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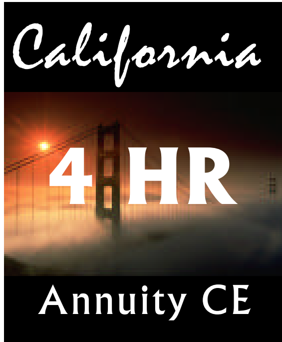


PART I: ANNUITY MARKETS

A COMPLEX WORLD

There are many market segments buying annuities. For the most part, however, you will be dealing with seniors and baby boomers. It is important that you keep in mind that the life of these mature citizens today is far more complex then they ever dreamed it could be. In their younger years, for example, the common thinking about insurance was . . . buy a whole life insurance to cover burial costs and/or to build a small pot of money down the road. People started with a vanilla whole life policy and paid on it forever. Issues like long term care coverage never existed (families took care of their own) and annuities had limited application. Conversely, mature generations today live with substantially higher exposure -- a response to more lawsuits, higher mortgages, escalating hospital bills and the prospect of living a lot longer than their parents.

These factors and more have created the need for specialized products and strategies, including annuities. Ideas are coming fast and furious. It is your job as a concerned and ethical agent to unwind this complexity and make your product suggestions crystal clear. Above all, you must share the downside potential present in any financial product . . . especially where you are replacing an existing product. Only then can a mature client make an informed decision.

THE MATURE MARKET CONTINUUM

Before you can inform your market, you need to understand them -- you need to understand their continuum. A continuum is something with a continuous structure. Your life is a continuum of events from going to school, to graduating college, to getting married, to getting your insurance license, etc. It is a structure that is constantly changing, yet continuous until you die. Top agents recognize that there is also a ***client continuum*** within which their clients progress through life and lifestyle changes.

Example: You've been helping Doctor Smith with his disability insurance needs for 10 years. As he nears retirement you suggest the idea of phasing out of his disability program and using the same funds to buy a long term care policy. The continuum changes from income replacement needs to coverage for long term care or a lifetime income.

Example: Mrs. Doubtfire is a long-time client. When her husband Elmer was still alive, you helped them with their life insurance needs and a small equity-indexed annuity. Now that Elmer is gone, Mrs. Doubtfire is on a fixed income with little liquidity. Your analysis of her suitability determines that she is not a candidate for any further annuity investments.

As you can see, the client continuum is in a constant flux as it responds to new terms, coverage limitations, underwriting changes, medical breakthroughs and other market-driven demands. Sometimes, agents who have been in the business for many years fall into the trap of failing to hone their skills to keep up with the times. Stay focused and

"tune in" to current events. Use this knowledge to provide "cutting edge" service and products to responsibly meet changing client demands.

SELLING TO SENIORS

When it comes to seniors, the complexity of insurance and annuities takes on new meaning where a ***senior's judgement and mental competence*** is often reduced or impaired. ***Symptoms*** you should be aware of include problems remembering recent events, difficulty in following simple directions, confusion, personality changes, difficulty in finding words or finishing thoughts, disorientation of time and place, inappropriate dress or hygiene, etc.

Recognition of these signs could mean the person you are dealing with does not have the capacity to make an informed and reasonable decision about his financial well-being. It would be ethically wrong to sell to this person.

In California, there could also be legal implications since a person entirely without understanding has no power to make a contract of any kind. Further, any contract made is subject to rescission. ***(Civil Code 38 and 39)***

ETHICS, COMPLIANCE & AGENT LIABILITY

It is predicted that some of the most highly litigated products in the insurance industry will those sold to seniors and other mature markets. Why? Perhaps some unethical agents are drawn toward policies sold to the elderly because they are often vulnerable to scare tactics and pressure pitches. Also, perhaps the time line of long-term insurance vehicles like annuities and long term care comes in to play. Policies sold today, for example, can and will fail to meet client needs when they need them most because in the time that passes before benefits might be used, there is a lot that can go wrong. This is all the more reason that your clients need to "lean on you" for your advice. You must be knowledgeable in your product, sell only what you understand and be certain it meets the stated needs of your client to the best of your ability.

A proper attitude about this responsibility is not only prudent, but important to your success. No agent can really prosper and move forward if he leaves a trail of dazed and unhappy clients behind. Understanding the mistakes of others and not making them yourself is probably the best way to assure this doesn’t happen. You have several ways to evaluate your selling performance, our advice is to let one measure be the problems you avoid in helping clients acquire valuable insurance protection and effective, safe investment opportunities. Likewise, it does little to build a thriving insurance practice only to have it all taken away from a single lawsuit. When you avoid the legal problems in selling insurance, you are protecting your own future as well. Some of the specific rules you must abide by are included in the next section.

Compliance is crucial, but it is not the same thing as being ethical. In fact, you can still be legal but ethically wrong. Posting a code of ethics or simply doing the right thing most of the time is still not enough . . . although it’s a start. You see, having high ethical standards, or more simply being honest, can be more important than being right because honesty reflects character while being right reflects a level of ability. Unfortunately, the insurance industry, for the most part, still rewards ability. There are,

for example, plenty of "million dollar" marketing winners and "sales achievement awards"; but few, if any, "Ethics & Due Care" certificates.

You bring a higher level of ethical conduct to your practice just by the manner in which you operate. This includes more ***effective communication***. A lot of times, making something easier for your client to understand means you have to sacrifice your ego. Face it, you really want to impress clients with your newfound knowledge about annuity facts and features . . . don't you? It's human nature. But, resist the urge to spout.

Higher ethical standards are raised when you are ***needs based***. A needs-driven sales system's analyzes a client's needs and determine how insurance and annuities can best meet those needs. It is not meant to generate the sale based upon the obvious points of the product or the need of the salesperson to produce. It uncovers a prospect's general financial problems or deficiencies so that the prospect begins to recognize the need. The problem is personalized to arouse interest in a possible solution.

Following are some examples of essential questions you would ask as a needs-based agent selling annuities:

- ✓ Is the client interested in growth or income?
- ✓ Is the client interested in current income or retirement income? How soon does he need to start receiving income?
- ✓ How much risk is the client ready to accept today and in the future? Could he stand the loss of his entire investment? How would an interruption in income affect him?
- ✓ What are the client's liquidity needs in the short-, intermediate- and long-term?
- ✓ What is the client's federal/state tax bracket? Does tax deferral through annuities make sense?
- ✓ Is the client under age 60, and is it likely that he will need to withdraw major portions of the annuity in the future? Will the ten percent penalty offset the benefits of tax deferral?
- ✓ Does the client demand full and complete protection of principal? Or, can the client afford to take risk in hopes of greater appreciation using variable contracts?
- ✓ Is the preservation of principal more important to the client than the effects inflation may have against a fixed yield?
- ✓ What are the survivor spouse/family needs in the event the client dies? How can these needs be accomplished?

Like any system, needs analysis works effectively only when it is used as it is designed. The system builds upon itself in terms of both content and data and is most effective when used from start to finish. Shortcuts undermine the effectiveness of the process. An agent following this system from start to finish can never be accused of less than professional point-of-sale practices.

Needs-based selling goes into great detail in analyzing needs and creating recommendations that are based upon airtight logic and conclusions. Needs-based selling involves the client, allowing him or her to use his or her own ideas and assumptions. It is a process that allows the prospect to participate and help you create financial planning solutions for needs based upon what he or she considers important. Analyses must represent and respect the client's opinions. The goals are those of the prospect, not the agent. If the goals are not the goals of the prospect, the prospect is not likely to go along with the agent's recommendations in the end.

The needs-based selling system is characterized by the recognition of accurately assessed needs, which are the result of careful and professional analysis. Through careful fact-finding, information is gathered about the prospect's desire to provide income to family members in the event of premature death or disability, as well as to plan for retirement needs and accumulation. The analysis performed is based upon interest rates, inflation assumptions and the prospect's views about his or her objectives and timetables.

Needs analysis helps the agent sell the right amount of insurance to the client for the right reasons. In today's competitive environment, agents cannot afford the exposure of makeshift or piecemeal sales practices. They must have a complete, comprehensive selling system. They must provide a needs-based analysis for their clients and generate trustworthy recommendations based on this investigation. Learning how to effectively determine needs gives the opportunity to offer a full array of financial products and services.

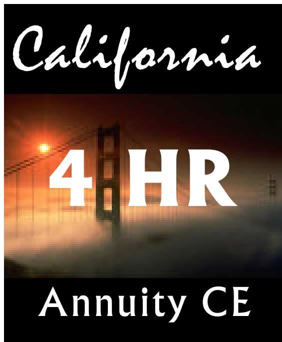
This sales system is focused on needs for another reason. In addition to needs being the best reason for a client to buy an annuity, it is also the best reason to sell an annuity. Sales based on greed, i.e., big returns on premium dollars paid, can be made by people other than life insurance agents. A sale based on greed is simply selling a return, or just selling a configuration of numbers on a piece of paper. This type of selling can be done by bankers, stockbrokers or even accountants. Selling based on a genuine need for life insurance is another matter. Needs-based selling is the thing that makes life insurance agents necessary; greed selling is the thing that could make them extinct.

Clients who have needs, also need ***solutions***. A responsible agent understands that this starts with matching specific needs of a client to dozens of policy features and benefit options – this is not a job for sissies! When all is said and done, however, a responsible, solutions-based agent must take the final step to assure himself and client that your insurance or planning suggestion is the most effective way to handle economic and health needs. You must sprinkle your client meetings with the following questions:

- Does this make sense to you?
- Have I given you all the information you need to make a decision?
- Is there something else I can answer to assure you that this is the right solution based on your needs?

These are essential questions because they help "clear the air" circulating around any doubts or concerns your client may have. And, they can also help limit your liability if something goes wrong down the road (more ideas on reducing conflicts with clients later).

A positive response to these questions is the feedback you need to know that you have "gotten through" to your client and are providing some real solutions to some very important needs.



PART II: CONTRACT PROVISIONS

Choices among annuity contracts are numerous and can be quite complex. It is your ethical and legal responsibility to know the difference between various contracts you are selling as well as options that are widely available. Following is a discussion of provisions common to many annuity offerings:

INTEREST RATES & COMPENSATION

Interest rate earnings paid from an annuity are similar to bank CD's. The amount of interest your client receives or is credited depends on how long he is willing to commit his money and what institution (company) he deposits with. Just like banks, some insurance companies simply offer higher rates and different maturities. Also, depending on the contract, interest can be sent to your client or reinvested to earn compound interest.

Insurers will sell annuity contracts with guaranteed yields for as long as 10 years. In replacing a bank CD or money market fund for an annuity with a maturity longer than one year (most are), your client may lose some flexibility. Likewise there can be surrender charges and penalties for those under 59.5 to withdraw funds . . . both reduce potential interest earnings.

To avoid unpleasant surprises, you should read all the fine print on behalf of your client. Is there and interest ***floor***? A ***ceiling***? Also, if an insurer is quoting a higher rate than anyone else, find out why. Know the base rate and assess any ***teaser rate*** that be offered. It may sound good in year one, but what will the interest yield be in subsequent years. Are there higher surrender charges associated with the higher interest? It's your responsibility to know.

Other forms of compensation provided by annuity contracts include a share in profits as in variable annuities or indexed annuities. Both include risks that could substantially effect earnings and your clients need to know this. Again, explore with them any interest floor or cap that is in the contract and, if applicable, the possibility of no earnings at all.

ISSUE AGES *(CIC 10112)*

Annuities can be purchased by just about anyone. Some companies place maximum age limits on owners and/or annuitants -- usually between ages 75 and 90. Younger buyers, under 18, may even possess all legal rights associated with owning contracts as long as they have the written consent of a parent or guardian. Of course, in the case of a minor, any liability resulting from the ownership of the annuity accrues to the parent or guardian.

MAXIMUM AGE FOR BENEFITS

Most companies generally require that annuitants be under the age of 75 when the contract is initially signed. Others allow a range up to age 90. Benefits are trigged when something happens to an annuitant or owner. However, some contracts ***require*** distribution or an orderly liquidation once the annuitant reaches a certain age, typically 80 or 85.

CRISES WAIVERS

If your client becomes seriously disabled or needs to go to a nursing home, their annuity contract may hopefully contain a waiver that triggers payments or withdrawals that are ***not subject*** to the usual surrender fees. Serious health changes, such as a chronic long term are illness, may also trigger annuity payments.

Not all annuity permit crisis waivers. In general, they seem to be more common and generous in fixed annuities, rather than variable contracts. And, situations that trigger the waiver and allow your client to make early annuity withdrawals vary from company to company. For instance, one insurer might require a 90-day nursing home confinement before your benefits are activated, while another might call for 60 days. In addition, one company may consider that your client is disabled if you're unable to work in any occupation, while another may require that he be unable to work in your current occupation. (A surgeon, for instance, may be deemed disabled by one insurer if he or she cannot operate because of, say, arthritis in the hands. Yet another company might decide that the doctor can still see patients in an office setting, without performing surgery.)

Death Waiver

This waiver passes on the full account value of the annuity to a beneficiary if the owner dies before annuitizing; that is, before you begin to receive payments from your annuity, presumably at retirement.

Example: Variable annuity owner John dies. The fund value as of the date proof of death is received; the total of all payments made into the annuity less withdrawals and related withdrawal charges; or the highest contract fund value, as calculated every third year on your contract anniversary date (adjusted for withdrawals he made). Annuity contributions remain unchanged even if your subaccounts have lost value. The beneficiary is responsible for taxes on the gain in your contract.

Nursing Home Waiver

When your client's contract includes a nursing home waiver, he won't be charged surrender fees and will be allowed access to some or all of his annuity if he is confined to a nursing facility.

Contracts may require a certain confinement period (usually 90 days) before withdrawals and there may be limitations on the type of care you are receiving before funds are released.

Example: Marge and John's annuity includes a nursing home waiver. However, the contract imposes a 180-day confinement period to a "licensed nursing facility" before penalty free withdrawals are allowed. In addition, a doctor must submit an attending physician's statement, along with a completed claim form. In essence, this insurer wants to be certain of their incapacitation. Insurers may additionally require that their own doctor examine your client before allow a waiver of penalties.

Terminal Illness Waiver

An annuity might contain a provision that waives surrender charges if the annuitant/owner becomes terminally ill, thus allowing access to money when it is needed most. While the definition of terminally ill may vary slightly from company to company, it's generally a condition that will result in your death within six months to a year. One annuity, for instance, defines a terminal illness as "an incurable condition that, with medical certainty, will result in death within one year."

As with the nursing home waiver, an insurance company may want certification from a doctor, and perhaps from their doctor as well, that the life expectancy is indeed only a matter of months.

Unemployment Waiver

Unemployment waivers are very rare. One that we know of, allows your client to withdraw from its contract if he is unemployed for more than 30 days.

Disability Waiver

The risk of disability is greater than the risk of death at all ages between 20 and 65. That said, it makes sense to protect your clients financially if the become disabled, and that includes annuity considerations. Unfortunately, relatively few insurers offer a disability waiver.

Where these waivers exist few will purposefully leave the definition of "disability" fluid. Some may state that if the owner/annuitant is unable to work, and thus can't earn a living, and a doctor attests to this, they will allow full access to the annuity without imposing surrender charges. This is a more liberal interpretation. More than likely, definition of disability will be considerably more stringent.

Charges and Fees

In most cases, there's no extra charge for waivers because they're built into the contract when purchased. There are, however, certain tax consequences that could apply to such withdrawals. It is always best to advise your client check with a tax advisor before taking money out of their contract.

PREMIUM PAYMENTS *(CIC 10540)*

Premiums for annuities are usually paid in one of three ways:

1) In the first method, the customer pays a single, lump sum premium when the contract is signed. For example, an individual may purchase an annuity with a single payment of $10,000, $50,000, or any other minimum amount that the insurance company will accept. Lump sum premiums can be paid for either immediate annuities or deferred annuities.

2) The second method is available only for deferred annuities. In this option, the customer pays premiums on a regular schedule (annual, semiannual, quarterly or monthly) until the date on which benefit payments begin. Some individuals choose this option because it is similar to making regular deposits in a savings account -- a comfortable, familiar habit.

3) The third option, is the flexible premium annuity. This feature permits flexibility in the timing and amount of premium payments. The flexible premium annuity often is attractive to individuals who want a program in which they can vary the amounts they save each year. People who earn commissions or other types of irregular income and families with growing children are two examples of customers who may be interested in a product with this type of flexibility. For example, contract terms of a typical flexible premium annuity may require an initial minimum deposit of $2,500. If the contract remains in effect, the funds that already have been paid in will continue to accrue interest, even if the annuity owner does not wish to pay into the annuity on a regular schedule. Most variable annuities are flexible premium contracts.

Note: An incorporated life insurer issuing life insurance policies on the reserve basis may collect premiums in advance. Such insurers may also accept moneys for the payment of future premiums related to any policies issued by it. No such insurer may accept such moneys in an amount to exceed (1) the sum of future unpaid premiums on any such policy or (2) the sum of 10 such future unpaid annual premiums on any such policy if such sum is less than the sum of future unpaid premiums on any such policy. This section shall not limit the right of such insurers to accept funds under an agreement which provides for an accumulation of such funds for the purpose of purchasing annuities at future dates.

SETTLEMENT OPTIONS

Settlement options refer to the various ways that funds from an annuity will be distributed. The insurance company and the annuity owner agree to settlement terms when the owner wishes to begin receiving income from the annuity. It is important to note that once an annuity contract is settled, the owner loses the right to make withdrawals beyond the scheduled payments, and the right to surrender the contract.

Four major types of settlement options are commonly available.

Single Lump Sum

The settlement may be made in a single lump sum. This lump sum includes both the amount the owner paid in premiums and the interest the funds have earned.

Interest-Only Payments

The owner may decide to receive interest-only payments until a later date on which another settlement option will take effect.

Designated Dollar Amount

The owner may elect to have the settlement paid in a specified number or designated dollar amount of payments over a number of years. For example, the annuitant could receive quarterly checks for equal amounts over a 10-year period.

Life Income Option

The life income option is perhaps the one most commonly associated with annuities. With the life option, the annuitant receives payments until he or she dies. Payments may or may not continue after the annuitant's death. Three life income options are straight life, period certain and refund.

Straight Life

A straight life annuity contract provides for guaranteed periodic payments that terminate upon the annuitant's death. No remaining balance is paid to a beneficiary or to the annuitant's estate after the annuitant dies.

To understand how a straight life annuity works, consider the case of Lee Smith, who several years ago purchased a straight life deferred annuity that would begin providing him with a regular income when he reached age 65. Lee lived until age 87 and received annuity payments until his death. Once he died, payments ceased. Had he died at age 67, the insurance company that had sold him the annuity would have stopped payments at that time. Had he lived to age 100 or more, the company would have made payments to him until then. The straight life annuity option, therefore, does not guarantee that the annuitant will receive payments equal to the amount paid as premiums on the contract. (In the event of the contract owner's death during the accumulation period, the proceeds will revert to the beneficiary. If no beneficiary has been named, proceeds will revert to the annuitant's estate.) Because this option limits potential payouts, insurance companies offer a higher return for it than for some other plans, such as those described next. Overall, the straight life annuity option provides the maximum income per dollar of outlay compared to other annuity options.

Period Certain and Refund Options

Some individuals do not want to use the duration of their lives as the factor that determines whether they will profit, break even or perhaps even lose money on their investments. Straight life annuities, therefore, do not appeal to them. Instead, these individuals often choose annuities with period certain or refund options. Period certain and refund options guarantee a minimum amount that the insurance company will pay on an annuity. Both of these options can be regarded as types of death benefits, since they provide for a payment to be made to designated beneficiaries upon the annuitant's death. Because they provide added benefits for the consumer and create additional costs for the insurance company, annuities with period certain and refund options offer the consumer lower per premium dollars than do straight life annuities.

Period Certain

Period certain refers to a guarantee from the insurance company that it will make annuity payments to a beneficiary for a specific number of years, even if the annuitant dies

before the end of this period. However, payments to the annuitant will continue as long as he or she lives.

Since a period certain option of a fixed annuity may be selected at the same time that other settlement agreements (such as the amount and frequency of payments) are determined, it guarantees that a specific sum will be paid out by the company. For example, consider a life annuity with a five-year period certain option. If the annuitant dies during the third year of the liquidation period, the insurance company will continue to make payments to the annuitant's beneficiary for the next two years. If the annuity pays out $4,000 each quarter ($16,000 a year), a five-year period certain guarantees that $80,000 will actually be paid out. (It is common for insurance companies to pay the present value of the remaining payments in a lump sum to the beneficiary rather than continuing the payments until the end of the certain period.) If the annuitant survives the first five years of the liquidation period, the annuity will continue to be paid out in the normal manner, ceasing upon the annuitant's death.

Refund Option

The refund option is another form of guarantee offered by insurance companies. This option provides that in the event of the annuitant's death, the company will pay out an amount at least equal to the total dollars paid in as premiums. Since this is another form of life income option, the company will, of course, continue to pay the guaranteed amount of monthly income for as long as the annuitant lives.

Refund options can be classified into two basic types. With a cash refund, the insurance company agrees that if the annuitant dies, it will refund, in cash, the difference between the income that annuitant received and the amount paid in premiums, plus interest earned. With an installment refund, the insurance company agrees to continue to make periodic payments to the annuitant's beneficiary until the total of the payments made to the annuitant and to the beneficiary equals the amount the owner paid for the annuity contract, plus interest earned. The longer the payout is to continue after the annuitant's death, the smaller the periodic payments will be. Refund and period certain options offer benefits to a consumer who is reluctant to invest a substantial amount of money in a product whose return depends solely on the length of his or her life. At the same time, not all annuity purchasers favor refund options. The main reason is money; annuities with refund options pay annuitants lower amounts of income than do comparable contracts without them. The refund option represents an extra benefit for the contract owner and an extra cost for the insurance company.

Non-Qualified Plans

Once a nonqualified annuity under a settlement plan, each payment is considered part nontaxable and part taxable income. This is because the initial purchase payment and any additional contributions you made were with after-tax money. An exclusion ratio is determined for each payment which then determines the amount of each payment to be excluded from taxes.

In addition to any income tax, there is a potential federal penalty for annuity withdrawals for investors under age 59.5. This 10% penalty (IRS Section 72q) was designed to discourage investors from withdrawing early from nonqualified annuities. However, should your client choose the option to settle his contract either on a lifetime or two

lifetimes, before age 59 1/2, withdrawals qualify as an exception to the penalty rule and will ***not*** be subject to the additional 10% tax. Those who are planning for early retirement may find this option advantageous.

Tax Qualified Plans

For qualified annuities (purchased through a qualified plan such as a 401(k)), the initial premium, any additional contributions and interest earnings were all untaxed. Therefore, 100% of each payment received through any settlement plan will be considered taxable income.

Surrender Charges (CIC 10127.10, 10127.12, 10127.13)

Most annuities levy a surrender charge (from 0 to 8%) for any withdrawals that exceed the free withdrawal (discussed below) privilege (typically 10%). The surrender charge usually fades away in time (0 to10 years). If your client withdraws money from a variable annuity within a certain period after a purchase payment, he will also incur a surrender charge. It is important to advise clients that this charge could effect the value of his account and reduce overall earning potential.

Example: Mark's annuity contract specifies a 6-5-4-3-2-1-0 surrender penalty structure. This means that the company's withdrawal or surrender penalty lasts for six years. The first year penalty is 6%, then 5% in the second year; 4% in year 3 and so on. After six years, there is no penalty to withdraw or surrender. Also, Mark may have the option to take free withdraws along the way as long as the amount taken out does not exceed the 10% free withdrawal limit.

Example: Ellen purchased a variable annuity contract with a $10,000 purchase payment. The contract has a schedule of surrender charges, beginning with a 7% charge in the first year, and declining by 1% each year. In addition, she is allowed to withdraw 10% of your contract value each year free of surrender charges. In the first year, she decides to withdraw $5,000, or one-half of your contract value of $10,000 (assuming that your contract value has not increased or decreased because of investment performance). In this case, she could withdraw $1,000 (10% of contract value) free of surrender charges, but she would pay a surrender charge of 7%, or $280, on the other $4,000 withdrawn. Ellen's overall earnings are reduced by $280 -- a reduction that might not occur in other investment mediums.

Market Value Adjustment

In periods of rapidly dropping or rising interest rates, insurers have developed a new tool to adjust yields -- the market rate adjustment (MVA). Simply put, the MVA will increase or decrease the surrender penalty, depending on market rates at surrender compared to the contract period guarantee rate. In other words, the MVA is a separate and additional adjustment made at the time of an early surrender that can be either negative or positive for your client. It all depends if interest rates have increased or decreased at the time your client wants to withdraw his money. The MVA does not typically apply to the free withdrawal portion or surrenders taken after the death of an annuitant.

Market rate adjustments can be very complex. Some are expressed as a factor or percentage rate adjustment tied to a certain block of securities owned by the insurer. If

your client decides to withdraw funds from his annuity at a time when market rates have risen, the insure will lose money when selling his securities and need to charge your client a higher penalty. If rates have dropped, there will be less MVA penalty.

Example: The value of Frank's annuity is $50,000. In the current year, his surrender charge is 6% or $3,000. However, since Frank purchased his annuity ***market interest rates have risen*** and his insurer indicates a MAV adjustment of $1,500 is necessary to offset the loss they will incur when they sell certain securities to return Frank's money. So, Frank's current surrender value is calculated as follows: $50,000, less $3,000 surrender charge, ***less*** $1,500 MVA adjustment for a net surrender value of $45,500.

Example: Sally needs to withdraw her $50,000 annuity with a current surrender charge of 6% or 3,000. Since Sally purchased this annuity, ***interest rates have dropped*** so her insurer has indicated that her MVA will actually soften her total surrender charges. Sally's current surrender value is calculated as follows: $50,000, less $3,000 surrender charge, ***plus*** $1,800 MVA adjustment for a net surrender value of $48,800.

Senior Citizens and Surrender Charges

There are a few exceptions to the collection of surrender charges where senior citizens (over age 65) are concerned:

- Surrender charges cannot be levied if a client ***cancels*** his annuity contract ***within the 30-day*** free look period.
- Whenever an insurer provides an ***annual statement*** to a senior citizen for his individual annuity contract issued after January 1, 1995, the insurer shall also provide the current accumulation value and the current cash surrender value, i.e., the surrender charges are disclosed.
- All annuity contracts for senior citizens that contain a surrender charge period shall either disclose the surrender period and all associated penalties in ***12-point bold print*** on the cover sheet of the policy or disclose the location of the surrender information in bold 12-point print on the cover page of the policy, or printed on a sticker that is affixed to the cover page or to the policy jacket.

POLICY ADMINISTRATION CHARGES AND FEES

Not all the money a contract owner pays into an annuity are invested, since some are used for sales commissions and fees. These charges differ among companies and among contracts. Some companies (mostly fixed annuity plans) have no charges other than the surrender fees discussed in the last section. In the event the insured dies, for instance, they guarantee to pay the beneficiary ***at least*** the amount paid in to the contract, regardless of the current cash value of the contract.

Variable contracts are quite different. Each typically has its own schedule of fees and other charges, and the investor should carefully assess these before making a purchase. These can include annual contract charges, management fees and mortality charges.

WITHDRAWAL OPTIONS

Most annuities allow withdrawals of up to 10 and percent per year after an initial waiting period of one year, without cost, fee or penalty. The ***free withdrawal*** is typically based on a percentage of principal, not the current value. However, some companies calculate the penalty free withdrawal on the greater of the current value or principal contributed.

Example: Mary invests $50,000 in an annuity and later adds another 25,000. In a few short years, her account grows to $100,000. Mary suddenly needs funds to pay for nursing home costs she has occurred. The maximum she can withdraw from most companies is $7,500 or 10% of her principal invested. More liberal companies might allow her to take out $10,000 or 10% of her current account value.

Some companies also let you take out ***all*** of your account growth (accumulated interest) at any time without a fee or penalty. Others levy penalties only during a prescribed period of time . . . the first five or seven years.

Example: Bill has owns a $250,000 annuity. His account is now worth $350,000. His insurer allows free annual withdrawals up to 10 percent based on the value of his ***original contribution*** or $25,000 per year and/or up to his annual earnings without penalty. If Bill needs it, he can take a $100,000 free withdrawal.

A few companies also permit ***cumulative withdrawals***. So, if your client hasn't needed to withdraw any funds, the amount he has not taken out accumulates to his credit.

Example: Susan's $100,000 annuity permits cumulative 10% annual free withdrawals -- $10,000 per year. It's been three years since Susan has owned her contract and she has not withdrawn a single dollar. A health care emergency requires additional cash. Her insurer allows her to take $30,000 from her account without penalty.

Note: Free withdrawals are a nice feature but it is not something that should completely ***drive*** your decision to recommend a particular annuity. Why? Because, a majority of people who own annuities never use their free withdrawal option and the restrictions on withdrawals typically fade away in a matter of years.

ANNUITIZATION OPTIONS

The annuity is an investment vehicle often used for retirement. These days, however, people are concerned more than ever about outliving their retirement nest egg. Many insurers respond to this with an array of annuitization options that can provide a stream of income for a specified period of years or for life!

When a client chooses to annuitize, the insurance company will turns their principle into a monthly, quarterly, semiannual, or annual income. Once a decision is made there is typically no turning back, although some new plans allow a client to stop receiving payments and take the remainder in a lump sum.

There are several ways to receive annuity income payments:

A ***straight life annuity*** provides income until the annuitant dies.

An ***annuity certain annuity*** provides income for a fixed period of time, such as 10 or 20 years.

A ***variable life annuity*** provides variable income during the annuitant's lifetime.

A ***variable life with period certain annuity*** provides variable income during the annuitant's lifetime. If the annuitant dies before the designated certain period, the insurer will pay the contingent payee you have selected.

A ***life income with refund annuity*** provides income throughout the life of the annuitant. If the annuitant dies before receiving payments at least equal to the purchase price of the annuity, the insurer will pay a refund to the contingent payee you have selected.

A ***life annuity with period certain annuity*** provides income until the annuitant dies. If the annuitant dies before the designated certain period, the insurer will pay the balance to contingent payee you have selected.

A ***joint and survivor annuity*** provides income to two or more individuals until all of the individuals die. Some contracts might reduce the amount paid to the surviving spouse after the death of the first spouse.

Other annuity income options include a lump sum payout or systematic distributions.
Which type of annuity is right for me?

Who would annuitize? Someone who wants out of his annuity without incurring a surrender charge. A widow or widower with no kids may care more about living comfortable doing their retirement years than skimming off their retirement and possibly outliving their money. Another strategy is to buy enough life insurance to cover the loss of the income from your death then elect the highest annuity payout without the fear of leaving a spouse broke.

In analyzing the decision to annuitize it is important to consider the following:

- In a fixed rate contract, the interest rate assigned to the payout will be frozen. There will be no adjustment for inflation or growth.

- The annuitization period will dramatically effect the payout amount. A $100,000 contract annuitized over five years will produce a much higher payment than one over 10 years. It also follows that a lifetime payout will be even less.

FIXED ANNUITY CONTRACTS

A fixed-rate annuity is a contract between a policyowner and an insurer that requires a policyowner to pay either a lump sum or periodic payments to the insurer to establish the principal, from which the insurer guarantees the policyowner a fixed or promised rate of return. The insurer allocates all of the principal invested by the policyowner to a general account, and, in return, makes guaranteed periodic payments to the annuitant out of the insurer's earnings from its investment portfolio held in the general account.

In a ***fixed-rate annuity***: the cash value accumulation (or the annuity income) is a stated dollar amount that is guaranteed by the insurance company and on which (or with respect to the annuity income) the insurer pays a specified or determinable rate of interest. In effect, it is a fixed-dollar, guaranteed-principal kind of investment medium that is in some ways analogous to CDs. The ***investment authority and investment risk*** are on the insurance company because it is the insurer that guarantees the cash value (or annuity income) and specifies the interest rate currently being paid on cash value accumulations.

Consequently, unlike variable annuities, fixed-rate annuities have little or no investment risk, because the payout is guaranteed by the insurer/issuer as part of its general account obligations. It is this reason that prompts many insurers and agents alike to compare them to CD's and even name them similarly as CD Annuities. Be advised, however, while they sometimes offer better rates and helpful tax advantages, they are also much harder to get out of, and they are not protected by the Federal Deposit Insurance Corp. Some experts advise against CD-type annuities because of the interest costs and IRS penalties involved in getting out. If rates go up, you're locked in at a lower rate.

Some CD-type annuities are different from other fixed annuities in that the guaranteed rate matches the penalty period. In other words, if you buy a five-year CD-type annuity at 4 percent, you're guaranteed to get 4 percent annually if you hold the CD for five years.

Other fixed rate annuities have no maturity date and often guarantee a rate only for the first year. The interest rate usually drops after the guaranteed period and is adjusted annually. Those annuities tend to have a bad reputation, even among people in the insurance industry -- the only people licensed to sell annuities.

The bottom line with fixed annuities is that tax-deferred earnings or a promise of an income you can't outlive are attractive features to many investors. ***Other issues*** to examine, however, include long-term risk, current liquidity, effective earnings (after penalties and bonus interest) and taxes down the road.

Death Benefits

Principal in a fixed-rate annuity contract is guaranteed everyday. This means that the beneficiary receives the greater of the principal or the value of the account as of the date of the annuitant's death. Beneficiaries may also have options as to how they receive a death benefit . . a lump sum or over five years. Accepting a five-year pay out can ease taxes slightly and result in a larger balance due to accumulated interest paid by the insurer. The death benefit lasts until the contract is terminated, annuitized or the annuitant reaches the age of annuitization . . . anywhere from 75 to 85.

Charges and Fees

Other than surrender charges (discussed above), most fixed-rate annuities have no associated fees or charges. Some have minimal annual contract fees of $30 or so. And, in low interest rate markets, even these must be considered in calculating overall yield.

Interest Rates

Fixed rate contracts may offer a set return for specified period of time. The rate can be ***guaranteed*** for this period or simply ***promised***. And rates can also vary widely between companies and products for a variety of reasons. Choosing a suitable rate means uncovering the length of time invested, the promised rate of interest, the guaranteed rate of interest as well as consideration for potential surrender charges if an early withdrawal is required. Many companies offer a first year bonus or teaser rate which can drop considerably in the subsequent years. n some cases, the only way to keep the bonus is to annuitize the contract. Further, a fair amount of companies are now applying market rate adjustments to any potential surrenders (see above) to reflect current market conditions. In other words, while it is important to assess the ***annual*** rate of interest credited, it is more likely that a ***multi-year*** strategy must be adopted to analyze the effective return of any fixed annuity. The longer the term, the more easily a surrender or MVA charge can be absorbed.

Example: Dave is considering an $100,000 annuity contract offering a current base rate of 5% with an additional 2% bonus in the first year but it will only apply if the client annuities his payout. Surrender penalties are 5-4-3-2-1-0 expire at the end of five years with a market value adjustment in place. The minimum guaranteed interest rate is 3%. As an ethical agent you need to point out to Dave that the rate of 5% is not promised and it is likely to be lower in subsequent years. Also, the 2% first year bonus will be lost unless Dave agrees to receive his money back over a period of years (typically 5 years). Finally, if Dave needs his money sooner and rates in the market have risen, it is likely that he will pay the applicable surrender charge plus additional penalties in the form of a MVA adjustment.

Crediting of Interest

When selling annuities, it is extremely important that you correctly explain to the buyer how the contract is designed to work. This can be easy or quite complex depending on how interest is credited. The current trend is to no longer use a calendar-approach to crediting interest. Companies today are more likely to credit interest quarterly, monthly or even daily. This allows insurers to be more competitive and react quicker to interest rate fluctuations in the market. Insurers are also using market rate adjustments (discussed above) to negatively or positively adjust a client's surrender charge where early withdrawal of funds is desired. Both factors eventually effect your client's yield.

What is critical to understand about any annuity interest rate is whether it is ***guaranteed*** or just ***promised***. Some companies offer a higher rate but only promise to continue paying it. Rates are often disguised with terms such as "base rate", when in fact, the credited renewal rate of interest "floats" in subsequent years.

The crediting of annuity interest rates is also effected by the nature of the product and company. Here are some basic designs to understand:

Portfolio Rate Annuities

These contracts offer a guaranteed interest rate for an initial period of time, such as one, three or five years. After the initial rate period, renewal rates are based on the earnings

of the underlying investment portfolio. In other words, all policyowners are lumped in a single group and given the same rate. When market rates are declining in the market, the portfolio type of contract would seem to be advantageous.

Banded or New Money Annuities

The banding approach will segregate different bands of contracts and assign different rates to each. Older contract monies might be earning one rate of interest, while newer contracts earn another. When interest rates are rising in the market, a new money plan would seem to be more advantageous.

CD-Type Annuities

These work basically the same as bank CDs in that the company will typically guarantee a rate for a given period of time. At the end of the guarantee period, the policyowner may surrender the annuity for its full value, transfer the full value to another annuity or renew for a new period of time. Of course, early withdrawal penalties may apply.

Two Tier Annuities

This type of product are the most difficult to explain and in some cases downright misleading. These plans may offer a large, up front bonus on top of the normal interest rate. However, the bonus may be forfeited unless the contract owner annuitizes. Or, a two-tier plan may credit the contract with a lower rate of interest if a partial or total liquidation is made. These plans often have much higher surrender charges . . . some never disappear. Interest crediting may also be lower if the owner chooses a minimum payout plan, e.g., choosing to annuitize over three years instead of five years. Rates during annuitization may also be artificially low to offset seemingly higher rates during accumulation.

Minimum Guaranteed Interest (CIC10168.25)

Beginning January 1, 2006, the state of California, new legislation (AB 284) regarding minimum guaranteed interest for fixed annuities. The primary goal of the law's revision is to provide a means to permit lower interest rate guarantees than the current law allows in low interest rate environments. Legislators agreed on a cap equal to the ***existing three percent*** interest rate. However, in order to provide some minimum level of guarantee to the consumer, a ***floor of one percent*** was also established. Finally, flexibility was provided to the companies by allowing for the re-determination of the minimum interest guarantees on a periodic basis by using the five-year Constant Maturity Treasury Rate, less 125 basis points

AB 284 also significantly reduces the maximum expense loads that may be charged by an insurer by limiting annual contract fees to $50. This bill, however, is ***does not*** affect any contract now in effect.

The passing of this bill is a strong indication that the current low interest rate environment is having an impact. Annuities are one of the few savings products that offer guaranteed lifetime income, ensuring that a person will not outlive their assets. Extremely ***low rates*** have had negative effects on the ability to accomplish.

VARIABLE ANNUITY CONTRACTS

To understand the structure of the variable annuity, we must compare it to the fixed annuity. Like the fixed annuity, the variable annuity is a contract between an individual and a life insurance company. With both types, the owner contributes premiums that, along with their earnings, are accumulated within the policy contract.

At an agreed-upon time, the insurance company begins making payments to the annuitant. Payments are made over the individual's lifetime or for some other stipulated period.

The basic difference between fixed annuities and variable annuities is the way in which accumulated funds are invested and the resulting payout. (Insurance companies often use the term "funded" or "funding" to describe the method of investment that characterizes the annuity contract -- for example, "the contract is funded by a separate account invested in mutual funds and government securities.")

With fixed annuities, the accumulated funds are commingled with the insurance company's general investments. These investments help form the basis for the guaranteed cash values of life insurance and conventional annuity contracts.

In general, insurance companies invest funds for their fixed products in long-term bonds and other non-speculative issues. In contrast, the premium payments made on a variable annuity are not combined with the insurance company's general investments; instead, they are placed in stocks, government securities and other types of fluctuating investments. These investments have more growth potential than those that underlie other investments, but they are also subject to a greater degree of risk. The investments make up a portfolio that is managed in much the same way as a typical mutual fund. For many years, marketers of annuity products, along with savings institutions, emphasized the advantages of conservative and secure investments.

During the 1930s, when U.S. economy was experiencing only moderate inflation rates, many people purchased annuities for retirement, in the belief that they ensured a comfortable, guaranteed income for life. A successful insurance company advertisement of the late 1930s enthusiastically proclaimed, "Retire for life on $300 a month!"

Then, rising inflation rates began to affect the average person's standard of living. Beginning in the 1960s, people became aware that they had to plan for more retirement dollars just to keep pace with anticipated increases in living costs. Savers sought financial instruments that could more readily keep up with inflation. Individuals of even average means were turning to the stock market for an increasing portion of their investments. Like savings institutions, insurance companies looked for ways to improve their traditional products. In an attempt to combine traditional annuity guarantees with the growth potential of a securities investment, they developed the variable annuity.

Variable Annuity Options

Variable annuities come in many different flavors. The difference between them lies in who has control over investing the money deposited into the annuity. With some, the insurance company determines how the annuity funds are invested. Others allow the annuity owner to have substantial control over the investment of funds.

Company-Managed Variable Annuity

The original variable annuities, introduced in the 1950s, were company-managed types. In this type of annuity, premiums paid in by contract owners are pooled and placed in what the insurance company designated as a separate account. This method serves to distinguish these investments from the company's other invested funds. (One advantage of variable annuity is if the insurance company runs into financial problems, the funds in the separate account are beyond the reach of the company's creditors. This is also true for the portfolios in self-directed plans.) The account is organized like a mutual fund in that it is made up of various investments -- usually stocks, bonds and government securities.

The insurance companies' investment managers buy and sell these investments on a continuing basis. Like mutual fund managers, the insurance company tries to invest the money wisely and profitably so that it will generate a competitive return for its investors. In addition, the insurance company must meet both state and federal regulations regarding investment practices for these products. (Variable annuities are subject to regulation by the Securities and Exchange Commission, Internal Revenue Service and state regulatory bodies.)

One of the better-known company-managed variable annuities is the College Retirement and Equities Fund, or CREF. Designed by the Teachers Annuity and Insurance Association, it was the first variable annuity, appearing on the market in 1952. Because of CREF's relatively long history, it has been the subject of many detailed studies.

For an example of a hypothetical company-managed variable annuity, see Illustration 1 at the back of this book. The investment portfolio for this annuity consists of a combination of stock, bonds and money market instruments.

Note that at different times, the insurance company's investment managers varied the mix of investments based on the perceived market potential for each type of investment used in the plan. For example, on December 31, 1992, the mix was 37 percent stocks, 18 percent bonds and 45 percent money market instruments. The fund managers decided that by June 30, 1993, they would sell all the stocks and switch to bonds (63 percent) and money market instruments (37 percent). By the concluding period, the fund consisted of a fairly balanced mix of 39 percent stocks, 36 percent bonds and 25 percent money market instruments. The above sequence of investment decisions demonstrates the continuous management of assets placed in variable annuity funds.

Investment managers consider various economic indicators in making decisions that they believe are timely and will lead to maximum profits.

Self-Directed Variable Annuity

With the self-directed variable annuity, the contract owner can choose from several investments . . . ***subaccounts*** . . . each with different goals. This allows an investor to diversify his holdings and select investments based on his or her objectives in much the same manner that a mutual fund investor does. Following are some typical choices:

Equity-Based: Funds are invested in steadily growing, strong companies with a history of growth potential. The goal is long-term growth.

Risk-Based: Exposure to companies on the cutting edge of innovation. The goal is to capture significant investment opportunities with the potential for greater price volatility (more risk).

Fixed Options: The fixed portion of a variable annuity emulates the fixed annuity. So, anytime an investor has had enough of choices or decides its time to move from equity- or risked-based position, he can move his funds here.

In effect, the contract owner may construct a personal investment portfolio within the annuity and his selection of investments can generally be made during both the accumulation and distribution periods.

Senior Citizen Considerations (CIC 10127.10)

In California, a senior citizen investor (age 60 and above) in variable contracts receives special consideration during the 30-day free look period. During this 30-days. The premium for a variable annuity may be invested only in fixed-income investments and money-market funds. This assures that upon a cancellation of the contract the owner will be refunded ***all*** premiums in full, as though the contract was never purchased.

Where the senior investor has specified his funds immediately invested in mutual funds, a cancellation will entitle him to a refund of the account value within 30 days.

Choosing an Annuity Investment Portfolio

The annuity application form lists the selection of investments that the insurance company offers. Based on his investment objectives, the customer indicates, usually in percentage units, how each premium is to be allocated among the selected accounts. Most contracts allow an unlimited number of percentage combinations. The applicant can even allocate the entire premium to a single investment choice.

A typical offering might include four mutual funds with differing objectives, plus a fixed account. The fixed account offers guaranteed safety of principal and specifies a fixed interest rate. (Interest rates on the fixed account may be guaranteed for periods ranging from one calendar quarter to one or two years or even longer.)

Changing the Investment Mix

One distinguishing characteristic of self-directed annuities is the owner's ability to change the composition of the annuity portfolio. Three major factors that affect how individuals invest their assets are their investment objectives and philosophies, and their financial standing and economic conditions. Since each of these factors may change over time, it is advantageous to the investor to be able to change the way in which his or her money is invested.

As an individual progresses through life, his or her investment philosophy and objectives often change. Many people who previously might have been inclined to take investment risks may become more cautious as they grow older. For the owner of a variable annuity, a change to more conservative investments may mean moving money from stock funds to funds composed of government securities or even a fixed fund. The typical self-directed variable annuity offers the contract owner the opportunity to redirect the investment of funds as his or her investment objectives change.

The owner may also make transfers to and from a fixed account. IN some cases this is done through an 800 number, via internet or through a stock broker.(Note, however, that transfers from the funds to the fixed account, or the reverse, are more limited than transfers among the funds.) These rules provide ample opportunity for changes in investment directions.

Changes in one's financial standing may also alter an individual's willingness to accept risks. For example, some individuals may invest in more aggressive and risky funds only after they have accumulated what they consider an adequate nest egg. Similarly, some individuals move their variable annuity funds into conservative options if they experience losses in their other investments.

Economic conditions and forecasts may also lead an individual to take advantage of a variable annuity's flexibility. When stock prices are expected to fall, some individuals direct their money out of stock funds and into other types of funds. When yields on other investments are falling, investors often move their money into bond funds because these generally are considered good investments during such periods. Thus, variable annuities allow the investor to react in the face of changing market conditions.

Examples of Self-Directed Plans

To better understand the implications of investment choices in a self-directed plan, look at some hypothetical investors and their choices of investment mixes from the options outlined on Illustration 2.

Young Executive: Ruth is a 25-year-old upwardly mobile executive. Her preferred investment mix looks something like this: 60 percent Emerging Growth Fund; 40 percent Growth Stock Fund. Ruth figures that she can invest in these rather speculative funds because if she makes some incorrect decisions and sustains some losses, she has plenty of remaining years in which to deposit additional funds and still accumulate an ample nest egg. Also, as Ruth grows older, she may become more conservative with her investment choices and less inclined to speculate.

Empty Nester: Charlie, age 55, is a university professor. He chooses an investment mix as follows: 50 percent Financial Bond Fund; 40 percent Cash Management; 10 percent Growth Stock Fund. Charlie's rationale for these relatively conservative choices is that he wants to be on the safe side -that is, accumulate as much as possible and expose only a small portion of his investment to risk. Perhaps, at an earlier age, he would have indulged in greater speculation, but now it seems wiser to be more conservative.

Retiree: Frank, age 66, is a retiree with a conservative investment mix: 50 percent Fixed Account; 50 percent Financial Bond Fund. Now that Frank is retired and receiving his lifetime payments, he wants to ensure a steady flow of income. He has split his choice right down the middle: half in the fixed account, with its designated interest rate and guaranteed safety of principal, and half in the bond fund, with its high current income yield and emphasis on capital preservation. Barring any drastic changes in the economy, Frank will probably continue to rely on this investment selection for his annuity income.

Computation of Annuity Accumulation and Payments

Owners of variable annuities receive regular statements on the value of their investment accounts. Like CD owners and other investment holders, annuity owners want to know the current values of their holdings.

Computing the value at any given time of a variable annuity contract can be complex. With a variable annuity, one is dealing with fluctuating stock market investments. The process, therefore, is more complicated than calculating the value of a CD, which has a guaranteed interest rate over a specified time period.

Most insurance companies have adopted a unit method of expressing annuity values. Generally, two types of units form the variable annuity contract. These units correspond to the two basic time classifications for annuities: the period during which dollars are being accumulated (accumulation period) and the period in which the insurance company makes the annuity payments (distribution period).

Accumulation Units

During the years in which premiums are paid into the contract, the annuity owner acquires accumulation units. Accumulation units have a designated initial price at the time of the annuity purchase, but fluctuate in value thereafter. In the case of company-managed products, the changing values will correspond to the performance of the pool of investments. This is similar to the way mutual fund values are expressed. With a mutual fund share, each accumulation unit of a variable annuity has a designated value on a given day. In the case of self-directed annuities, the values of the fund or combination of funds the policy owner has chosen are totaled. The value of each accumulation unit is then calculated from this total.

Under both company-managed and self-directed plans, each premium payment purchases a certain number of accumulation units. The number of units varies according to the unit's current market value. The number of units continues to increase as additional purchases are made, although each unit's value will vary over the life of the contract, according to its worth in the marketplace. This, too, is similar to the manner in which mutual fund share values are calculated.

The following example illustrates how this works out in practice:

Initial Value of Accumulation Unit on 1/1/04	$5
Monthly Premium Payment	$100
Initial Number of Units Purchased	20

Subsequent Accumulation	Unit Values	Number of Units Purchased
2/1/04	$5.05	19.80
3/1/04	$4.87	20.53
4/1/04	$4.94	20.24
5/1/04	$4.99	20.04
6/1/04	$5.12	19.53

At the end of the six-month period, the owner will have a total of 120.14 accumulation units. As stated above, the value of these units will continue to fluctuate according to the unit's market value. With each premium payment, the contract owner adds to the total of accumulation units. The accumulation unit price will probably continue to fluctuate. When the annuity matures, the contract owner will have been credited with a specified number of accumulation units.

Annuity Units

In order for the insurance company to begin paying out income from the annuity, accumulation units are converted into annuity units.

An annuity unit is a measure of value that an insurance company uses when it calculates the amount of income to be paid to an annuitant. At retirement, the annuitant is credited with a designated number of annuity units.

The exact number of annuity units to be credited depends on four basic factors.

The first factor is the annuitant's age. As described earlier, the insurance company calculates from its mortality tables all charges in order to provide a designated amount of lifetime income at a specified age.

The second factor is the number of guaranteed payments. If the annuitant chooses a period certain life income option, the extra charge for that benefit will be reflected in the calculation of the annuity unit.

The third factor is the interest rate that the insurance company projects. If the company predicts a fairly high interest rate, the annuity unit will have a greater value than it would with a lower rate. Interest rates typically are projected annually to determine the projected investment return.

Finally, there are administrative expenses to be incorporated into the unit cost calculation.

Fluctuating Value of Annuity Units

The calculated number of annuity units remains constant over the payment period. The annuitant has the option of choosing a fixed or a variable payment, or, as is often the case, a combination of both.

With the variable payout, the annuity unit's value may fluctuate, just as it does during the accumulation period. The value will continue to vary according to the performance of the underlying investment portfolio and the general administrative costs that the company incurs. Obviously, the amount of periodic income also will fluctuate.

For example, suppose that on January 1, the date the annuitant retires, he or she has collected a total of 10,000 accumulation units. Assume further that at that time the 10,000 units have a market value of $50,000.

Using the above process, the insurance company then converts the annuitant's 10,000 accumulation units to 100 annuity units.

On the first payment, each annuity unit is worth $10. If the annuitant chooses the fixed payment option, the $1,000 monthly payment, as listed in the example below as of January 1, would remain constant for the balance of the payout period.

Assume that the annuitant chose a variable mode of payment. In that case, a six-month projection of monthly payments would be as follows:

Date	Annuity Unit Value	Monthly Payment to Annuitant
1/1	$ 10.00	$ 1,000
2/1	10.17	1,017
3/1	9.73	973
4/1	9.89	989
5/1	10.11	1,011
6/1	10.57	1,057

There are two important reasons for the continued fluctuation in variable annuities after the retirement income period begins.

The first is that the portfolio's value constantly changes to reflect current market conditions. The second is that the investments funding the annuity contract also change continually, just as they do during the accumulation period. The various stocks, bonds and other financial instruments that make up the portfolio continue to be bought and sold. In a company-managed plan, the insurance company's investment managers continue to supervise this process. In a self-directed plan, the contract owner may frequently change the contents of the portfolio.

Charges and Fees

Each contract typically has its own schedule of fees and other charges, and the investor should carefully assess these before making a purchase. Some companies impose management charges. Fairly typical contract charges are from $0 to $50 per year for administration, plus a few assess an investment management fee of 1 percent or more of the variable account's total value. Funds held in a fixed account usually escape the investment management fees. The insurance company typically justifies these fees by providing for a guaranteed death benefit and covering the administrative expenses involved in providing a life income.

Variable contracts are also known to charge a mortality fee which pays for the guaranteed death benefit. The purpose is to cover the insurer's overhead and commissions. These charges generally run from .15 percent to 2.0 percent annually and it is usually a fixed rate that will not increase over time.

Example: Joan invests in a variable annuity and learns from the prospectus that a 1.25% mortality charge will be deducted from her account. In the first year her account value is $20,000 resulting in a mortality charge of $250. In the second year her account grows to $25,000 resulting in a $312.50 mortality charge and so on. It is interesting to note that even though the mortality charge is expressed as an annual charge it is calculated and subtracted from the contract value ***each day***.

Dollar Cost Averaging

Investors who are little unsure of their ability to choose portfolio winners can invest using a simple risk-reduction technique called dollar cost averaging. The ***concept*** behind dollar cost averaging is that by spreading purchases over several types of variable subaccounts, potential highs and lows in each subaccount will be spread and ultimately averaged over time. Further, because units are bought at specific intervals, some units will be bought at low prices and some will be bought at high prices. The average is likely to be fairly constant.

Like fixed annuities, there are bonus plans that lure investors. When funds are placed in the fixed side of the variable plan, investors must be wary of their true yield since many offer teaser rates that later, when rates drop below base or promised levels, represent poor yields.

Death Benefit Guarantees *(CIC 10168.4)*

Most variable annuities include a guaranteed death benefit that pays out upon the death of the annuitant. The amount the beneficiary receives is typically the ***greater of*** . . .

- The original invested amount plus additional contributions less any withdrawals OR
- The value of the account less any withdrawals

Example: Bob invests $150,000 in a variable annuity and later adds another $100,000. Along the way, however, Bob withdrew about $50,000 to cover some unanticipated taxes. At the time of the annuitant's death, Bob's account was valued at over $500,000. What is his death benefit? The greater of the investment or account value would be $500,000, less the $50,000 or a death benefit of $450,000.

Of course, the death benefit does not last forever. When the annuitant reaches annuitization age . . . anywhere from 75 to 90 . . . the death benefit ceases. Furthermore, some companies charge a mortality fee to pay for the death benefit guarantee ranging from .15 to 2.0% per year of the account value.

Many companies also offer the ability to improve the death benefit amount to an amount equal to the account value or many times the account value as an incentive to purchase. Others allow investors to ***step-up*** the death benefit by periodically renewing an owner's contract with a new surrender penalty schedule.

Example: Fritz purchased a $100,000 variable annuity with a penalty period of five years. During the time Fritz owned his contract his account value bounced around from $150,000 to $250,000. At the end of five years, Fritzs' withdrawal penalties have faded away and the value of his account is $200,000. Fitz is concerned that his account value could fluctuate more over the next five years so he accepts his insurer's offer to step-up his death benefit to a minimum of $200,000 . . . his current account value. In exchange, the insurer restarts another five-year withdrawal penalty schedule.

California, like many states, has passed minimum nonforfeiture laws. The purpose of such laws is to make sure that contract owners receive ***something*** when and if he stops making premiums. Most annuity contracts provide cash surrender values benefits prior to maturity. California law states that in no even shall any cash value surrender benefit

be less than the minimum nonforfeiture amount at that time. And, the death benefit under such contracts shall be at least equal to the cash surrender benefit.

Living Benefit Guarantees

As the market for variable annuities becomes more competitive, insurers are "sweetening the pot" to attract more business. One such perk is to offer living benefit guarantees.

Such a guarantee might protect your mutual fund investments against losses if you hold the investment for a period of time. Other living-benefit guarantees might promise to pay a guaranteed retirement income, regardless of the investment account performs

Example: Joan's variable annuity includes a living benefit option that guarantees a minimum future amount of income. Regardless of how her investment options perform, on her 10th or later contract anniversary, she can convert her contract to a guaranteed amount of income.

Living benefits are optional and exercisable at the discretion of the policyholder. The more these benefits come into play, the more the pricing is challenging. There is also discussion on the effect these options may have on insurers. More aggressive companies, for example, could experience problems if the stock market continues to perform poorly for an extended time period. In a catastrophe, the cost they charge for the benefits would be inadequate."

Performance and Investor Considerations

The initial objective of the variable annuity concept was to design a financial instrument that would combine the guaranteed features of annuities and the growth possibilities of equities.

One popular theory was that the cost of living and common stock prices tend to move in the same direction over the long run. During the 1950s and 1960s, there did seem to be a definite correlation between rising stock prices and the cost of living. However, a comparison of the consumer price index and Standard and Poor's index of 500 stocks from 1970 to present day shows wide fluctuation, even during periods of accelerated inflation. In the 1970's some variable funds dropped by almost 40 percent in a matter of a few years at the same time inflation was skyrocketing. Individuals who already had started drawing their annuity benefits saw their payments decrease, while the cost of living increased. Not only did the downturn affect retirees, it also affected those who were still investing for the future. Therefore, even those who were still accumulating retirement funds were disappointed to learn that fund values did not appear to conform favorably to current economic conditions.

Some financial authorities have explained this phenomenon by proposing the existence of a definite relationship between inflation and stock prices. They point out that when prices rise rapidly, there is a corresponding increase in interest rates. When interest rates rise sharply, the stock market reacts by moving in the opposite direction. Therefore, when the cost of living takes a sudden jump, it seems that the value of the variable annuity unit tends to fall.

Proponents of the variable annuity, however, assert that they have never viewed this product as a temporary hedge against sudden inflation. To them, the variable annuity is based on the assumption of a long-term correlation between inflation and investment returns.

Based on this principle, a variable annuity would be a favorable investment because it would allow investors to enjoy a rise in income as the economy's productivity increases.

Investor Considerations

The variable annuity, with its combination of traditional guarantees and investment flexibility, offers great promise as a financial planning tool. It has the potential to be more responsive to economic trends than the conventional savings account or even the traditional fixed annuity.

However, the savings customer who has basically considered only fixed investments should be aware of the special concerns connected with the purchase of a variable annuity.

Risk

There are two important points to keep in mind regarding the ***risks of variable annuities***. One concerns the ***insurance company*** that issues the annuity, and the second concerns the ***investment's fluctuating nature***. Regarding the first point, it is essential to note that, while both fixed and variable annuities are marketed by savings institutions, neither product is covered by federal insuring agencies. The investment is backed by the guarantees made by the insurance company that sells the annuity contract.

Although the insurance industry's record of financial stability has been very good, the annuity purchaser should investigate the company that issues the contract. While the savings institution marketing the annuity will have investigated the insurance company, the counselor must explain to the customer that government insurance does not apply to annuity products. In previous cases of insurance company failure, other insurance carriers have assumed the failed company's financial obligations.

However, this process has entailed some delays. Furthermore, although principal was safeguarded, the interest earnings promised in the original contract were not always credited to the investor.

The second area of risk -- the fluctuating nature of the variable annuity -- was discussed at length earlier. Investors should recognize that whenever they place money in variable annuities, the dollar value of their investments is subject to both upward and downward changes. An investor should assess his or her tolerance for risk when selecting a variable annuity and composing the annuity portfolio.

Particular caution is needed during the retirement period, when the contract owner may be contemplating changing investment strategies. Many owners take a more conservative investment position at this time than when they were making deposits and accumulating funds.

While it is possible to increase income payments by making the right investment choices, it is also possible to make the wrong decisions. Unlike during the accumulation period, when there is sufficient time to make up for a temporary loss, once retirement begins, it is difficult to recoup any losses resulting from investment mistakes.

Choosing an Annuity Type

Determining which type of variable annuity is suitable for an investor depends mainly on two factors. One factor is the potential purchaser's investment sophistication. The other is the extent to which the person wishes to become involved in investment decisions.

The first consideration applies to the inexperienced investor with limited knowledge of the stock market. In this case, a company-managed variable annuity is probably the better choice, since the insurance company will make all the investment choices and manage the portfolio.

The second consideration concerns whether the contract owner wishes to continually monitor changing economic conditions and be responsible for changing the direction of investments in the annuity portfolio. With the self-directed type of variable annuity, the investor decides on the mix of investments in the portfolio. It is the contract owner's responsibility to periodically review these investments to see whether their performances are still in tune with his or her investment objectives, and adjust the portfolio accordingly. The self-directed plan is probably more suited to an investor who is accustomed to making these types of decisions.

Equity Annuity Options

In a general sort of way, the equity index annuity combines the traditional features of a fixed annuity which include;

- Guarantee of principal
- Tax deferral
- Free withdrawals
- Surrender charges when applicable . . . with;
- Current rates credited which are linked to the equity markets.

This type of annuity provides a rate of return that is determined as a defined share in the anticipated appreciation of a major stock index. The annuity will provide a guaranteed minimum return as do regular fixed annuities.

One of the major keys to the equity annuity is to allow the investor to participate in interest rates that are linked to the equity markets but avoiding the possibility of downside market risk.

So, a Equity Indexed Annuity (EIA) is a fixed annuity with traditional guaranteed minimum interest rates, with an excess interest feature that is linked to an equity index such as the S&P 500 (explained below).

The contractual features of the annuity fit within the general definition of a non-security that mark it as an insurance product not requiring a securities license.

What is probably more important are the differences between the various Equity Index Annuities and how the index or interest calculation is made. There are also substantial variation between company designs, and quite frankly, no two products are alike.

Equity Index Annuity Investments

The EIA is a fixed annuity and the lion's share of EIA premium dollars are invested in the same types of fixed-rate investments that insurance companies use to support their traditional fixed interest annuities. In a traditional fixed annuity, current (or excess) interest is paid in the form of a declared current crediting rate. In an EIA, current (or excess) interest is paid in the form of participation in the equity index.

Again, the major part of the investments cover the underlying minimum contract value guarantee. The carrier deducts a percentage of their investment earnings (called a "spread") to pay for expenses and their profit margin. The balance is used to purchase future participation in the equity index growth. The company can hedge future index growth by buying call options. They may buy them directly on the ex change floor or from a third party like a bank.

It may seem counterintuitive but the level of the S&P 500 Index or the current direction of the stock market is not the significant factor in setting participation rates. In fact, it is the level of current interest rates that actually determines the amount of stock market participation the company can offer. The higher current market rates, the more investment earnings are available with which to purchase call options which then allows a higher participation and cap rate.

The cap permits the company to offer a higher participation rate by setting an upside limit on the index growth. If the Index increases over the cap, the carrier does not keep the difference because they only hedged up to the limit of the cap.

Buying call options that are not used to actually hedge a liability is considered speculative and would be considered a high-risk transaction.

All things being equal, the higher the participation rate, the lower the cap and vice versa. Unfortunately or fortunately, depending on the understanding of the insurance producer, various combinations of the participation rate and cap rates are available even possibly in the same annuity product.

The Process of Indexing Explained

"Indexing" is an investment strategy that seeks to match the performance of a defined group of securities. This group of securities forms a recognized market measurement called an "index." An index is a benchmark or relative measurement of performance. One example is the Consumer Price Index that tracks the changes in prices of consumer goods from year to year.

Indexing seeks to match overall performance of the index, so the particular securities held and the quantity of each is pre-determined by the composition of the index. Investment managers for a S&P 500 Index fund will purchase each of the 500 stocks in proportions that match the index in order to replicate the performance of the index itself. Indexing is often called "passive investing" because the type and amount of each stock

is decided by the index composition. This is in contrast to "actively managed" investing where a professional money manager devises unique strategies and investment philosophies in order to select individual securities. Indexing emphasizes diversification and by definition results in reduced trading activity.

Indexing arose from the "efficient market" theory of the 1960s, so it is not a new concept. If, as efficient market theory suggests, markets naturally tend toward optimum efficiency, it is questionable as to whether any strategy or philosophy can consistently outperform the market (at least do so by a significant margin.) If efficient market theory holds true, then simply "buying the market" (or, indexing) will be the least risky and most effective investment strategy.

The historical performance of the stock market is clear - over the long term it has simply gone up. However, while the trend has been decidedly upward, there has been significant volatility with some extreme highs and lows over short-term periods. This daily volatility means that investors may experience significant increases or decreases to their principal within the course of a few days.

Indexing is a "buy and hold" investment strategy. "Buy and hold" (in the context of the S&P 500 tends to outperform an "active trading" strategy for the average investor. We know that the average investor over time has exhibited a "buy high, sell low" behavior that is detrimental to long term investment returns.

The advantages of indexing can be evaluated by considering the indexed mutual fund, one of the most popular investment vehicles of the '90's.

Interest Crediting Methods

Modern equity index annuities are currently utilizing the Standard & Poor's 500 Composite Stock Price Index more commonly known as the S&P 500 Index. This index is a widely recognized measure of equities in the US stock markets.

While the S&P Index is the most widely used index today you should also be familiar with other indexes that are and can be used. Some of these other indexes include the following;

- Standard & Poor 100 also known as the OEX Index
- S&P 400
- Nikkei National Index which represents the Tokyo stock exchange
- DAX Index which represents the German Exchange
- FTSE Index which represents the Financial Times Stock Exchange in London

There are also a number of insurance carriers that use some sort of internal operations to create the needed annuity returns using their own investment department instead of a major index. Others even may use a reinsurer to create the returns.

Monthly Averaging

In some annuities, the average of an index's value is used rather than the actual value of the index on a specified date. The index averaging may occur at the beginning, the end, or throughout the entire term of the annuity.

Averaging at the beginning of a term protects you from buying your annuity at a high point, which would reduce the amount of interest you might earn. Averaging at the end of the term protects you against severe declines in the index and losing index-linked interest as a result. On the other hand, averaging may reduce the amount of index-linked interest you earn when the index rises either near the start or at the end of the term.

The averaging modifier (modifiers serve to limit the Index Benefit by affecting the amount, timing and crediting of Index interest credits) serves to limit the S&P 500 Index growth to which the participation rates are applied. For example, if the market gained 1% per month each month for one year, (e.g. from 500 to 563) it would be up a total of 12.67% at year-end. The average index value would be 532 or a 6.74% average annual increase.

Point to Point

Compares the change in the index at two discrete points in time, such as the beginning and ending dates of the contract term.

Advantage: May be combined with other features, such as higher cap and participation rates, that may credit you with more interest.

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, if it declines dramatically on the last day of the term, then part or all of the earlier gain can be lost. 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.

The index-linked interest, if any, is based on the difference between the index value at the end of the term and the index value at the start of the term. Interest is added to your annuity at the end of the term

Possibly the most basic type of equity index method is the ***Long-Term Point-to-Point*** method.

As the name implies, there are only two days in this index calculation method, the starting point and the ending point. For example, if Point A (the starting point) is 500 on an index and Point B (the ending point) is 550, then an unadulterated or pure Point-to-Point method would register a gain of 10 percent. That number would then be multiplied by the participation rate to determine the index gain for that period.

The ***annual point-to-point*** method uses an annual measure for calculating index returns.

So far, two pure Point-to-Point basic designs have emerged, the "Annual Point- and the "Long Term Point-to- In the classic unadulterated version of the Long Term Point-to-Point index method, the only days that count in the index gain calculation are the first day (the issue date) and the last day of the index term. Whatever the market did in between is IRRELEVANT. Only the first and last day of the entire index term count.

High-water Mark Designs

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.

Advantage: May credit you with more interest than other indexing methods and protect against declines in the index.

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.

Annual Reset

Compares the change in the index from the beginning to the end of each year. Any declines are ignored.

Advantage: Your gain is "locked in" each year.

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 This design, in all its variations, counts gains by the year, recognizes those gains, and locks them in so they are not lost in market downturns. All three zones of gain are counted.

Thus, you can see that Annual Point-to-Point designs of greater than one year generally have an annual reset of the starting point feature. Gains are registered below the initial starting point, which can be about half of the total possible gains. Also, all annual gains are added or combined together for a term total, as opposed to Long Term Point-to-Point, Average End, or High Water Anniversary Mark, Look-Back designs, where ONLY ONE point is derived from the index formula, and then a number and an effective annual yield are calculated.

Combination Methods

In an effort to give consumers even more choice, companies are assembling combination contracts that use many of the methods described above.

Spreads

In some annuities, the index-linked interest rate is computed by subtracting a specific percentage from any calculated change in the index. This percentage, sometimes referred to as the "margin," "spread," or "administrative fee," might be instead of, or in addition to, a participation rate. For example, if the calculated change in the index is 10%, your annuity might specify that 2.25% will be subtracted from the rate to determine the interest rate credited. In this example, the rate would be 7.75% (10% - 2.25% = 7.75%). In this example, the company subtracts the percentage only if the change in the index produces a positive interest rate.

Cap Rates and Participation Rates

Another trade-off to consider is the long-term guarantee of the participation and cap rates.

A ***cap rate*** is the explicit maximum account value percentage increase allowed. The cap for an annual reset product is the maximum account value percentage increase allowed for a given policy year. A cap serves to set an upward limit on the client's Index Benefit. Cap rates are clear state limits on the index growth.

Participation rates represent the percentage of the increase in the index that will be credited to the accumulation value, which may be subject to the cap in some of the contracts. To add to some of the confusion already created, a contract with a 100% Participation Rate does not necessarily produce a greater Index Benefit than a contract with an 85% Participation Rate.

If guaranteed for the term, an 85% participation and 14% cap would become 65% and 12% respectively. Realize, you have a design similar to a traditional interest based annuity and a long term guarantee of these participation and cap rates would create significant surplus strain (just like it does for an interest based fixed annuity. Ever notice that traditional interest based annuities' long term rate guarantees are lower than the current, year to year guarantees?) Similar to "company practice" with interest based annuities, it is the company's intention to maintain the participation and cap rates for the length of the term. The bottom line ... if you deal with a reputable carrier with a reputation for fair and honest renewal rates, the annual reset design will provide the intended benefits and results.

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.

Minimum Interest Guarantee

One of the EIA features that is most commonly misunderstood is the minimum contract value. This value is an underlying secondary guarantee or "safety net" that ensures a guaranteed minimum cash value is available to the consumer.

The minimum contract value is guaranteed regardless of how the index performs. (Index performance is reflected through index increase credits to the current accumulation value.) So if the index stays flat or declines over the entire term of the contract (so that effectively, no index increases are earned) this minimum contract value comes into play. Of course, the likelihood that the Index will remain perfectly flat or consistently decline over a long period of time is statistically small. However, this guarantee exists to accommodate that scenario.

When calculating "cash value" benefits, such as a surrender value, death benefit, annuitization value or withdrawal the buyer always receives the greater of the current

accumulation value or the minimum contract value guarantee. In non-registered products, this value must comply with minimum Non-Forfeiture Regulations, which for single premium contracts equals 90% of the premium at 3% interest compounded annually. (The regulation for flexible premium contracts is 65% at 3% interest compounded annually.) Today, the most common minimum contract value provision is 90% at 3% interest, which, for example, would equal 110% of principal at the end of a seven-year term. However, there are contracts that now guarantee 100% of premium at 3% interest and some flexible premium contracts guarantee less than 90% of premium at 3% interest.

Some contracts "top up" the minimum contract value at the end of a term to equal the current accumulation value as of the just ended term. This effectively increases the minimum contract value guarantee to reflect previously earned index credits.

In and of itself, the minimum contract value is not a particularly meaningful feature with which to compare the competitiveness of a product. In reality, this value will only be meaningful:

- Upon early surrender.
- If the index is flat or declines over the entire term.

Premature Surrender

If your client withdraws all or part of the value in his annuity before the end of the term, a withdrawal or surrender charge may be applied. A withdrawal charge is usually a percentage of the amount being withdrawn. The percentage may be reduced or eliminated after the annuity has been in force for a certain number of years. Sometimes the charge is a reduction in the interest rate credited to the annuity.

Some annuities credit none of the index-linked interest or only part of it if you take out all your money before the end of the term. The percentage that is vested, or credited, generally increases as the term comes closer to its end and is always 100% at the end of the term.

Like fixed and variable contracts, EIAs may have a limited "free withdrawal" provision. This lets you make one or more withdrawals without charge each year. The size of the free withdrawal is limited to a set percentage of your annuity's guaranteed or accumulated value. If you make a larger withdrawal, you may pay withdrawal charges. You may also lose index-linked interest on amounts you withdraw.

Most annuities waive withdrawal charges on withdrawals made within a set number of days at the end of each term. Some annuities waive withdrawal charges if you are confined to a nursing home or diagnosed with a terminal illness. Your client may, however, lose index-linked interest on withdrawals.

Charges and Fees

Other than surrender charges (discussed above), most equity indexed annuities have no associated fees or charges. However, where participation rates are involved, administrative fees may be charged ranging from 1 percent to 2.5 percent annually. Contracts with less than 100 percent, however, typically do not charge such fees.

Annuity Riders

In an effort to be a competitive as possible, many annuity companies offer a myriad of annuity rider options. Some are available only at the time the contract is issued, others can be added later.

Life Insurance

Most contracts offer a standard death benefit payable upon the death of the annuitant. For additional fees, a rider can be purchased to enhance death benefit amount . . . say to double the amount of the original premium or total premiums invested. Others allow investors to ***step-up*** the death benefit to the account value of the contract by periodically renewing an owner's contract with a new surrender penalty schedule.

Living Benefits

Living benefits are optional and exercisable at the discretion of the policyholder. Such a guarantee might protect your mutual fund investments against losses if you hold the investment for a period of time. Other living-benefit guarantees might promise to pay a guaranteed retirement income, regardless of how the investment account performs.

Long Term Care

Long-term care riders to life policies or annuities often pay ***living benefits*** when a serious illness occurs, even when no nursing home care is needed. For example, victims of strokes, heart attacks, cancer, coronary artery surgery, and renal failure can collect benefits while they are still living. Sometimes the policy holder can receive as much as 25 or 50 percent of the policy's face value up front, rather than in regular monthly payments.

These riders have limits. They may not cover nursing home stays outside the United States or long-term care resulting from alcoholism, drug addiction, or attempted suicides. The long-term care riders usually cover nursing home care only after a stay in a hospital or in a skilled nursing home where medical treatment is dispensed. Most nursing home residents enter the homes directly, not after a stay in a hospital or skilled nursing homes.

The money available for nursing home benefits on a long-term care rider is normally two percent of insurance coverage per month. By this rule, a $100,000 policy would pay $2,000 per month. However, if the policy is over $150,000, the policy holder may get less than two percent. For example, suppose the policy holder has a $300,000 life insurance policy with a long-term care rider, and he is confined to a nursing home. This insured may get two percent of the first $150,000 ($3,000) plus one-half percent of the next $150,000 ($750) for a total of $3,750 per month. Also, some policies place a limit on the monthly payment amount. Some policies permit the policy holder to collect 100 percent of the amount of the life insurance, while others cap it at 50 percent. Most polices require that the policy holder pay at least for the first 60 days of nursing home care before a long-term care rider kicks in.

With some riders, the policy holder will have to make out-of-pocket payments for at least 180 days before he can collect. Some long-term care riders will not pay until the policy holder has been paying the extra premium for at least three years. For example, if an individual buys a long-term care rider in 1997, he may not be able to collect before 2000, 2002, or some other date.

Most long-term care riders will pay for skilled care or intermediate care nursing home stays. However, some riders do not pay for custodial care. Others will pay only after a specified number of days in a hospital or a specified number of weeks in a skilled care or an intermediate care home. While receiving benefits from a long-term care rider, the policy holder is not obligated to keep paying premiums if the rider has a waiver of premium feature.

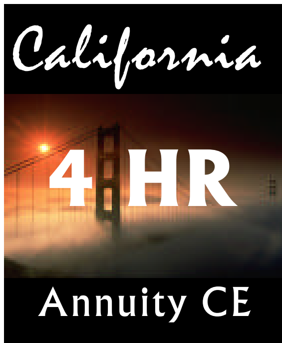
The problems with funding long term care coverage through an accelerated death benefit policy are obvious: Benefits may be slower than a stand alone policy, benefit triggers can be tricky and there is typically no inflation protection other than by expensive inflation riders. Furthermore, the death benefits that could have gone to an insured's estate are usually "eaten-up" in long term care costs thus defeating the purpose of buying a life insurance policy.

Also, agents must be sure to differentiate between actual coverage and a simple ***crisis waiver***, which allows the waiver of certain fees should a special illness develop.

Loan Provisions

Many annuity companies permit loans up to the contracts cash value. However, there are usually many statutory regulations, regarding maximum interest charged, repayment, disclaimers that the loan will offset any cash value or death benefit, etc.

When an annuity is ***inside a qualified plan***, these requirements are even stricter where loans are limited to 50% of the current present value with a maximum repayment period of 5 years. In addition, loans must have a level amortization (repayment) plan.



PART III: SELLING CALIFORNIA ANNUITIES

The selling of insurance and annuities in is complex. There are still many unknown factors about premiums or benefits and the proof that you did a good or bad job may not surface for 10, 20 or 30 years; all of which promote the possibility that a lawsuit could land in your lap at anytime, up through your own retirement. That is why agents must practice due care at every moment and through every phase of the annuity sale.

A few ways to minimize conflicts between yourself, clients and your carrier include:

- Meet all California Code requirements of annuity sale disclosure and suitability.
- Select product that is suitable for your client.
- Know the product you are selling, including all reasonably priced and widely available options the policy offers.
- Be sure coverage is adequate at the time of sale.
- Be wary of "special agent relationships" that may define you as a fiduciary to the client.
- Avoid ***dual agency*** status where you have defined yourself as an "expert" or having special knowledge.
- Develop ***standard operating procedures*** to handle all clients the same.
- Consult an attorney or capable advisor before giving clients advice in areas of taxation, estate planning, asset protection, financial planning, etc.

Let's look at some specific areas of compliance in California:

ADVERTISING

The cornerstone agent ethics is the handling and choice of company, product and sales presentation to best serve a client's financial planning. As it relates to advertising, you should provide sales materials that are clear as to purpose and honest and fair as to content.

Senior Advertising

California requirements ***(CIC 787)*** are very specific about advertising directed at seniors (anyone age 65 or older):

No insurer, agent, broker, solicitor, or other person or other entity shall solicit persons age 65 and older in this state for the purchase of disability insurance, life insurance, or annuities through the ***use of a true or fictitious name which is deceptive or misleading*** with regard to the status, character, or proprietary or representative capacity of the entity or person, or to the true purpose of the advertisement.

Further, advertisements shall not employ ***words, letters, initials, symbols, or other devices which are so similar to those used by governmental agencies***, a nonprofit or charitable institution, senior organization, or other insurer that they could have the capacity or tendency to mislead the public. Examples of misleading materials, include, but are not limited to, those which imply any of the following:

- The advertised ***coverages*** are somehow provided by or are endorsed by any governmental agencies, nonprofit or charitable institution or senior organizations.
- The advertiser is the same as, is connected with, or is ***endorsed by governmental agencies***, nonprofit or charitable institutions or senior organizations.
- No advertisement may ***use the name of a state or political entity*** in a policy name or description.
- No advertisement may use any name, service mark, slogan, symbol, or any device in any manner that implies that the insurer, or the policy or certificate advertised, or that any agency who may call upon the consumer in response to the advertisement, is ***connected with a governmental agency***, such as the Social Security Administration.

It is also important that any advertising you employ does not imply that the reader may ***lose a right, or privilege, or benefits*** under federal, state, or local law if he or she fails to respond to the advertisement.

Further, an insurer, agent, broker, or other entity may not use an ***address so as to mislead or deceive as to the true identity, location, or licensing status*** of the insurer, agent, broker, or other entity.

Likewise, no insurer may use, in the trade name of its insurance policy or certificate, any terminology or words so similar to the name of a governmental agency or governmental program as to have the capacity or the tendency to confuse, deceive, or mislead a prospective purchaser.

No insurer, agent, broker, or other entity may solicit a particular class by use of advertisements which state or imply that the occupational or other status as ***members of the class*** entitles them to reduced rates on a group or other basis when, in fact, the policy or certificate being advertised is sold on an individual basis at regular rates.

Also remember, all advertisements used by agents, producers, brokers, solicitors, or other persons for a policy of an insurer shall have ***written approval of the insurer before they may be used***.

Who is exempt from these rules? Any person or entity that is not required to be licensed and non-resident agents representing an insurer that is a direct response provider.

Advertising Defined ***(CIC 787b)***

For the purposes of this section, an advertisement includes envelopes, stationery, business cards, or other materials designed to describe and encourage the purchase of a policy or certificate of disability insurance, life insurance, or an annuity.

Legally speaking, all client contact is considered advertising. So, be careful in any memos, e-mails or discussions you have with a client. Be sure you are not violating the spirit of any rules by inferring something about product, company or yourself that could mislead or confuse a client as to your ***real intentions***.

Required Information License Number

As a review, every licensee shall prominently affix, type, or cause to be printed on business cards, written price quotations for insurance products, and print advertisements distributed exclusively in this state for insurance products its ***license number*** in type the same size as any indicated telephone number, address, or fax number. If the licensee maintains more than one organization license, one of the organization license numbers is sufficient for compliance with this section.

Use of The Word "Insurance"

Effective January 1, 2005, every licensee shall prominently affix, type, or cause to be printed on business cards, written price quotations for insurance products, and print advertisements, distributed in this state for insurance products, the word "***Insurance***" in type size no smaller than the largest indicated telephone number. A penalty can be levied on ***each piece*** of printed material that fails to conform to this requirement.

The only exception here is if the failure to comply was beyond the control of the agent. In addition, this requirement does not apply to general advertisements of motor clubs that merely list insurance products as one of several services offered by the motor club, and do not provide any details of the insurance products.

Internet Sales

A person who is licensed in this state as an insurance agent or broker, advertises insurance on the Internet, and transacts insurance in this state, shall identify all of the following information on the Internet, regardless of whether the insurance agent or broker maintains his or her Internet presence or if the presence is maintained on his or her behalf:

- His or her name as it appears on his or her insurance license, and any fictitious name approved by the commissioner.
- The state of his or her domicile and principal place of business.
- His or her license number.

A person shall be deemed to be transacting insurance in this state when the person advertises on the Internet, regardless of whether the insurance agent or broker maintains his or her Internet presence or if it is maintained on his or her behalf, and does any of the following:

- Provides an insurance premium quote to a California resident.
- Accepts an application for coverage from a California resident.
- Communicates with a California resident regarding one or more terms of an agreement to provide insurance or an insurance policy.

Seminar or Class Meeting Advertisements

In addition to any other prohibition on untrue, deceptive, or misleading advertisements, no advertisement for an event where insurance products will be offered for sale may use the terms "seminar," "class," "informational meeting," or substantially equivalent terms to characterize the purpose of the public gathering or event unless it adds the words ***"and insurance sales presentation"*** immediately following those terms in the same type size and font as those terms. Of course, advertising must also comply with requirements to display your license number.

Direct Mailers (CIC 787)

Any advertisement or other device designed to produce leads based on a response from a potential insured which is directed towards persons age 65 or older shall prominently disclose that an ***agent may contact the applicant*** *if that is the fact. In addition, an agent who makes contact with a person as a result of acquiring that person's name from a lead generating device shall disclose that fact in the initial contact with the person*

So, if your product or way of operating requires an onsite visit or return phone call to a senior, you need to disclose that you will be contacting them.

Fines and Penalties

Agents

Any broker, agent, or other person or other entity engaged in the transactions of insurance, other than an insurer, who violates this article is liable for an administrative penalty of no less than one thousand dollars ($1,000) for the first violation.

Upon a second violation, an agent will be liable for an administrative penalty of no less than five thousand dollars ($5,000) and no more than fifty thousand dollars ($50,000) for each violation.

In addition, if the commissioner brings an action against a licensee for the violations above and determines that he may reasonably be expected to cause significant harm to seniors, the commissioner may suspend his or her license pending the outcome of a hearing.

Insurers

Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars ($10,000) for the first violation. Second violations can bring a $30,000 to $300,000 fine and a rescission of the annuity or policy in violation.

SALES PRACTICES

State codes of insurance and thousands of legal actions against insurance producers focus on one thing . . . agent conduct. A few years ago, no one knew what ***market conduct*** meant. Today there are class action suits and negligence claims filed against

insurers and agents alike amounting to millions of dollars for a variety of sales and legal conduct violations. Of course, agent conflict is nothing new. Our research found cases dating back to the early 1800's. What is different between cases of today and the ones that occurred years ago is the trend toward fiduciary responsibility. In essence, the courts are viewing agents as ***more than mere salesmen***. Recent cases, for example, lean toward the precedent that agents, as insurance professionals, ***should have known*** something was wrong compared to years ago where agent liability was generally limited to issues of ***outright negligence***. There ***is*** a world of difference between the two that is best explained by the ***legal precedent theory***. In a nutshell, because our legal system makes legal decisions based on precedents, it is destined to constantly expand. Each decision in the chain sets the stage for the next step of expansion. The result can be demonstrated court cases. In Southwest v Binsfield (1995), for example, the agent ***should have known*** that a specific coverage option was important to the business he insured. In Brill v Guardian Life (1995) the agent ***breached his fiduciary duty*** by not using an ***optional*** conditional receipt. Clearly, these cases represent an expansion of agent liability . . . from decades-old "contract" issues to fiduciary duties. Dozens of cases may have proceeded these cases: in each, the level of agent duty was notched higher and higher as attorneys convinced attorneys that agents should be held more accountable.

Agent accountability today may also come with a high price tag. Consider the following court cases where the actual dollar losses incurred by client victims was extremely low compared to the ***high punitive damages*** levied against agents and their insurers:

State Farm v Grimes	*$1,900 Actual losses*	*$1.25 Million Punitive Award*
Independent v Peavy	*$412 Actual losses*	*$250,000 Punitive damages*
National Life v Miller	*$258 Actual losses*	*$350,000 Punitive damages*

As you read these amounts you may be thinking that the damages were high because insurance companies have ***deep pockets***. They can afford to pay these sums of money, which is why juries awarded them. However, you must also keep in mind that virtually every agency agreement in existence has some kind of ***indemnification clause*** or wording that entitles the insurer to demand reimbursement from you, the agent, for malpractice, negligence or action leading to a jury award. In other words, if you have a contributing exposure to a problem that caused the insurer to pay-out big bucks, you probably have the same exposure when the ***insurer*** comes after you personally!

Reasonable Expectation & Detrimental Reliance

The majority of selling infractions by agents center around two legal concepts: reasonable expectation and detrimental reliance. Here is a brief summary if each:

Reasonable expectation

No matter how clear the language, ***all policies*** contain areas of ***ambiguity***. When conflicts arise, the courts generally turn to ***theories of reasonable expectation***. In a nutshell, if a policy could imply to a reasonable or average policy holder that coverage is in force or benefits exist, yet that exact language does not exist in the policy, then

coverage / benefit DOES extend to the policyholder. In other words, the courts generally favor the insured.

Many times it is the agent's misrepresentation of policy terms that sways the client into believing he is covered or that an anticipated outcome will accrue, only to find out he is not or it doesn't. Illustrations of annuity contracts with seemingly realistic rates of return and projected values is a clear example of how agents build a client's expectations. In cases where coverage or results were misrepresented, courts may interpret that the expectations of the client were at a level that a reasonable person would expect coverage or the intended results represented.

Detrimental Reliance

Where the insured reasonably believes he is covered or receiving a certain benefit by virtue of representations by an insurance agent or broker, the failure of the broker to produce the coverage/benefits or else warn the client at once that coverage/benefits could not be obtained constitutes a failure to exercise the requisite skill or diligence required of a broker. One of the key elements in a ***detrimental reliance claim*** is whether or not the reliance placed on the agent caused the insured to miss the opportunity to obtain alternative coverage or keep good coverage/benefits he already had.

As you will learn below, detrimental reliance is an important concept you must keep in mind when exchanging or replacing a client's coverage/benefits with another contract. A decision by that client to change, made on information you provided, should reasonably benefit the client in some, if not multiple ways . . . and the fact that you need a commission is not one of them!

Tax Consequences

Annuities are sold for their tax advantages. The laws are complicated and could have far-reaching effect on a client's overall yield. Agents have been known to underestimate tax consequence by forgetting to advise clients a tax exists or overestimate them in promoting the unnecessary replacement of a contract simply because the exchange will be tax free.

New legislation ***(CIC 789.9, SB 620)*** is clear when it comes to seniors: If a life agent offers to sell to an elder (age 65 or older) any life insurance or annuity product, the life agent shall advise an elder or elder's agent ***in writing that the sale or liquidation*** of any stock, bond, IRA, certificate of deposit, mutual fund, annuity, or other asset to fund the purchase of this product ***may have tax consequences***, early withdrawal penalties, or other costs or penalties as a result of the sale or liquidation, and that the elder or elder's agent may wish to consult independent legal or financial advice before selling or liquidating any assets and prior to the purchase of any life or annuity products being solicited, offered for sale, or sold.

Medi-Cal and Annuities

For years, agents have seized on the fears of client's regarding Medi-Cal eligibility. Clients have been sold considerable product that purportedly exempts income or assets

from the eligibility rules so as to believe they will qualify for Medi-Cal when the time comes. Many of these exemption holes have been plugged and there are penalties for people and their agents who attempt to abuse the system.

New legislation makes this very clear: A life agent who offers for sale or sells a financial product to an elder on the basis of the product's treatment under the Medi-Cal program ***may not negligently misrepresent*** the treatment of any asset under the statutes and rules and regulations of the Medi-Cal program, as it pertains to the determination of the elder's ***eligibility*** for any program of public assistance.

In addition, the following disclosure is required. The statement shall be printed in at least 12-point type, shall be clearly separate from any other document or writing, and shall be signed by the prospective purchaser and that person's spouse, and legal representative, if any. The State Department of Health Services shall update this form to ensure consistency with state and federal law and make the disclosure available to agents and brokers through its Internet Web
Site:

"NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY

If you or your spouse are considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message!

You or your spouse do not have to use up all of your savings before applying for Medi-Cal.

UNMARRIED RESIDENT

An unmarried resident may be eligible for Medi-Cal benefits if he or she has less than (insert amount of individual's resource allowance) in countable resources.

The Medi-Cal recipient is allowed to keep from his or her monthly income a personal allowance of (insert amount of personal needs allowance) plus the amount of any health insurance premiums paid. The remainder of the monthly income is paid to the nursing facility as a monthly share of cost.

MARRIED RESIDENT

COMMUNITY SPOUSE RESOURCE ALLOWANCE: If one spouse lives in a nursing facility, and the other spouse does not live in a facility, the Medi-Cal program will pay some or all of the nursing facility costs as long as the couple together does not have more than (insert amount of community countable assets).

MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE: If a spouse is eligible for Medi-Cal payment of nursing facility costs, the spouse living at home is allowed to keep a monthly income of at least his or her individual monthly income or (insert amount of the minimum monthly maintenance needs allowance), whichever is greater.

FAIR HEARINGS AND COURT ORDERS: Under certain circumstances, an at-home spouse can obtain an order from an administrative law judge or court that will allow the at-home spouse to retain additional resources or income. The order may allow the

couple to retain more than (insert amount of community spouse resource allowance plus individual's resource allowance) in countable resources. The order also may allow the at-home spouse to retain more than (insert amount of the monthly maintenance needs allowance) in monthly income.

REAL AND PERSONAL PROPERTY EXEMPTIONS

Many of your assets may already be exempt. Exempt means that the assets are not counted when determining eligibility for Medi-Cal.

REAL PROPERTY EXEMPTIONS

ONE PRINCIPAL RESIDENCE: One property used as a home is exempt. The home will remain exempt in determining eligibility if the applicant intends to return home someday.

The home also continues to be exempt if the applicant's spouse or dependent relative continues to live in it. Money received from the sale of a home can be exempt for up to six months if the money is going to be used for the purchase of another home.

REAL PROPERTY USED IN A BUSINESS OR TRADE: Real estate used in a trade or business is exempt regardless of its equity value and whether it produces income.

PERSONAL PROPERTY AND OTHER EXEMPT ASSETS

IRAs, KEOGHs, AND OTHER WORK-RELATED PENSION PLANS: These funds are exempt if the family member whose name it is in does not want Medi-Cal. If held in the name of a person who wants Medi-Cal and payments of principal and interest are being received, the balance is considered unavailable and is not counted. It is not necessary to annuitize, convert to an annuity, or otherwise change the form of the assets in order for them to be unavailable.

PERSONAL PROPERTY USED IN A TRADE OR BUSINESS.

ONE MOTOR VEHICLE.
IRREVOCABLE BURIAL TRUSTS OR IRREVOCABLE PREPAID BURIAL CONTRACTS.
THERE MAY BE OTHER ASSETS THAT MAY BE EXEMPT.

This is only a brief description of the Medi-Cal eligibility rules. For more detailed information, you should call your county welfare department. Also, you are advised to contact a legal services program for seniors or an attorney who is not connected with the sale of this product.

I have read the above notice and have received a copy.
Dated:_______________ Signature:
____"

More Medi-Cal Restrictions

An annuity shall not be sold to a senior (age 60 years and older) in any of the following circumstances:

The senior's purpose in purchasing the annuity is to affect Medi-Cal eligibility and either of the following is true:

- The purchaser's assets are ***equal to or less than the community spouse*** resource allowance established annually by the State Department of Health Services pursuant to the Medi-Cal Act.
- The senior would ***otherwise qualify*** for Medi-Cal.
- The senior's purpose in purchasing the annuity is to affect Medi-Cal eligibility and, ***after the purchase of the annuity***, the senior or the senior's spouse would not qualify for Medi-Cal.

If an annuity is issued but violates any of these provisions, the insurer must rescind the contract and refund to the purchaser all premiums, fees, any interest earned under the terms of the contract, and costs paid for the annuity.

In-Home Solicitation Rules ***(CIC 789.10, SB620)***

In-home solicitations have been the source of senior abuse for years. Now there is specific legislation that addresses this area of annuity sales.

Any agent who meets with a senior (anyone age 65 or older) in the senior's home is required to deliver a ***notice in writing*** to the senior no less than ***24 hours prior*** to that individual's initial meeting in the senior's home.

If the senior has an existing insurance relationship with an agent and requests a meeting with the agent in the senior's home the same day, a notice shall be delivered to the senior prior to the meeting. The notice shall be in substantially the following form, with the appropriate information inserted, in ***14-point type***:

In-Home Solicitation Form

(1) During this visit or a follow-up visit, you will be given a sales presentation on the following (indicate all that apply):

( ) Life insurance, including annuities
( ) Other insurance products (specify): __________________.

(2) You have the right to have other persons present at the meeting, including family members, financial advisors or attorneys.

(3) You have the right to end the meeting at any time.

(4) You have the right to contact the Department of Insurance for information, or to file a complaint. (The notice shall include the consumer assistance telephone numbers at the department)

(5) The following individuals will be coming to your home: (list all attendees, and insurance license information, if applicable)"

Upon contacting the senior in the senior's home, the person shall, before making any statement other than a greeting, or asking the senior any other questions, ***state that the purpose of the contact is to talk about insurance***, or to gather information for a followup visit to sell insurance, if that is the case, and state all of the following information:

(1) The name and titles of all persons arriving at the senior's home.
(2) The name of the insurer represented by the person, if known.

Each person attending a meeting with a senior shall ***provide the senior with a business card or other written identification*** stating the person's name, business address, telephone number, and any insurance license number.

The persons attending a meeting with a senior shall end all discussions and ***leave the home of the senior immediately after being asked*** to leave by the senior.

A person may not solicit a sale or order for the sale of an annuity or life insurance policy at the residence of a senior, in person or by telephone, by using any plan, scheme, or ruse that misrepresents the true status or mission of the contact.

Sharing Commissions (CIC 1724)

An agent, broker, or solicitor who is not an active member of the State Bar of California may not share a commission or other compensation with an active member of the State Bar of California.
For purposes of this section, "commission or other compensation" means pecuniary (consisting of money) or nonpecuniary compensation of any kind relating to the sale or renewal of an insurance policy or certificate or an annuity, including, but not limited to, a bonus, gift, prize, award, or finder's fee.

Replacement (CIC 10509.8)

While the replacement of one annuity with another is not a bad thing, the introduction of new restrictions make it clear the Department of Insurance wants focus on abuses. Agents who are particularly aggressive in this area should exercise extreme caution in the presentation and implementation of a replacement contract.

Unnecessary Replacement

A pattern of frequent replacements, especially those where the client did not materially benefit, is not only against insurance codes, it can be used to establish a detrimental reliance civil claim, i.e., you could be sued by your client. One of the key elements in a ***detrimental reliance claim*** is whether or not the reliance placed on the agent caused

the insured to miss the opportunity to obtain alternative coverage or keep one that would have been just as good or better.

As a responsible agent, you should advise clients to explore the reasons they might consider a keeping what they have? Are they simply unhappy with their return? Would they have also lost money in a different contract? Would their existing insurer add a rider to enhance their death benefit to keep them from leaving? Is the contract meeting their original goal of legacy planning?

A correct analysis of any annuity replacement is a matter of common sense. What is your client leaving behind? What is he gaining in the move? Most experts believe there should be ***multiple reasons and benefits*** for justifying the ***replacement*** of a contract because of the associated costs in moving. For some, the first red flag is the current surrender. If it is more than 3 percent, a replacement plan would have to offer a lot to make up the difference. It would also be wise to write down why the current policy does not meet a client's needs, e.g., fees are higher and death benefit is lower than a replacement contract. Assessments of the actual surrender value invested (not a comparison of the original contracts investment) should demonstrate that at various hypothetical returns, the move is reasonable. And, an evaluation of new surrender charges and a client's need to access his funds is a must.

Knowing this, let's understand the new law and look at some examples:

Under new code sections, you are in violation of California law if you recommend the replacement of an existing contract by use of a materially ***inaccurate presentation or comparison*** of an existing contract's premiums and benefits or dividends and values or annuity to a person age 65 or older.

For purposes of this section, ***"unnecessary replacement"*** means the sale of an annuity to replace an existing annuity that requires that the insured will pay a ***surrender charge*** for the annuity that is being replaced and that does not confer a ***substantial financial benefit*** over the life of the policy to the purchaser so that a reasonable person would believe that the purchase is unnecessary.

Substantial Financial Benefit

While ***substantial financial benefit*** is not defined in the code, a reasonable person would conclude that a contract owner should anticipate that the risk of exchanging or replacing one contract for another should amount to benefits that are ***more*** than an even swap; especially where surrender charges are required.

Example: Phil agrees to replace a $100,000 deferred annuity earning 5% with a new contract offering a first year bonus of 7%. Surrender charges in the swap will amount to $3,000. Over the life of the contract Phil calculates the replacement, after charges and taxes, made him a total of $100. Is this a substantial financial benefit? Probably not, considering the amount of principal, risk and his time. How about 1,000 profit? Probably so. A move that nets $1,000 against $100,000 seems reasonable. Of course, the courts typically decide, on a case by case basis, what is reasonable. It is probably best to have multiple reasons for making a replacement.

Example: Irene has $50,000 invested in a variable annuity. Her death benefit is equal to the original value or surrender value at time of death and all surrender charges have worn off. Her agent finds a new contract with a slightly better return, reduced charges, a short surrender period and an enhanced death benefit that increases the death benefit at surrender by 40% with no underwriting required. A substantial financial benefit? As long as Irene does not appear to need to access to her funds before the new surrender charges lift and the added death benefit is something she needs anyway, it seems reasonable that this replacement is warranted since Irene will substantially upgrade her death benefit. Before you recommend the move, however, wouldn't it be prudent to evaluate Irene's true life insurance needs first? Perhaps the added life coverage is available somewhere else or not needed at all.

Agent Knowledge

If there is a ***pattern*** that develops, where policyowners purchase replacement policies from the same agent yet owners indicate on applications that a replacement is not involved, it shall be considered that the agent has knowledge that replacement was intended. The point here is that some agents know full well the only benefit from a replacement is the commission. Attempting to disguise the transaction is illegal and could cost you your license or a major lawsuit. This is exactly what happened in a recent case that received national attention. Agents knew they had to comply with state disclosure forms, but advised clients to leave out certain information or simply sign a blank form. The agents and company have paid dearly for this mistake.

Bait and Switch

Less than ethical agents use the illusion of providing a benefit to soften a client's perspective and then sell them something else. This is the classic definition of bait and switch. Many times the procedure is to ***qualify*** potential ***victims*** through a process of a deceptive interview or application . . . referred to as a ***pretext interview*** . . . with the sole purpose to gather confidential information. Often, clients are coerced into providing information under the guise of some potential benefit and once the information is retrieved, a product sales pitch is tailored.

Trust Mills

An example of this in the annuity area is the creation of what attorney's refer to as a ***trust mill***. It's purpose was to provide unsuspecting clients the benefit of an inexpensive trust when the real purpose was to expose client assets to uncover and sell potential annuity prospects. On July 18, 1996 the California Attorney General and State Bar filed a joint lawsuit against the Alliance for Mature Americans, a non-law firm trust mill, in the Los Angeles County Superior Court. The lawsuit sought an injunction, more than $200 million in restitution, and more than $3 million in civil penalties. The lawsuit alleged that the Alliance for Mature Americans used "scare tactics" and unlawful and deceptive business practices to sell living trusts to senior citizens, some of whom suffered from Alzheimer's and Parkinson's diseases, in order to obtain confidential information to sell these persons annuities. The lawsuit also alleged that the Alliance for Mature Americans engaged in the unauthorized practice of law by training non-attorney salespeople to promote themselves as estate planning experts. In April, 1997 the Alliance for Mature Americans agreed to a settlement of the lawsuit whereby it would make restitution of $1

million, pay a civil penalty of $100,000, and discontinue its sales of estate planning services and living trusts.

As a result of this kind of deceptive practice, the Insurance Commissioner released a special bulletin in 2001 explaining agent and insurer responsibilities relating to any marketing scheme involving bait and switch tactics. A copy of this bulletin is provided (Attachment II) at the back of this course and is suggested reading by all agents.

Specific insurance codes have also been established to address these illegal activities:

No insurance institution, agent or insurance support-organization shall use or authorize the use of pretext interviews to obtain information in connection with an insurance transaction.

A ***pretext interview is defined*** as an interview whereby a person, in an attempt to obtain information about another person, perform one or more of the following acts:

- Pretends to represent a person he is not
- Pretends to represent a person he is not representing
- Misrepresents the true purpose of the interview
- Refuses to identify himself upon request

Long Term Care Sales

Sales of long term care coverage, some attached as riders to annuities, are another area of bait and switch abuse. Their purpose is to capture the client's fear of a long term illness in order to promote the sale of the annuity. This is not to say that these contracts do not provide long term care benefits . . . it simply isn't their sole purpose.

For example, for years now, the insurance industry has designed annuity contracts that appeal to the liquidity needs of seniors and other market groups. Most new generation annuity policies, for example, offer ***free withdrawals*** that allow the owner to withdraw from the account value every year in case of a medical emergency or long term care illness. However, sometimes agents sometimes forget to mention that only 10 to 15 percent can be withdrawn without incurring penalties.

Additional drawbacks to both long term care riders and annuity coverage should be noted, but often are missed, such as: Benefits paid may be less than the standard long term care policy, particularly in areas such as home health care and assisted living. Similarly, the duration of payments will most certainly be limited. And, without inflation protection, the proceeds may do little to cover actual LTC costs. "Pot of money" approaches will most likely be exhausted in a matter of years or sooner and few, if any, can be expected to provide lifetime benefits.

Other Unlawful Practices ***(BPC 6125)***

It is important that agents do not represent themselves as having skills they do not possess in order to make a sale. The trust mill was just one example of this. Others include the practice of drafting, delivering and interpreting legal documents if you are unqualified to do so. An agent who decides to offer legal advice could be determined to

practicing law without a license . . . a clear violation of the California Business and Professions . . . *No person shall practice law in California unless the person is an active member of the State Bar.*

Therefore, areas such as estate planning, eldercare planning Medi-Cal planning and tax planning should be left to the professionals who are trained to advise in these fields.

Suspension *(CIC 1668.1, SB 618)*

The State of California is serious about agents using their position to influence or misrepresent clients . . . especially senior citizens. That is the focus of SB 620 and SB 618. As such, new legislation has given the Commissioner the "teeth" to enforce illegal agent activities. One such method is license suspension or revocation.

Existing law prohibits a person from soliciting, negotiating, or effecting contracts of insurance, or acting in the capacity of various types of insurance agents, unless the person holds a valid license from the Insurance Commissioner authorizing the person to act in that capacity. Existing law authorizes the commissioner to deny an application for a license for various reasons.

The new law goes much further by authorizing the commissioner to suspend or revoke any permanent license issued if:

A licensee induces the client to make a ***loan or gift*** *to or investment with the licensee, or to otherwise act in other specified ways that benefit the licensee or other people acquainted with or related to the licensee.*

Suspension, revocation and/or monetary penalties may also be assessed against any licensed agent who:

Induced a client, whether directly or indirectly, to cosign or make a loan, make an investment, make a gift, including a testamentary gift, or provide any future benefit through a right of survivorship to the licensee, OR

Induced a client, whether directly or indirectly, to make the licensee or any of the persons listed in subdivision a ***beneficiary*** under the terms of any intervivos or testamentary trust or the owner or beneficiary of a life insurance policy or an annuity policy, OR

Induced a client, whether directly or indirectly, to make the licensee, or a person who is registered as a domestic partner of the licensee, or is related to the licensee by birth, marriage, or adoption, a trustee under the terms of any intervivos or testamentary trust, OR

Use a ***power of attorney*** granted by client has to purchase an insurance product on behalf of the client for which the licensee has receives a commission, OR

Induces the client to provide the benefits for a person who is related to the licensee by birth, marriage, or adoption; a person who is a friend or business acquaintance of the licensee; a person who is registered as a domestic partner of the licensee.

The ***exception*** to these rules is the case where transactions by the licensee are on behalf of a person related to the licensee by birth, marriage, or adoption; or a person who is registered as a domestic partner of the licensee.

Penalties (CIC 782, 786, 789.3, 1738.5, 10509.9)

The seriousness of the new legislation is also underscored in the penalties assessed for violations:

Misrepresentation of Policy Terms or Benefits

Misrepresentation of policy terms or benefits is a misdemeanor crime and punishable by a fine not exceeding one thousand five hundred dollars ($1,500) or by imprisonment not exceeding six months.

Duplicate, Unnecessary Coverage / Deceptive Advertising

Seniors who are abused via a duplication or unnecessary coverage. Or, who are deceived by an agent representing himself to be someone he is not will results in still penalties, including an administrative penalty of no less than one thousand dollars ($1,000) for the first violation; $5,000 to $50,000 for a second violation. If the Commissioner at anytime believes the agent can be reasonably expected to cause harm to seniors, his license may be suspended. Further violation can result in another $10,000 fine for the agent and form $30,000 to $300,000 for the insurer. Further, based on the outcome of a hearing, the agent's license could be suspended or revoked.

Informed Decision / Reasonable Replacements

Annuity buyers are entitled to information to make an informed decision and the reasonable expectation that the consequences of a replacement of their existing policy is made. Agents not providing this are subject to an administrative penalty of no less than one thousand dollars ($1,000) for the first violation; $5,000 to $50,000 for a second violation. If the Commissioner at anytime believes the agent can be reasonably expected to cause harm to seniors, his license may be suspended. Further violation can result in another $10,000 fine for the agent and form $30,000 to $300,000 for the insurer. Further, based on the outcome of a hearing, the agent's license could be suspended or revoked.

Failure to Refund A Contract Refund To A Senior

Seniors (age 60 and older) are now entitled to a 30-day free look and a total refund of their premiums. Insurers that fail to make these refunds in a timely manner will pay the applicant interest from the date the insurer or entity received the returned policy or certificate.

Day in Court

Any allegations of misconduct perpetrated against a person age 65 or over shall result in a hearing to be held within 90 days after receipt by the department of the notice. . Based on the outcome of a hearing, the agent's license could be suspended or revoked.

ANNUITY SUITABILITY

In the world of insurance annuities, client's must decide ***when*** to invest, ***what*** to invest and ***how much***. As an agent, it is your job to analyze needs and be an advocate or problem solver to make sure the requested benefits are delivered.

A client views annuity contracts in terms of obtaining ***future benefits***, i.e., in most cases, your customers can only hope that the contract they purchase is appropriate. That is why agents are vital players in solving client needs. The greater agent due care exercised, the more valuable the service.

Example: Irene is a divorced mother of three teenage children. Through scrimping and saving she has managed to amass $100,000 in savings. Her goal is invest these funds to have a larger pot of money when her kids begin college in three to five years. She communicates this to an agent who advertised annuities as a safe alternative to bank CD's. He invests her money in a fixed annuity with a nine-year surrender charge. Of course, when it came time to fund college expenses there were taxes and penalties which offset her earnings and diminished the funds she needed. Think this doesn't happen? It's an actual case that led to a lawsuit and a claim of misrepresentation. Unfortunately, the agent could only provide a brief narrative account with no meeting notes or written documentation. Surrender charges were eventually waived and the producer was charged-back the commissions.

There are variety of techniques that are accepted and used to determine customer needs or suitability. Some are more traditional than others. Most are seen as solutions to ***identify*** a certain customer segment. They give logical, rational explanations about where the customer fits in but do not explain how the customer ***feels and cares***. Contract applications are an example of information an agent might use to identify who he is about to invest.

Suitability Duties

At this point, you may be asking . . . what's the bid deal? People need annuities I provide it! Why does everything have to involve the law? Well, an agent has a legal duty to use ***reasonable skill*** in asking certain questions during the application process to determine types of coverage needed (Smith v Dodgeville Mutual Insurance – 1997). Further, failing to determine the nature and extent of the coverage/benefits requested as in Butcher v Truck Insurance Exchange - 2000, may subject you to a lawsuit.

For a majority of suitability lawsuits, the basis of liability is relationship and purpose. Legally a ***personal relationship is created*** when a prospective insured consults an insurance agent, provides that agent with specific information about his unique circumstances and relies on the agent to obtain appropriate coverage tailored to these circumstances. Courts have recognized that the relationship between a prospective insured and an insurance agent (like the relationship of attorney and client) is that of principal and agent, for the purpose of negotiating a policy suitable to the client's needs (Nu-Air Manufacturing Co. V. Frank B. Hall & Co. - 1987). Further, an insurance agent owes the prospective insured a duty of unwavering loyalty similar to that owed by an attorney to a client. It is the special ***fiduciary nature*** of the relationship between a prospective insured and an insurer that lends the relationship a ***personal character***

similar in scope to the lawyer-client relationship. For this reason, alleged acts of negligence on the part of an insurance agent who has been consulted for the ***express purpose*** of meeting a client's unique needs create a ***personal tort***.

In Forgione v. State Farm Insurance - 1995, allegations in a complaint made clear that the insureds ***expected*** the agents to respond to the couple's unique, personal insurance needs. A $600,000 claim proved that what they were sold was not a suitable contract.

In another case (Anderson v. Knox - 1961) agent Leland Anderson ***specialized*** in a particular type of insurance product. However, the court discussed the issue that this type of product could be useful for a person whose income and financial condition is such that his income tax puts him in high brackets and who has the means to liquidate the steadily increasing debt out of other sources. What brought about the controversy in this case was that Knox was ***not*** that kind of man. Premiums for the plan were over $7,000 per year. Knox had an annual salary of $8,100 per year and investment income of $1,600 per year!

Was Anderson guilty of a breach of duty in a failure to make disclosure of certain facts? Was this product suitable? What about the rather large commissions, not ordinarily possible with a client in this income category? The court said . . .

'The appellant was an experienced expert in the field; the insured a mere layman who was led to believe that the plan would meet certain expressed objectives. Certainly the relationship was a fiduciary one in which the plaintiffs were entitled to believe the agent's material statements.'

The court determined that Knox ***did rely*** upon Anderson's statements and that it would be unreasonable to argue that Knox should have found out for himself, because of some principle of caveat emptor, that the program was not at all what it was represented to be.

The court awarded Knox compensatory damages, exemplary and punitive damages and damages for 'grievous mental anguish and great distress of body and mind'.

Meaning of Suitability Conduct

So, what does this all say about suitability conduct? Is your job more than just handling transactions? Yes it is! Your gut tells you so and some very important court cases make it your duty. In essence, beyond being the most responsible agent you can be, you should ***size-up your client*** and ***anticipate his needs*** when he can't. How can this be accomplished? You'll need more than luck. Aside form determining current and future risks that you know about, you need to expect those that haven't happened. For instance, shouldn't you know that a 50-year-old baby boomer client is a far more complex individual than his parents before him. His insurance needs are also more complex: higher life limits to cover college and entrepreneurial pursuits; medical coverages, long-term care and bigger retirement "pots" for a longer life span; higher primary and umbrella coverages as a buffer against the litigation explosion; etc.

To really uncover as many of these client needs as possible, you must know more about your clients. Of course, a client profile is the best way to accomplish this. Customer profiles can provide a lot more information than you would gleam from an application.

Example: Cathy and Jim Runion are average boomers. They have $200,000 term life policy but want you to provide them with a safe investment option for $200,000 they have saved. They like the tax-deferred aspect of annuities and they really like the investment attributes of a variable contract since they have some years before they retire. Your analysis shows they meet suitability standards, but you also know that a loss of this money in any way could devastate their retirement. Thinking on a different level, you also know that the protection provided by California State Guaranty Fund that backs any insurance company you recommend is limited. In California, the limit on life and annuities is $300,000 per policyholder; and, at risk variable portions of contracts are typically excluded. Since they already have $200,000 on life insurance, you scale back your recommendation to a $100,000 fixed annuity, advising they place the remaining $100,000 in a high-yielding bank CD.

Note: It is illegal to induce a sale of any insurance product by citing the backing of the California State Guaranty Fund

Every additional bit of information you learn about your client helps you get closer to knowing what makes him "tick" and how he ticks could be a best indicator of how you need to insure him. Are you uncovering his or her "core beliefs"? Is he or she following generational trends? Where do they see themselves five years from now? How will they get there? These are not questions you will find on insurance applications nor many client profiles. In some cases, your clients will not know the answers to these questions themselves -- you may need to interpret for them. But, by all means never do this without involving them in the process.

And, of course, once you have asked all the questions you must be sure that you implement or ***meet their needs to the best of your ability***.

Annuity Suitability

In 2003, the National Association of Insurance Commissioners (NAIC) adopted the new ***Senior Protection Annuity Transactions Model Regulation*** (SPATMR) The purpose of this action is to establish guidelines for insurers and producers for determining suitability standards for fixed and variable annuities sold to senior consumers. These guidelines are available for various states to adopt and or modify in creating new suitability legislation which many do not currently have.

Key elements of SPATMR include the following:

- The model regulation creates standards and procedures for producers to follow when making annuity recommendations to individual seniors (over age 65) who are considering the purchase or exchange of a fixed or variable annuity.

- The model requires agents to make a ***reasonable effort*** to obtain information on a senior's financial, tax and investment objectives.

- The model establishes that producers must have ***reasonable grounds*** for recommending an annuity on the basis of facts disclosed by the consumer.

- The model establishes procedures to supervise and enforce compliance by producers through review of selling documents, training and period audits.

Identifying Need

The message of the NAIC and any suitability effort is the importance of identifying the need to gather information ***before*** making any recommendation. At a minimum, this information should include:

Income: What is the annuity prospect's current income? What are his needs in the future? What other sources of income are present today? Tommorrow?

Liquid Assets: What is the prospect's ratio of cash to hard assets? Is it adequate? How will this change in the future? Will purchasing an annuity negatively effect his liqduity?

Long Term Care: Does the prospect have a plan for long term care in place? Does he understand the need to have one before investing elsewhere? What other sources could help care for a long term care illness?

Tax Status: What is the prospect's tax bracket? Considering this, is an annuity advantageous or not? How will the future change his tax status?

Investment Objectives: Where does the prospect see himself in 10 years? 20 years? Is he realistic? If so, does he need to emphasize growth or income to get there? Does he have time to meet his goals? Is the prospect financial sophisticated? Is he capable of monitoring an investment plan such as a variable annuity?

Life Insurance: Does the prospect have life insurance? Is it adequate?

Other Information: Has the prospect taken advantage of retirement plan options available to him at work? Why not? Does he understand how they benefit him? Does he have time to create a meaningful plan? What is the prospect's tolerance for risk? What is the prospect's tolerance for insurance products? Non-insurance products?

Need For Full Disclosure

Matching contract terms to client needs is another important aspect of determining suitability. Complete disclosure of terms, surrender charges, expenses and important issues such as cash surrender benefits or death benefits that fall short of minimum nonforfeiture amounts are the only way your client can make an informed decision to proceed. Most contracts should have critical omissions like this prominently displayed in the policy. If not, it is your responsibility to bring them up. How will you know? Obtain specimen policies for every product you plan to offer. Carry them with you to show disclosures and to understand that all features of the contract are in line with your customer needs and objectives.

Example: An agent sells annuity policies to mostly retired clients where the average purchase was about $20,000. The agent typically represents that the principal was available at anytime and the accumulation value of the contracts are guaranteed to grow to certain levels. Both representations are so false so as to prove a scheme for which

the agent is considered liable for fraud -- a penalty punishable by fines and prison in the State of California.

Record Keeping

Annuity contracts, like variable annuities, can be quite complex. You will need to stress to your client that he keep accurate records of subaccount investment choices as well as their performance.

Required Disclosures *(AB 2107)*

The thrust of the new annuity legislation is disclosure and suitability. Only then can you recommend a reasonable solution; only then can a client make and informed decision to purchase or pass.

Assembly Bill 2107 (2001) significantly strengthened disclosure in the selling of annuities . . . especially to seniors. This legislation requires agents to make specific disclosures about the consequences of financial transactions related to Medi-Cal eligibility. Many points of this legislation have already been discussed and the full text of this bill is included as Attachment II at the end of this course. To summarize:

- A special Notice Regarding Standards for Medi-Cal Eligibility is now required to be signed by the annuity buyer for any financial product geared to Medi-Cal or its eligibility.
- Agent conduct and history will be investigated and deemed to be relevant in any action or breach of duty concerning the selling of Medicare supplement insurance, long term care insurance, etc.
- The definition of senior financial abuse is expanded as well as the need for people who work among the elderly to act more responsibly by recognizing their rights to feel secure from abuse.
- Agents need to apprise seniors that the sale of existing assets or annuities in order to buy new ones can have negative tax consequences and associated penalties.

Policy Cancellations and Refunds *(CIC 10127.10, 10509.6)*

Senior citizens who purchase annuities must now be given the right to cancel them within 30 days. This law applies to all contracts sold and delivered after 1/1/04. Return of the policy during the cancellation period has the effect of voiding the policy from the beginning and placing the parties in the same position as if no policy had been issued. That means that all premiums and policy fees shall be refunded by the insurer. If the insurer or entity issuing the policy or certificate fails to refund all of the premiums paid, in a timely manner, then the applicant shall receive interest on the paid premium at the legal rate of interest

If a variable annuity is involved, the owner is entitled to a full refund of his account value. And, during the 30-day ***free look*** cancellation period the premium ***must only be invested in fixed-income investments***.

These new rules are underscored by the need for every policy to print, in 12-point bold, the following disclaimers:

YOU HAVE PURCHASED AN ANNUITY CONTRACT. THIS POLICY MAY BE RETURNED WITHIN 30 DAYS FROM THE DATE YOU RECEIVED IT FOR A FULL REFUND BY RETURNING IT TO THE INSURANCE COMPANY OR AGENT WHO SOLD YOU THIS POLICY. AFTER 30 DAYS, CANCELLATION MAY RESULT IN A SUBSTANTIAL PENALTY KNOWN AS A SRRENDER CHARGE.

For ***variable annuity*** contracts, the disclaimer is slightly modified as follows:

THE POLICY MAY BE RETURNED WITHIN 30 DAYS FROM THE DATE YOU RECEIVED IT. DURING THAT 30-DAY PERIOD, YOUR MONEY WILL BE PLACED IN A FIXED ACCOUNT OR MONEY MARKET FUND, UNLESS YOU DIRECT THAT THE PREMIUM BE INVESTED IN A STOCK OR BOND PORTFOLIO UNDERLYING THE CONTRACT DURING THE 30-DAY PERIOD. IF YOU DO NOT DIRECT THAT THE PREMIUM BE INVESTED IN A STOCK OR BOND PORTFOLIO, AND IF YOU RETURN THE POLICY WITHIN THE 30-DAY PERIOD, YOU WILL BE ENTITLED TO A REFUNBD OF THE PREMIUM AND POLICY FEES. IF YOU DIRECT THAT THE PREMIUM BE INVESTED IN A STOCK OR BOND PORTFOLIO DURING THE 30-DAY PERIOD, AND IF YOU RETURN THE POLICY DURING THAT PERIOD, YOU WILL BE ENTITLED TO A REFUND OF THE POLICY'S ACCOUNT VALUE ON THE DAY THE POLICY IS RECEIVED BY THE INSURANCE COMPANY OR AGENT WHO SOLD YOU THIS POLICY, WHICH COULD BE LESS THAN THE PREMIUM YOU PAID FOR THE POLICY. A RETURN OF THE POLICY AFTER THE 30-DAYS MAY RESULT IN A SUBSTANTIAL PENALTY, KNOWN AS A SURRENDER CHARGE.

The ***free look provisions (CIC 786)*** apply to persons 60 years and older and do not apply to contracts sold through group plans.

FOR A MORE COMPLETE DISCUSSION OF CALIFORNIA ANNUITY SELLING, INCLUDING SPECIFIC DISCLOSURE FORMS DISCUSSED IN THIS COURSE, VIEW OUR ANNUITY 2004 (#198) ONLINE AT WWW.CECLASS.COM OR CALL US AT (800) 498-5100 TO ORDER.

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