term. Because interest is not credited until the end of the term, you may not receive any index-link gain if you surrender your EIA early.</p>

- **Index Averaging.** Some EIAs average an index’s value either daily or monthly rather than using the actual value of the index on a specified date. Averaging may reduce the amount of index-linked interest you earn.
- **Interest Calculation.** The way that an insurance company calculates interest earned during the term of an EIA can make a big difference in the amount of money you will earn. Some EIAs pay simple interest during the term of the annuity. Because there is no compounding of interest, your return will be lower.
- **Exclusion of Dividends.** Most EIAs only count equity index gains from market price changes, excluding any gains from dividends. Since you’re not earning dividends, you won’t earn as much as if you invested directly in the market.

Can I Get My Money When I Need It?

EIAs are long-term investments. Getting out early may mean taking a loss. Many EIAs have surrender charges. The surrender charge can be a percentage of the amount withdrawn or a reduction in the interest rate credited to the EIA.

Also, any withdrawals from tax-deferred annuities before you reach the age of 59½ are generally subject to a 10 percent tax penalty in addition to any gain being taxed as ordinary income.

Do EIAs and Other Tax-deferred Annuities Provide the Same Advantages as 401(k)s and Other Before-tax Retirement Plans?

No, 401(k) plans and other before-tax retirement savings plans not only allow you to defer taxes on income and investment gains, but your contributions reduce your current taxable income. That's why most investors should consider an EIA and other annuity products only after they make the maximum contribution to their 401(k) and other before-tax retirement plans. To learn more about 401(k)s, please read *Smart 401(k) Investing* available at www.finra.org.

Is It Possible to Lose Money In an EIA?

Yes. Many insurance companies only guarantee that you'll receive 87.5 percent of the premiums you paid, plus 1 to 3 percent interest. Therefore, if you don't receive any index-linked interest, you could lose money on your investment. One way that you could not receive any index-linked interest is if the index linked to your annuity declines. The other way you may not receive any index-linked interest is if you surrender your EIA before maturity. Some insurance companies will not credit you with index-linked interest when you surrender your annuity early.

If You Have Questions

If you have questions about EIAs, you can contact your state insurance commissioner at www.naic.org. You can check out whether the person selling an EIA is registered with FINRA. Check FINRA BrokerCheck online at www.finra.org/brokercheck or call our Hotline at (800) 289-9999.

More Information

For additional information, the following resources are available at www.finra.org:

- Investor Alert: *Variable Annuities: Beyond the Hard Sell*
- Investor Alert: *Should You Exchange Your Variable Annuity?*
- *Notice to Members 05-50, Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities*
- National Association of Insurance Commissioners' *Buyer's Guide to Equity-Indexed Annuities*
- Securities and Exchange Commission's *Variable Annuities: What You Should Know*

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