What you need to know before you buy an Equity-Indexed Annuity

What is an Equity-Indexed Annuity* (EIA)?

An EIA is a long-term investment contract between you and an insurance company. It offers a guaranteed minimum return, plus it offers a variable rate based on the return of a specific index. During the accumulation period – when you make a lump sum payment or a series of payments – the insurance company credits you with a return based on changes in that index. The most commonly used index is Standard & Poor's 500 Composite Stock Price Index (S&P 500). After the accumulation period, the insurance company makes periodic payments to you per the contract, unless you choose to receive a lump sum.

* Equity-Indexed Annuities are also called Indexed Annuities.

Important provisions of an EIA

Insurance companies sell EIAs with a variety of provisions that can affect your return. While an investment in an EIA may be a suitable investment for some people, you should think about the following provisions of EIAs to help you decide if investing in an EIA is right for you:

Surrender charges

To cash out an EIA prior to its maturity date (5 to 10 years), you typically must pay a surrender charge. It is common for an EIA to have a surrender charge of 10 percent during the first year. For example, if you cashed out your $10,000 EIA during the first year, and it has a 10 percent first-year surrender charge, you would pay $1,000. After the first year, surrender charges usually – but not always – decrease over time.

Guaranteed minimum cash value

Generally, your guaranteed minimum cash value is less than the amount you paid for the EIA. Typically, it is 90 percent of your initial purchase amount, plus accumulated interest at a specified minimum interest rate.

Minimum interest rate

The minimum interest rate is typically 3 percent and it may only apply to a portion of your initial purchase amount.

Interest rate cap

The terms of your contract may limit the interest rate you can earn on an investment in an EIA. This means you would not earn any interest for gains in the index beyond the interest rate cap.

Method to calculate interest

Companies that sell EIAs may compute interest using the simple interest method or the compound interest method. The EIA contract should specify the method. The simple interest method calculates interest based on your initial purchase amount. The compound interest method calculates interest you earn on your initial purchase amount, plus interest you accrue from previous terms. This results in more interest earnings than under the simple interest method.

Participation rate

The participation rate specifies the rate at which an EIA will earn interest in relation to a specific index. For example, if the participation rate is 80 percent and there is a 10 percent growth in the stock index over the year, then the EIA would accumulate interest at 8 percent for that year.

Asset or margin fees

The insurance company may subtract an asset or margin fee from any gain in the index to determine the interest rate on your EIA. For example, if the index growth is 10 percent, your EIA contract might specify that your insurance company will subtract a 2.25 percent fee from the 10 percent resulting in a 7.75 percent interest rate on your EIA.

An EIA usually includes all of the provisions listed above, but the rates may vary.

Deciding if an EIA is right for you

As with any other insurance or investment product, you must first think about your own personal situation. An EIA may not be a suitable investment for you. For example, high surrender charges may apply if you need to cash out your annuity before it matures for living expenses or medical care. But, if you do decide to buy, it's important to understand the terms and the trade-offs so you can choose the right EIA. Ask yourself:

- >> How much retirement income will I need in addition to what I will receive from Social Security and my pension plan?
- >> Will I need supplementary income for others in addition to myself?
- >> How long do I plan to leave my money in the annuity?
- >> When do I plan on needing income payments?
- >> Will the annuity allow me to gain access to the money when I need it?
- >> Do I want a fixed annuity with a guaranteed interest rate and little or no risk of losing the principal?
- >> Do I want a variable annuity with the potential for higher earnings that aren't guaranteed and the possibility that I may risk losing principal?
- >> Am I somewhere in the middle and willing to take some risks with an equity-indexed annuity?

Things to think about before you buy an EIA

Can I lose money?

Yes, you could. Many insurance companies only guarantee you will receive 90 percent of the premiums you paid, plus interest at a specified minimum rate. If you don't earn enough index-linked interest to make up for the difference between the premium you paid and the amount guaranteed, you could lose some of your paid premium. Also, some insurance companies will not credit you with index-linked interest when you surrender your annuity early. Some insurance companies may offer EIAs that guarantee greater than 90 percent of premiums you pay, even up to 100 percent. However, the costs and fees associated with these EIAs may be greater than those with lower guarantees.

What questions should I ask my agent or company about EIAs?

>> Are you licensed to sell EIAs in Washington state?

>> How long is the term?

>> What are the surrender charges or penalties if I want to end my contract early?

>> Can I get a partial withdrawal without paying charges or losing interest? Does my contract include vesting?

>> What charges, if any, do you deduct from my contract value?

>> What is the participation rate?

>> Does my contract have an interest rate cap?

>> Do you use averaging and how does it work?

>> Do you compound interest during a term?

>> Is there a margin, spread, or administrative fee? Is this in addition to or instead of a participation rate?

>> Which indexing method are you using in my contract?

>> Does my annuity waive withdrawal charges if I am confined to a nursing home or diagnosed with a terminal illness?

>> What annuity income payment options does it offer?

>> What is the death benefit?

Are there potential tax ramifications I should know about?

Yes. If you surrender an EIA early, the Internal Revenue Service (IRS) may require you to pay a 10 percent tax penalty. In addition, the IRS may tax your earnings as ordinary income – as opposed to other types of investment income, such as capital gains. Be sure to consult your tax advisor for more information.

Are insurance companies and agents that sell EIAs licensed in the state of Washington?

Both insurance companies and agents must be licensed to sell any annuity product. The Office of the Washington State Insurance Commissioner can provide consumers with licensing information. Your agent may also be licensed with the Department of Financial Institutions (DFI). DFI can provide you with information about any complaints it has received concerning your agent.

The information provided in this brochure is not meant to be all inclusive. Please read all sales materials and contract forms before you buy any insurance or investment product. And ask questions and get answers that you understand before you sign anything.

For more information, contact:

Office of the Insurance Commissioner
1-800-562-6900 www.insurance.wa.gov
Insurance agent licensing:
https://fortress.wa.gov/oic/laa/LAAMain.aspx
Insurance company licensing:
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Department of Financial Institutions
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Washington State Office of the Insurance Commissioner

WASHINGTON STATE DEPARTMENT OF FINANCIAL INSTITUTIONS