Annuities and the Standard Minimum Nonforfeiture Rate for Deferred Annuities

Department of Financial Regulation

Annuities Defined

- Annuity definition
  - a contract sold by an insurance company;
  - under which the person or group purchasing the contract pays a single premium (contribution) or multiple contributions;
  - in exchange for the insurer's promise to pay a single income payment or a series of income payments at regular intervals over time.

Types of Annuities

- Individual or group
  - **Individual annuities** are contracts between the insurer and a single or joint contract holder.
  - **Group annuities** are contracts between the insurer and an entity, usually a retirement plan or employer.

- Immediate or deferred
  - **Immediate annuities** pay an income stream as soon as issued.
  - **Deferred annuities** continue to accumulate value until a later date. Deferred annuities have two phases – accumulation and payout.

Types of Annuities

Fixed, variable, indexed or hybrid

- A **Fixed Annuity** provides a guaranteed fixed rate of interest for a specified period. Contributions are guaranteed against loss.
- A **Fixed Indexed Annuity** operates similarly to a fixed annuity; however, returns are based on the performance of an index (e.g., the S&P 500) with a minimum guaranteed rate. Contributions are also generally guaranteed.
- A **Variable Annuity** fluctuates based on the actual returns of the investments selected within the contract.
- A **Variable Indexed Annuity** fluctuates based on the returns of market indexes.
- A **Hybrid Annuity** combines features of two or more of the previous annuities.

Important Annuity Terms

- **Principal –** The amount of money contributed to the annuity
- **Accumulation Period** – The period during which the contract holder is contributing funds to the annuity
- **Payout Period** – The period during which the annuity is making payments to the contract holder
- **Surrender Charge** – A fee charged when a contract holder withdraws funds from an annuity prior to the end of the initial accumulation period.
- **Surrender Period** – The period during which a surrender charge will be incurred if the contract holder chooses to withdraw funds early.

Important Annuity Terms

- **Credited Rate** – The rate used to credit interest to an annuity during the life of the contract. It may also be used in the calculation of the surrender value.
- **Nonforfeiture Rate** – The rate used to determine an individual deferred fixed annuity's <u>minimum</u> value at the time of surrender.
- **Surrender Value** – The cash value of the annuity at the time the contract holder chooses to terminate the contract instead of initiating payout.
- **Riders** – Additional Features that can be added to an annuity contract for a fee such as guaranteed minimum income and withdrawal benefits, enhanced rates of return, step-up death and principal values, etc.

Other Annuities Features and Considerations

- Annuities are primarily used as retirement vehicles and are generally intended for long term investment.
- Annuities are generally illiquid. Early withdrawals often subject the contract holder to surrender fees that can be significant in early years but decline over time.
- Annuities allow for tax-deferred growth and are therefore subject to tax penalties when withdrawals are made prior to age 59 ½.
- Annuities are subject to a number of fees and charges which generally increase based on the complexity and risk of the particular product.

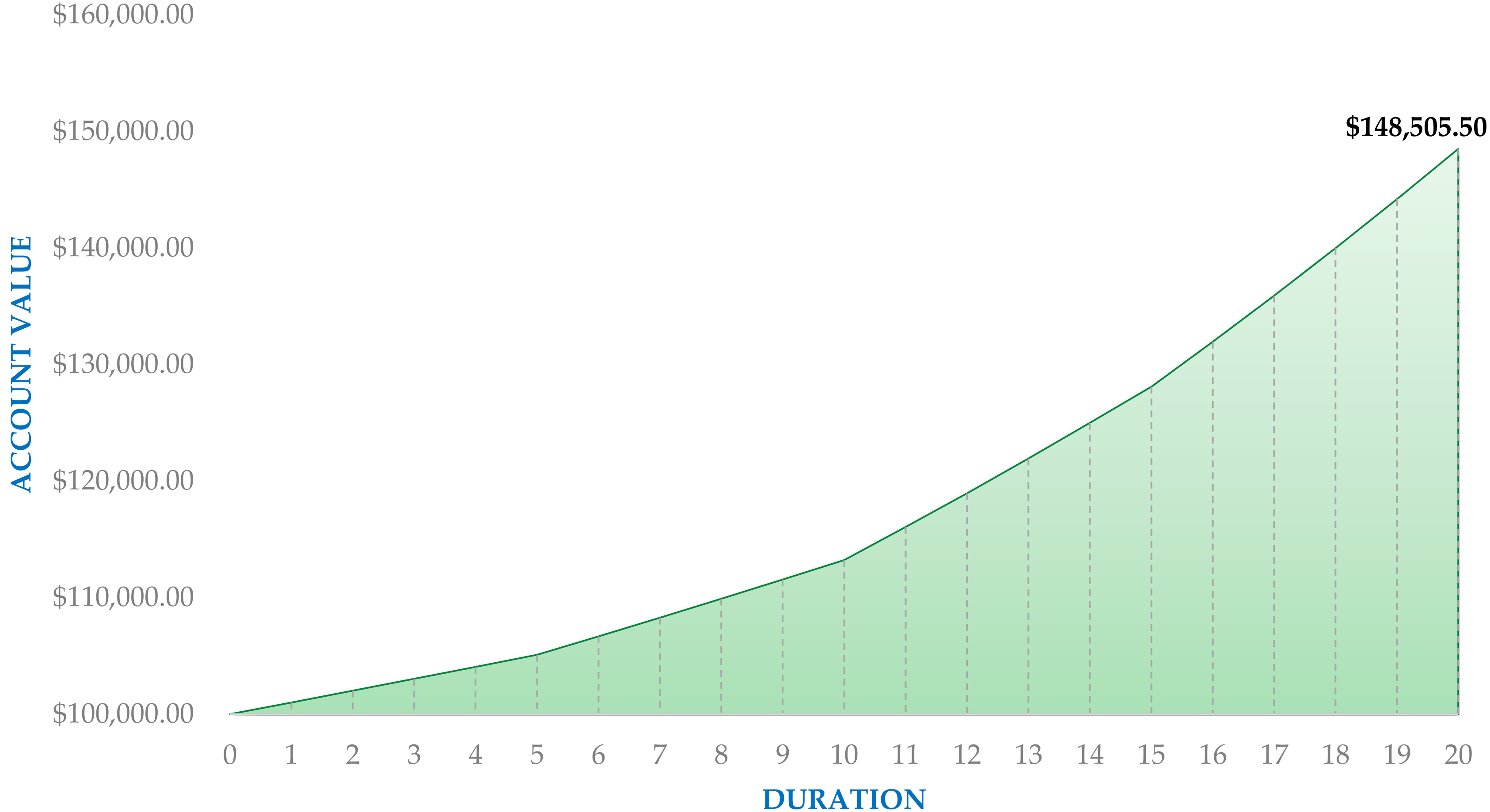
Individual Deferred Fixed and Fixed Indexed Annuities

- The Statutory Minimum Nonforfeiture Interest Rate only applies to these types of annuities.
- During **accumulation**, contract holder makes one or more tax-deferred contributions that earn interest, either fixed for a specific period or based on index-linked returns (**credited rate**).
- During **distribution**, the insurer pays one or a series of fixed income payments consisting of a return of accumulated principal and growth.
- Consumers choose the insurer, credited rate (fixed or index-based), duration and other contract features (e.g., future income, guarantees, etc.) that best meets their needs.

Fixed Annuities Vs Other Options

- Fixed Annuities –
  - Pros - Guaranteed interest, principal protection, tax-deferred growth, optional guaranteed income features, periodic interest rate adjustment.
  - Cons – Lower income opportunity, illiquidity, no cost of living adjustment, early withdrawal penalties.
- Certificates of Deposit
  - Pros – Fixed rate of return, lower fees
  - Cons – Not tax-deferred, illiquid, no guaranteed income feature options, no periodic interest rate adjustments
- Bonds
  - Pros – Guaranteed income stream if held to maturity, higher yields, greater liquidity
  - Cons – income stream period limited, credit and default risk, may not be tax-advantaged
- Fixed Income Mutual Funds
  - Pros – Higher Yields, fully liquid
  - Cons – Principal risk and market risk, no guaranteed income options

Hypothetical Accumulation Period Fixed Annuity Growth



Hypothetical $100,00 initial investment with credited rate reset every 5 years.
Credited rates - Years 0-5 @ 1%, 5-10 @ 1.5% ,10-15 @ 2.5% and 15-20 @ 3%

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What Happens When the Accumulation Period is Interrupted?

- If a contract holder stops making contributions during the accumulation period and triggers or requests the termination of the annuity contract, an insurer must refund to the contract holder a benefit value of the annuity.
- This value is generally based on the present value of the annuity minus any applicable charges. This present value would include interest earned based on the annuity's credited rate as defined by the contract.
- For individual fixed and fixed indexed deferred annuities, this value must not be less than the statutory minimum nonforfeiture amount set by § 3750.

Vermont's Standard Nonforfeiture Law

8 V.S.A. § 3750

This law sets the minimum amount that an individual deferred annuity contract must pay a contract holder as:

- paid-up annuity,
- cash surrender, or,
- death benefits

if the contract holder surrenders the policy or stops making contributions during the annuity's accumulation period.

Nonforfeiture Value Calculation

The minimum nonforfeiture value of an individual deferred annuity is equal to:

87.5 percent of the accumulated gross value of contributions;

minus any prior withdrawals, partial surrenders, and loans taken against the contract;

minus an annual contract charge;

plus interest at a rate determined as follows:

The lesser of three percent per annum and the following, which shall be specified in the contract if the interest will be reset:

(i) The five-year Constant Maturity Treasury Rate reported by the Federal Reserve as of a date, or average over a period, rounded to the nearest one-twentieth of one percent, specified in the contract no longer than 15 months prior to the contract issue date or redetermination date under subdivision (iv) of this subdivision (C).

(ii) Reduced by 125 basis points.

(iii) Where the resulting interest rate is not less than one percent.

(iv) The interest rate shall apply for an initial period and may be redetermined for additional periods. The redetermination date, basis, and period, if any, shall be stated in the contract. The basis is the date or average over a specified period that produces the value of the five-year Constant Maturity Treasury Rate to be used at the redetermination date.

Nonforfeiture Rate History

National Association of Insurance Commissioners' (NAIC)
Model Nonforfeiture Law

1981: Nonforfeiture Rate = 3%, Adopted in VT same year

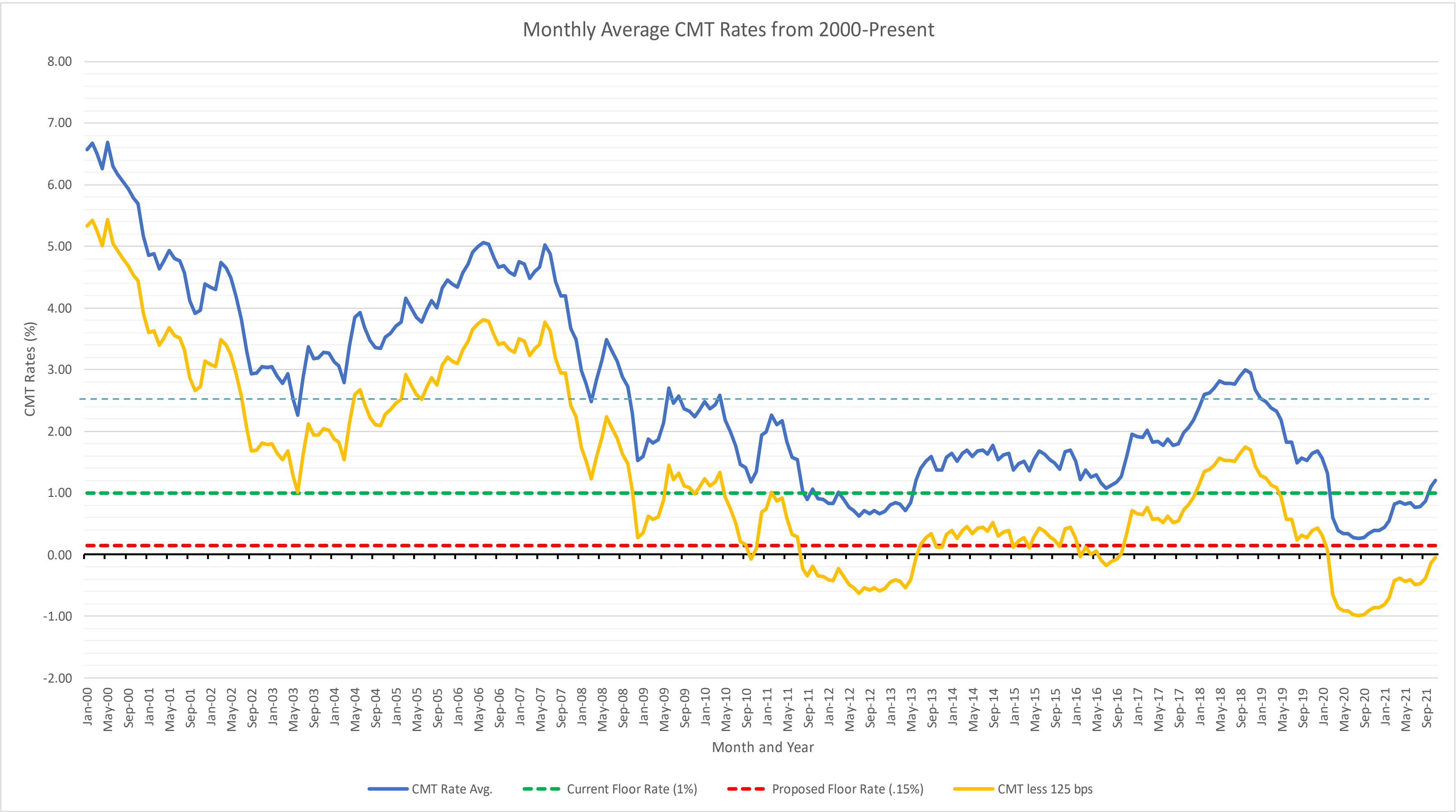
2002: Nonforfeiture Rate = 1.5%

2003: Current, variable calculation = Between 1-3%, Adopted in VT same year

2021: Model rate lowered to a floor of .15%

2022: 21 states have enacted the amendment; 3 are awaiting signature and 8 states have legislation pending.

Historical Monthly Average Constant Maturity Rates



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Consumer Perspective

- Annuities are important retirement tools for consumers.
- Consumers seek credited rates and other features that are sufficient to allow them to give up liquidity during the accumulation period in exchange for future income.
- In order to meet consumer needs, a variety of annuity choices such as multiple insurers, income features, credited rates, guarantees, fee and surrender charge schedules are important.
- Minimum nonforfeiture rates are not a significant factor in consumer choices.

Insurer Perspective

- Insurers compete to offer attractive products by increasing crediting rates and offering desirable guarantees.

- Persistent low interest rate environments impact the ability to offer attractive rates and guarantees by narrowing margins and making investment more difficult.

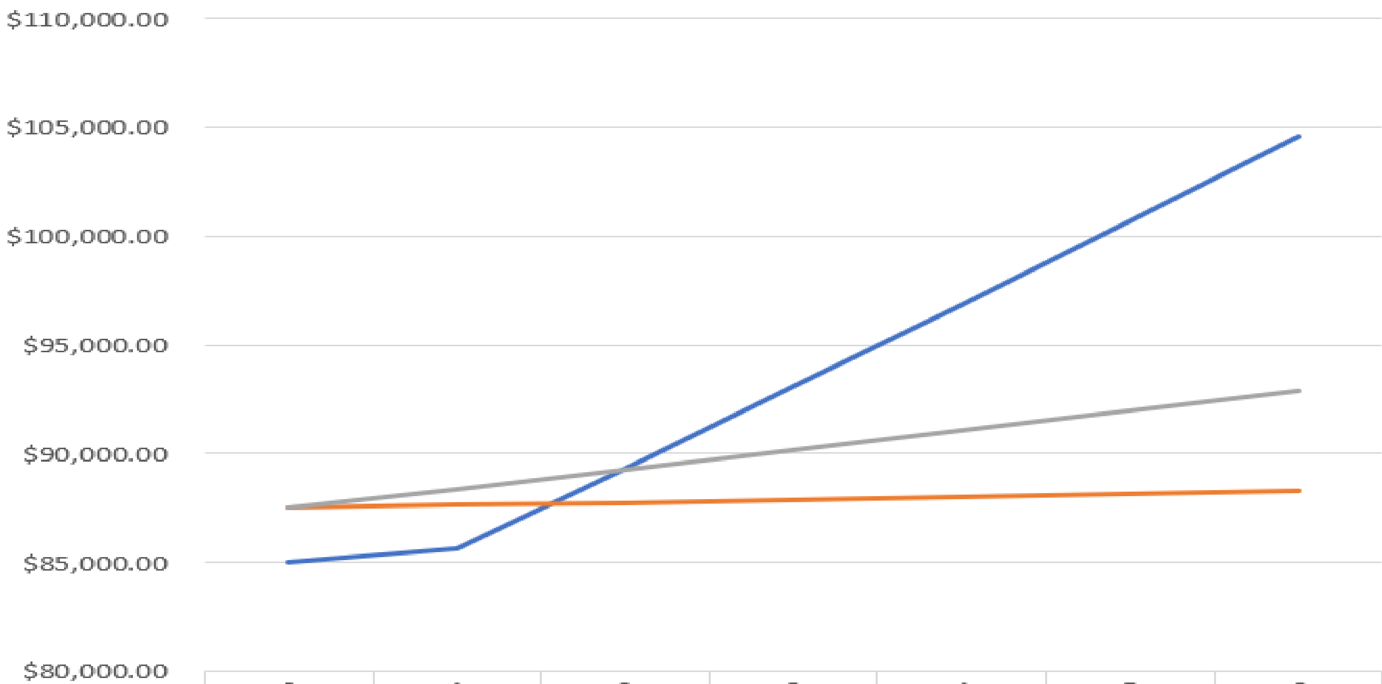
- Requirements to pay a statutory minimum nonforfeiture rate that is close to or higher than the actual market interest rate exacerbate low interest rate environment concerns.

- Insurers may need to choose between increasing investment risk or decreasing product offerings/features, potentially increasing the risk to insurer solvency and liquidity.

Consumer Impact of the Proposed Change

- Applies to new contracts only
- Nonforfeiture rate only impacts **surrenders** in the early years of the accumulation period.
- Nonforfeiture rate is **variable** and rises with interest rates.
- If interest rates are 2.25 percent or above, the calculated "floor" using the current and proposed rates is the same.

Sample Calculation of Annuity Values Versus Minimum Nonforfeiture Rates



	0	1	2	3	4	5	6
Credited Rate 0.75%	$85,000.00	$85,637.50	$89,324.95	$93,062.89	$96,851.88	$100,692.47	$104,585.2
NF Rate 0.15%	$87,500.00	$87,631.25	$87,762.70	$87,894.34	$88,026.18	$88,158.22	$88,290.46
NF Rate 1%	$87,500.00	$88,375.00	$89,258.75	$90,151.34	$91,052.85	$91,963.38	$92,883.01

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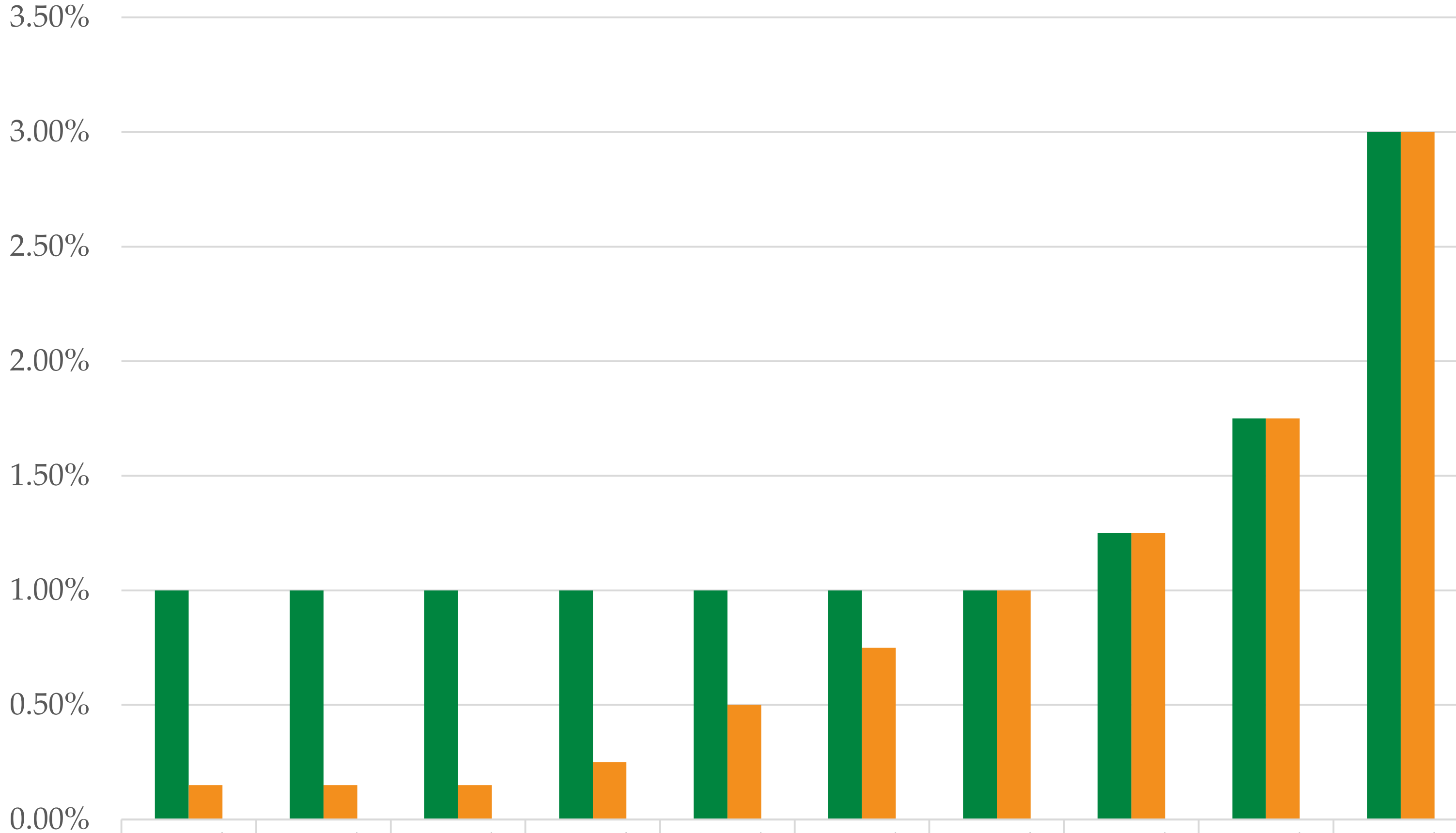
1% vs 0.15% Minimum Nonforfeiture Rate Values at 0% to 4% 5 Year Treasury Rates



	0.00%	0.50%	1.00%	1.50%	1.75%	2.00%	2.25%	2.50%	3.00%	4.00%
1% Minimum	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.25%	1.75%	3.00%
0.15% Minimum	0.15%	0.15%	0.15%	0.25%	0.50%	0.75%	1.00%	1.25%	1.75%	3.00%

Questions?