FACTS ABOUT ANNUITIES

How Will I Get Income from My Annuity?

Annuity product innovations offer a variety of ways to receive guaranteed income, including through withdrawal benefits, income riders also known as guaranteed lifetime withdrawal benefits (GLWBs) or guaranteed lifetime income benefits (GLIBs), and annuitization. These options provide retirees a specific amount of guaranteed income while ensuring flexibility and control over their retirement savings.

Annuitization

Traditional income payout options from annuities include guaranteed income for life, guaranteed income for a specified period, or a combination of a lifetime payout with a period certain. These options are typically referred to by the industry as “annuitization.” Annuitization is available in both immediate annuities (also called payout or income annuities) as well as deferred annuities. Once an annuity owner chooses to annuitize, he or she will receive the selected income stream guaranteed. Given that inflation is a concern for many individuals planning for retirement, some annuities offer features that hedge against inflation making their guaranteed income payouts worth less in the future. These inflation adjustment features may be based on the Consumer Price Index (CPI-U) or other inflation measurement indices. Here is a typical list of annuitization options available on immediate and deferred annuities:

- **Life Option**
  The life option typically provides an income stream for life, which can help protect the annuity owner from outliving income in retirement.
- **Joint-Life Option**
  This commonly selected option allows the surviving spouse to continue receiving income payments when the annuity owner dies. The monthly payment is lower than that of the life option because the calculation is based on the life expectancy of both the annuity owner and spouse.
- **Period Certain**
  With this option the value of the annuity is paid out over a defined period of time that the owner chooses such as 10, 15 or 20 years. If a 15-year period certain payout is selected and the annuitant dies at any time during those 15 years, then all remaining payments through the end of the fifteenth year would be paid to the beneficiary.

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

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

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

- **Electing Not to Take Payments**
  With deferred fixed annuities, an owner is not required to take payments unless he or she so chooses. This is beneficial in that the retiree doesn't need to make any payout decision until and if income is needed.

Income Riders

Income riders have become one of the most popular benefits ever added to fixed deferred annuities. NAFA members are reporting more than 50 percent of people who purchase fixed deferred annuities also elect to add an income rider. These income riders are also commonly referred to as guaranteed lifetime withdrawal benefits (GLWBs) or guaranteed lifetime income benefits (GLIBs).

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

An income rider on a fixed or fixed indexed annuity allows the owner to build a secure retirement income. The payout provided by the income rider is then guaranteed by the issuing insurance carrier for the life of the annuity owner. The issuing insurance carrier bears all of the investment and longevity risk on the guaranteed payout, which means that the consumer is completely protected from these risks.

Some annuity carriers even provide for the income to substantially increase in the event that the annuity owner becomes confined to a nursing home, further sheltering the owner from risk. In addition, the customer retains access to the annuity's remaining value while continuing to reap the benefits of interest credited to the annuity's value.

How Income Riders Work

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

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

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

How Income Riders Work – At a Glance

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

Withdrawal Benefits

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

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

Liquidity Available under an Annuity

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

- **Terminal Illness Rider**
  This feature is a special form of penalty-free partial withdrawal. To qualify, the annuity owner must be diagnosed by a doctor as terminally ill (death expected within one year) after the first policy year. Upon qualification, the owner may usually elect a penalty-free withdrawal of up to 75% or 100% of the account value.

Tradeoffs of Income Choices

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

  The first tradeoff for the guarantee that one cannot outlive his or her savings is that the owner may not change the election. Therefore, if the retiree needs more money for unexpected expenses, he or she may not access the money chosen to be annuitized. Note: The insurance industry has recognized and solved for this need with GLWB income riders mentioned previously. In addition, many annuities do not owe the beneficiary any remaining value when the annuity owner dies. Consumers who would like a payout of the remaining value to beneficiaries need only select from the products that offer this benefit and, in exchange for the benefit, accept a lower income stream than they would have received otherwise.

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

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