FIA EDUCATION SERIES

NAFA has created this series to promote education on how FIAs work and important factors to consider when buying one.

HELPING CONSUMERS UNDERSTAND FIAs

OCTOBER 2020

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NATIONAL ASSOCIATION FOR FIXED ANNUITIES

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LETTER FROM THE CEO

On behalf of NAFA, the National Association for Fixed Annuities, I would like to introduce you to the latest in the Fixed Indexed Annuity Education Series, designed to help consumers better understand the inner workings of fixed indexed annuity (FIA) products and to develop an awareness of how they might fit into financial and retirement plans. We hope this educational series helps demonstrate how FIAs can provide enhanced returns for consumers, while limiting downside or losses with their guaranteed minimum interest rates, a concept which becomes extremely important when planning for retirement.

Fixed indexed annuities, just like traditional fixed annuities, are insurance products that provide downside protection from loss of principal, with a guaranty that the interest earned on the annuity contract can never go below zero. In a traditional fixed annuity, the interest that the annuity can earn is locked in for a set period defined by the product and generally in annual increments. In an FIA, the return or rate is determined based on an interest crediting formula or method established by the issuing insurance company that is linked to the performance of a market index, such as the S&P 500.

This educational series provides information to help clients understand how FIAs can meet their financial needs and mitigate risks to their savings as well as providing a source of stable retirement income. This report provides an overview of the benefits of an FIA compared to other solutions. All pieces in this series are available at https://nafa.com/education/consumer-materials/.

NAFA is the premier trade association exclusively dedicated to fixed annuities. We are committed to providing information and education regarding the value of fixed annuities and their benefits to our members, journalists, and the general public to help Americans plan for a lasting and safe retirement.

Charles J. DiVencenzo, Jr.
President & CEO

The FIA Education Series is produced on behalf of NAFA by CANNEX Financial Exchanges., Ltd. CANNEX is a leading provider of annuity pricing and analytics.

Simply reliable data

UNDERSTANDING THE KEY BENEFITS OF AN FIA

A fixed indexed annuity (FIA) provides a unique range of benefits for the consumer. It may be possible to invest in a product that does any of these given things more efficiently, but none combines all of these factors into a single offering.

Let's break down the elements and discuss them separately.

Key Benefits of an FIA

- Principal Protection
- Guaranteed Income
- Market Participation
- Death Benefit
- Access to Your Money
- Tax Deferral

PRINCIPAL PROTECTION

Fixed annuities, including the FIA, give you principal protection, which means that you will never lose money based on index performance. The amount of interest you receive varies based on the performance of the external index, but a decrease in the index value doesn't reduce the account balance. This means that the **FIA gives you the opportunity for more gains than other fixed-rate products while protecting you from losses.**

A bank certificate of deposit (CD) offers a similar guarantee and pays interest at the end of the term. CDs are available in varying terms, ranging from a month to years, though the interest also depends on the length of the term. And, with a CD, if you choose to withdraw your money early, you will pay a penalty. **By contrast, the FIA allows some access to your money without penalty at first and then you have unlimited access at the end of the surrender period.**

While the CD has a set interest rate, the credited interest you get from the FIA will vary and may be higher or lower than what you would get from a CD, though the credited interest can only increase the account value. However, other fees can reduce the contract value of an FIA, including charges for additional benefits or choosing a particular index.

GUARANTEED INCOME

One key reason that people buy an annuity is to have reliable income during retirement. One popular way to **get lifetime income with an FIA is through an optional benefit that guarantees income through regular withdrawals that can either start immediately or at a later date.** This gives you the option of either taking regular income that's guaranteed for life or forgoing the guarantee and using the money in other ways. A **"withdrawal benefit"** can offer different features and comes with conditions in order to keep the guarantee, but that guarantee means that the insurance company will continue payments for life even if the contract runs out of money.

People who are considering other ways to generate regular income in retirement often look at **bond laddering**, a popular and time-tested option. With this strategy, the "ladder" is a series of bonds that mature at different times (often a year apart), which means they come to the end of their term and you are then free to reinvest your money. You may select bonds that pay interest regularly or that pay back the principal plus interest once it matures. The process of reinvesting both generates regular income through interest and gives you access to some amount of the portfolio.

When we compare the guaranteed income from an FIA against a bond ladder, the first point is that the bonds are not guaranteed. The amount of risk that you take on varies a lot depending on the type of bond, but the ones with a higher yield carry more risk. The safest bonds, such as ones issued by the federal government, also have a lower yield that would make it impossible to generate the same amount of income from interest alone as you would from the FIA with the withdrawal benefit. You would have to also spend some of the principal and run the risk of running out of money during your lifetime. **The FIA's withdrawal benefit allows you to take money out of your account but guarantees that the income payments will continue for life, no matter how low the account gets**.

If you run into an emergency or your circumstances change, you may change your plans. A bond ladder gives you access to your money when each bond matures; in the alternative, you can sell the bond prematurely, though its value may go up or down based on interest rates. The FIA allows some access to your money without penalty until the end of its surrender charge period. With a bond, you must reinvest the money at the end of its maturity and, if interest rates have changed, you may get even less interest on a new bond. The FIA, by comparison, continues to generate income or increases in value as long as you keep the contract and the income guarantee remains constant no matter what happens to interest rates. Some withdrawal benefits can go up over time, either because of index performance or increases that are part of the benefit design. The crediting rate, such as cap or participation rate, may change over the life of the contract but is independent from the income generated by withdrawal benefit.

It is important to mention that all annuities allow conversion of all or some of the contract into a guaranteed income stream, a process called "**annuitization**." If you choose to annuitize, you exchange the money in the account for the future guaranteed income. Alternatively, you can make a tax-free purchase of a different annuity that is specifically designed for income and has either a higher payout or certain features you want.

MARKET PARTICIPATION

Unlike other fixed annuities, the interest rate from the FIA is tied to the performance of an index. When the index drops in value, the FIA does not; when it rises, the FIA credits interest in relation to that index. **The FIA calculates interest based on a crediting method, not the index itself, but it does allow market participation that no other fixed annuity does.** NAFA provides more detailed information on how certain crediting methods work at in other pieces in this series that are available at https://nafa.com/education/consumer-materials/.

Another investment vehicle that is often used for retirement savings, the **structured note**, is similar in operation to the FIA in several ways. It links the yield to an index, security, or a group of securities and also uses a crediting method, some that are much more involved than what is available on an FIA.

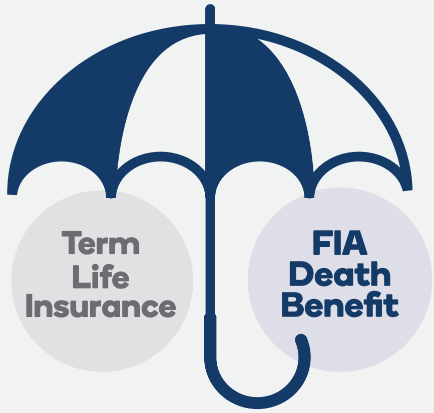
Unlike an FIA, some of these products can have negative performance and lose money. Because of this, they are considered securities and must be sold by a licensed financial professional who can evaluate the product. The Securities and Exchange Commission does not look at the products themselves, unlike an annuity, which must be examined and approved by each state where it is sold. In addition, annuities are subject to state regulation both in the design and sales.

Both a structured note and an FIA represent promises about future payments, so there is the risk that the company backing it will not be able to follow through on this promise. You have to consider the bank that issues the structured note or the insurance company that issues the FIA. Ratings agencies give ratings on both, but there are additional protections for consumers with insurance products.

The added regulations around an annuity provide more consumer protection than a structured note but may also bring a higher cost when comparing similar benefits. Most structured notes simply do not offer the same principal protection that an FIA does, though there are notes that do this as well. Like a bond, a structured note has a maturity. If you want to access this money before the maturity, it can be difficult to sell, and you may receive less than you paid for it. **FIAs, on the other hand, allow some access to your money without penalty until the point where you have free access to the entire account balance without incurring a penalty.**

DEATH BENEFIT

If you are concerned about the inheritance you leave behind, the death benefit available in an annuity can be valuable. Beyond the basic benefit on all contracts, with an additional fee many FIAs offer an **enhanced death benefit** that increases the value of the legacy you leave your heirs. No investment account includes this type of benefit.



You can also buy a death benefit through the purchase of life insurance. A **term life policy** does just that for an annual fee over the course of a specific time period when the insurance is in effect, such as 10 or 20 years. This generally involves underwriting and is a more complicated process than adding a death benefit on an FIA.

A term life insurance policy has a stated value that will not change as long as you have it, but the death benefit on an FIA may change if you start taking withdrawals. Therefore, the value of the death benefit on an FIA is linked with your intention to take income. If you do withdraw income from the FIA, you may reduce the death benefit over time. By the same token, term life insurance is only effective for a set period, after which your heirs can no longer collect a benefit.

The timing of death is unpredictable and can have a more serious effect on family finances when it happens earlier in life. Though the primary value of an FIA is not to provide life insurance, it may be more important depending on your circumstances.

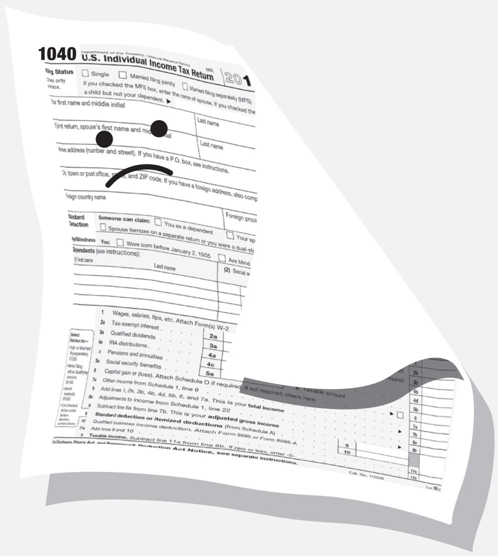
ACCESS TO YOUR MONEY

One important consideration is access to your money. Any annuity is part of a plan and you should plan to stick with that plan for some time. Even so, you retain some access to your money. **With an FIA, you have free access to some of your account value at all times (generally 10% per year).** After a certain period of time, you have the freedom to make whatever changes you want to the contract.

A savings account is very safe and you have full access to your money. However, the tradeoff is that the interest rate is extremely low. This is a great option for emergency funds but does not allow the opportunity for growth you get with an FIA.

TAX DEFERRAL

As with other annuities, FIAs provide **tax deferral,** which can be valuable both in and out of retirement. Tax deferral is available through a few other sources. If this is a high priority for you, then you should make sure that you are taking advantage of other tax deferral opportunities. For most people, this starts with a workplace savings program, such as a 401(k), which may also provide the bonus of an employer match. In addition, you may be able to contribute to an IRA. Beyond this, an **FIA is a great way to extend tax deferral while taking advantage of the other benefits of these products**.



The tax deferral matters only when FIAs are purchased outside of an account that itself features tax deferral. Because there are many other reasons to choose an annuity, people often purchase them within an IRA, meaning that tax deferral is not a major consideration in the decision to buy an annuity. Either way, it always makes sense to discuss these issues with a tax professional.

SOMETHING TO CONSIDER

FIAs offer principal protection, guaranteed income, the opportunity to take advantage of market gains, flexible death benefits, and the ability to access some of your account value during the accumulation phase of your contract. There is no other product that combines these benefits, so you can see how it can make sense for people with very different needs. As you understand the issues important to you and how they fit into your financial planning or retirement strategy, the FIA is a product that offers the flexibility and key benefits that may help you meet these goals.