Quick Q&A on Fixed Index Annuities

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Fixed index annuities (FIAs) are a fairly recent addition to the annuity family. It was introduced around the mid-90s and combines features of the two previous classes of annuities: the variable and the fixed.

Unlike the variable annuity (VA), the FIA offers a guaranteed minimum interest rate (about 3% in 2007) and provides security against loss of all or most of the investor's principal.

While most fixed annuities (FAs) use only a set rate in calculating the credited interest, the FIA's credited interest is linked to the performance of market indices (the S&P 500, the S&P 100, the Russell 1000 Index, and others), so it has the potential for greater growth.

However, FIAs are not designed as aggressive investment tools, and the returns are considered generally conservative. These products are designed for retired employees who cannot afford market losses or near-retirees with very limited investment horizons ahead of them.

What are the regulations that cover the sales of FIAs?

FIAs, which are insurance products, have been subject to a controversial FINRA ruling, NTM-05-50. According to FINRA, the sales of these products must follow the same stringent regulations that govern the sales of securities products. Certain phrases and even words (e.g. "investment" and "deposit") cannot be used in FIA advertising and marketing materials.

Both California and Iowa have passed state regulations requiring agents to pass annuity training before soliciting annuity sales to individual investors. In California, the training applies to all agents who wish to sell all types of annuities.
Iowa producers were to complete a class covering suitability, early withdrawals, surrender charges and the advantages and disadvantages of the FIAs by January 1, 2008 in order to sell these products in the state. Other states are expected to impose similar regulations.

What are some of the most important features of the FIA contract?

The Indexing Method measures any changes in the market index. Contracts may use annual reset (ratcheting), high-water mark and point-to-point. This is used to calculate the FIA's index-linked interest rate.

The Participation Rate determines the amount of the increased index that will be used to calculate index-linked interest. The FIA participation rate varies with the issuing insurance provider and may change every day for newly issued annuities. Most providers offer a guaranteed participation rate for a specified period and will adjust it for the next period. Some FIA participation rates are guaranteed to never dip below a minimum or go above a maximum set level. This is used to calculate the contract's index-linked interest.

To calculate the index-linked interest rate of the FIA, its participation rate is multiplied by the measured change in the market. If the calculated change in the index is measured at 9% and the contract's participation rate is 70%, the index-linked interest rate of the FIA would be 9% x 70% or 6.3%.

The Cap Rate (or Cap) is the upper limit on the index-linked interest rate or the maximum rate of interest the FIA will earn. If the index-linked interest is 6.3% but the contract carries a 6% cap rate, only 6% – not the whole 6.3% – would be credited. Some FIAs do not impose any caps.

The Floor on Equity Index-Linked Interest is the minimum index-linked interest rate the FIA contract will earn. Typically the floor is set at 0% meaning the index-linked interest earned would be zero – and not negative – even if the index decreases in value.

The Margin (a.k.a Spread or Administrative) – a specific percentage from any calculated change in the index – is used to calculate the index-linked interest rate in some FIAs in addition to a participation rate. The company deducts this percentage if the change in the index results in a positive interest rate.

If the calculated change in the index is 10% and the margin fee is 2.25%, the interest rate would be 7.75% (10%

- 2.25%).

How do the different insurance features affect each other?

Typically a small percentage of every premium dollar is used to cover initial expenses such as employees' paychecks, marketing costs, and producers' commissions.

A portion of the premium is used to purchase government bonds to cover the minimum guaranteed interest rate provided by the FIA. The amount of money allocated for government bonds increases with the level of the minimum guarantee stipulated in the contract.

A higher guaranteed minimum rate lowers the contract's participation rates and increases its margin fees and caps because the insurer needs to purchase more government bonds with every premium dollar. Whatever is left of the premium dollar is used to purchase index options. This is what insurers use to cover the excess interest credited to the annuity.