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Equity-Indexed Annuities

An equity-indexed annuity (EIA), like any annuity, is a contract between you and an insurance company. You pay premiums in a lump sum or periodically, and the issuer promises* to pay you some amount in the future. With an EIA, the interest earnings are tied to the performance of an equity index. The EIA issuer also provides a minimum guaranteed* interest rate on your premiums paid. With an EIA, your interest earnings may increase if the market performs well, but if the market performs poorly, your principal still earns a minimum interest rate, according to the terms of the annuity contract.

An equity index represents the total dollar value of the stocks or bonds of the companies comprising the index. Some well-known indexes include:

- ***New York Stock Exchange Composite Index***
- ***S&P 500***
- ***American Stock Exchange Composite Index***
- ***Dow Jones Industrial Average***

Note, however, that any return, whether guaranteed or not, is only as good as the insurance company that offers it. Both the EIA's principal and its earnings are entirely dependent on the insurer's ability to meet its financial obligations.

Basics

The first EIAs that were introduced worked very simply; the interest rate was determined by computing the difference between the value of the index to which the annuity was linked on the annuity's issue date and the value of the same index on the annuity's maturity date. If the difference was negative (i.e., the market performed poorly and the value of the index decreased), interest was calculated using the minimum rate guaranteed* by the issuer. If the difference was positive (i.e., the market performed well and the value of the index increased), the interest rate used was a percentage of the difference--but usually not the entire difference.

****Annuity guarantees are subject to the claims-paying ability of the annuity issuer.***

Participation rates

The participation rate determines how much of the gain in an index will be imparted to your annuity. For example, if the difference (i.e., gain) in the index is 7% and the participation rate is 90%, then the interest rate is 6.3% (90% of 7%). Participation rates of 70% to 90% are typical. Obviously, the higher the participation rate, the higher the return. However, EIAs have many features, some of which can offset a lower participation rate or other features. Keep this in mind when considering an EIA or making comparisons between EIAs.

Unlike variable annuities where the buyer's money is directly invested in subaccount portfolios, buyers of EIAs are not directly invested in the index or the equities comprising the index. The index is merely the instrument used to measure the gain or loss in the market, and that measurement is used to calculate the interest rate.

Indexing methods

The indexing method is the approach used to measure the change in an index. The original method, which measures index values at the beginning and end of the term, is known as the point-to-point or European method. Still used today, the point-to-point method is the simplest approach, but it fails to consider market fluctuations that occur in between the issue and maturity dates. This can result in unsatisfactory returns if the market declines at the end of the term. Another approach, known as the high-water-mark or look-back method, looks at the value of the index at certain points during the term, such as annual anniversaries. The highest value of these points is then used to compute the difference from the date-of-issue value. A third approach, the averaging method, also looks at the value of the index at certain points during the annuity's term,

Four main indexing methods:

- *Point-to-point or European*
- *High-water-mark or look-back*
- *Averaging*
- *Reset or ratcheting*

then uses the average value of these points to compute the difference from either the date-of-issue value or the date-of-maturity value.

The fourth main indexing method is known as the reset or ratcheting method. With this method, start-of-year values are compared to end-of-year values for each year of the annuity's term. Decreases in the index are ignored, and increases are locked in every year.

How interest is credited to an EIA

With some EIAs, no interest is credited until the end of the term. With others, a percentage of the interest is vested or credited annually or periodically, which gradually increases as the end of the term nears. Further, some EIAs pay simple interest while others pay compound interest. These features are important not only because they affect the amount of your return, but also because having interest vested or credited to your EIA periodically instead of at the end of the term increases the likelihood that you'll receive at least some interest if you surrender your EIA before maturity.

***Caution:** Many EIAs have surrender charges, which can be a percentage of the amount withdrawn or a reduction in the interest rate. Further, withdrawals from tax-deferred annuities before age 59½ may be subject to a 10% penalty.*

Interest rate cap

Some EIAs put an upper limit on the interest rate the annuity will earn. Say, for example, that an EIA has an interest rate cap of 6%. If the gain in the index is 7% and the participation rate is 90%, the interest rate will be 6%--not 6.3%.

Asset fee/spread/margin

Some EIAs charge an asset fee, also known as spread or margin, which is a percentage that is deducted from the interest rate. The asset fee may replace the participation rate or it may be added to it. For example, if the gain in the index is 7%, the interest rate on an EIA with an asset fee of 2% will be 5%. If there is also a 90% participation rate, the interest rate will be 4.5%.

***Tip:** All of an EIA's features should be clearly spelled out in the prospectus or other sales literature, and if you purchase the EIA, in your contract as well.*

You should ask the following questions about an EIA:

- *What is the minimum guaranteed* interest rate?*
- *What is the participation rate?*
- *What is the indexing method? How does it work?*
- *Is there an interest rate cap?*
- *Is there an asset fee/spread/margin? Is it in addition to or instead of a participation rate?*
- *What is the term?*
- *When is interest credited or vested?*
- *Is interest compounded?*
- *What are the surrender charges?*
- *What are the penalties for partial withdrawals?*

* Guarantees are subject to the claims-paying ability of the issuer.

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