American Academy of Actuaries

Issue Brief

What Are the Various Types of Insured Annuities?

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Key Points

- There are many different types of insured annuities in the U.S., but they are all often simply called "annuities," which often cause considerable confusion among many financial professionals and writers
- Some annuities provide periodic income, while others are primarily accumulation vehicles that could be converted into income at the discretion of the owner. It is also important to understand the differing degrees of risk among fixed, indexed, and variable annuities.
- Having a clear understanding of annuity types is important to personal finance writers, advisers, and retirement plan actuaries who serve defined contribution plans.

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An annuity is a contract issued by an insurance company wherein the purchaser makes either a lump sum payment or a series of payments and receives disbursements from the insurance company in return, either in the form of continuous payments or payments at the request of the contract owner.

There are many different types of insured annuities in the U.S., but they are all often simply called "annuities," which can cause considerable confusion. This issue brief provides clarity by explaining the various types of annuities available to individuals and their potential uses, as well as discussing some relevant tax implications. The scope does not include group annuities that are paid from defined benefit pension plans nor annuities purchased by a pension plan as a means of transferring the risk ("pension risk transfer")[1] to an insurance company. Although this issue brief discusses general features of annuities, it is important to note that specific features of any individual product will vary by company.

Let's start with a few definitions of terms that will be used throughout the paper:

Account Value is the value of a deferred annuity (discussed later). It comprises the amount of money paid into the annuity by the owner, plus any interest or investment results (positive or negative) earned, with adjustments (expense charges and charges for optional benefits, which are discussed later).

1 *Pension Risk Transfer*; American Academy of Actuaries; October 2016.

Annuitant is the person during whose life the payments are made. For example, if benefit payments will be made for the rest of Mr. Smith's life, he is considered the annuitant. However, if the owner is Ms. Smith, the payments would go to whomever Ms. Smith specifies for the term of Mr. Smith's life.

Beneficiary is the person or entity (e.g., an estate or trust), if any, named by the owner to receive the value, if any, remaining in the annuity upon the death of the owner and/or the annuitant. Not all annuities have a benefit payable upon death.

Crediting Interest Rate is the interest rate credited to the account value, where applicable. The rate is declared by the insurer in advance, usually at the beginning of each contract year.

Owner generally is the person or entity whose money is used to buy the annuity; however, other arrangements are possible. The owner is responsible for paying any taxes on annuity payouts. The owner maintains any revocable rights in the annuity, such as to change the person or entity to receive the payments or who is the named beneficiary. The owner is typically also the annuitant, but not in every situation. In addition to a person, a corporation, trust, or other legal entity may also be an owner.

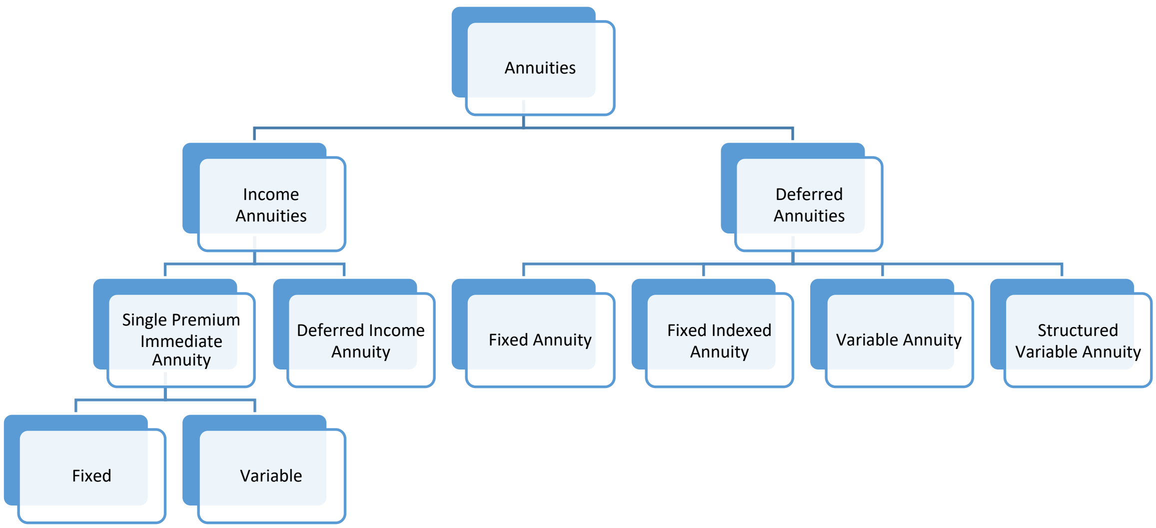
Note that most annuities, other than certain amounts in variable and structured variable annuities (defined below), are backed by the financial strength of the issuing insurance company. To protect against insurer insolvency, all states and the District of Columbia have guaranty associations that provide protection up to a certain level of the account value of a deferred annuity or the present value of benefits for an income annuity. The level of maximum guarantee is commonly $250,000 but varies by state, ranging from $100,000 to $500,000.[2]

2 National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) website.

Members of the Lifetime Income Risk Joint Committee, which authored this issue brief, include Noel Abkemeier, MAAA, FSA—*Co-Chairperson*; Michael Bain, MAAA, FCA, FSPA, ASA, EA; Nancy Bennett, MAAA, FSA, CERA; C. David Gustafson, MAAA, FCA, EA; Andrew Huh, MAAA, FSA; Scott Japko, MAAA, FSA, EA; Cynthia Levering, MAAA, ASA; Spencer Look, MAAA, ASA; Steven Mendelsohn, MAAA, FCA, EA; James Ritchie, MAAA, FCA, ASA, EA; Michael Schmidt, MAAA, FSA; Mark Shemtob, MAAA, FSA, FCA, EA, MSPA—*Co-Chairperson*; Mary Stone, MAAA, FSA, FCA, EA; Ricardo Trachtman, MAAA, FSA—*Co-Chairperson*; Amy Trainor, MAAA, FSA; Shuhan Wang, MAAA, FSA; and Benjamin Yahr, MAAA, FSA.

Annuities can be divided into two main categories: **Income annuities** are used to generate guaranteed income in retirement, while **deferred annuities** are generally used as retirement savings vehicles, although they also include an income option. Figure 1 depicts the various types of annuities.

Figure 1. The various types of annuities.



Income Annuities

There are two primary types of income annuities. Annuities that begin payments within one year are called Single Premium Immediate Annuities (SPIA); annuities that defer payments to a future date are called Deferred Income Annuities (DIA).

Single Premium Immediate Annuity—SPIA

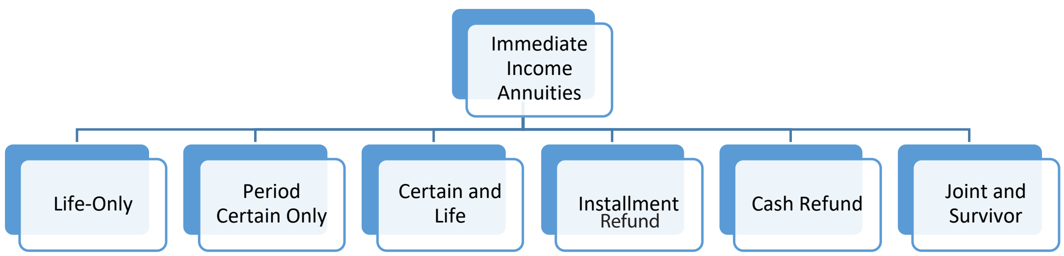
Fixed SPIAs: With a fixed SPIA, the purchaser pays a single premium in a lump sum to the life insurance company.[3] The annuity payment is fixed and guaranteed by the insurance company. The annuity may not be redeemed for cash. The owner chooses the frequency of payments and the payment option (addressed below) at the time of purchase. The insurer makes benefit payments typically monthly, although they could be made quarterly, semiannually, or annually. The benefit payment option cannot be changed after purchase. Each of these choices, along with other factors, such as age and sex of the annuitant(s), determine the amount of the benefit payments. Additionally, there are features available in the marketplace wherein benefit payments increase by a set percentage, typically between 2% and 3% per year, compounded annually, to mitigate the impacts of inflation.[4] Including this feature will increase the price of the annuity, assuming the same initial benefit payment.

3 Although the premium is ultimately paid to a life insurance company, it initially may be paid to an intermediary like an insurance agency or a bank.
4 Increases based on actual inflation generally are not available.

Variable SPIAs: Variable SPIAs are similar to fixed SPIAs, but the periodic payments fluctuate with the change in value of the underlying investments. The owner selects an Assumed Interest Rate (AIR), which influences the amount of the initial income payment and determines what portion of the change in the value of the underlying investments is reflected in the changes in future payments. A high AIR creates a large initial income payment but reduces future increases, and vice versa. Whereas a fixed SPIA provides a predictable income, a variable SPIA provides an income that could initially be greater or less than that with a fixed SPIA, depending upon the AIR, and fluctuates over time, depending upon whether the actual investment return exceeds or falls short of the AIR.

Annuity payouts can be made in various forms that recognize the time period over which payments will continue, whether the payments continue for a lifetime, whether there is a fixed number of guaranteed payments, and whether there is a single payee or joint payees. Figure 2 describes the options; a discussion of each follows.

Figure 2. Payment options for both fixed and variable immediate income annuities.



Life-Only: The insurance company makes benefit payments as long as the annuitant is alive, even if that is to age 100 or older, thereby transferring the financial risk of the annuitant living a long life to the insurance company. This option is referred to as "life contingent" because payments are contingent on the annuitant still being alive. Among the life contingent payment types, this is the least expensive. The price of a life contingent annuity is dependent on the interest rate environment at the time of purchase as well as the age and sex of the annuitant (although annuities in all defined benefit and defined contribution retirement plans covered by the Employee Retirement Income Security Act of 1974 [ERISA], like 401(k) plans, as well as other annuities in some states, are required to be unisex). While a life-only annuity can address longevity needs, some people are uncomfortable buying one because of the possibility of an early death, in which case there are no residual benefits, and the life insurance company retains any remaining value. Other payment options (described below) can protect against that possibility, although they involve additional initial cost, assuming the same monthly payment.

Period Certain Only: The insurance company makes payments for a fixed period of time (the period certain), say, 10 or 20 years, whether the annuitant is alive or not. If the annuitant dies before the end of the certain period, payments continue to the named beneficiary as scheduled. The price of this option is dependent upon the interest rate environment at the time of purchase but is not affected by the age and sex of the annuitant or the named beneficiary. While this may provide a greater income than a life-only option, it does not address longevity risk for a person who lives to a high age.

Certain and Life: This is a combination of the previous two payment options. The insurance company makes payments as long as the annuitant is alive, but if the annuitant dies during the certain period, payments continue to the named beneficiary until the end of the certain period. For example, if Ms. Smith buys a 10-year certain and life annuity making monthly payments and then dies in four years, monthly payments will continue to her named beneficiary for six years after her death. The price depends on the age and sex of the annuitant (but not the named beneficiary), the length of the certain period, and the interest rate environment at the time of purchase. The monthly income will be less than that from a life-only option because of the income continuation after death. This option can mitigate the concern of a purchaser by reducing the value that could be lost at death.

Installment Refund: This option is almost the same as a certain and life annuity, except that the certain period is set equal to the premium paid divided by the monthly payment. For example, Ms. Smith pays $100,000 to buy an installment refund annuity paying her $500/month. The certain period would be 16 years and 8 months because that is how long it takes for the sum of the $500 monthly payments to equal the premium ((16 x 12) + 8) x $500= $100,000. The price depends upon the same factors as the certain and life option. The monthly income will be less than that from a life-only option because of the income continuation after death. This option can mitigate the concern of a purchaser by reducing the value that could be lost at death.

Cash Refund: This option is similar to an installment refund annuity except that if the annuitant dies before the sum of the benefit payments made at least equals the premium, a lump sum payment will be made to the named beneficiary equal to the premium paid less the payments previously received. For example, Ms. Smith pays $100,000 to buy a cash refund annuity paying her $490/month. If she were to die at the end of the fourth year, she would have received 48 payments totaling $23,520. Her beneficiary would receive a single payment of $76,480 ($100,000-$23,520) upon her death. The monthly income will be less than that from a life-only option because of the payment after death. This option can mitigate the concern of a purchaser by reducing the value that could be lost at death.

Joint and Survivor: The insurance company makes payments contingent on the lives of two people and the price depends on the age and sex of both of them. This helps protect income for a couple. Payments typically remain level as long as either of the two people are alive, or they can decrease upon the death of either or just a specified one of the annuitants. For example, Mr. and Mrs. Smith buy an annuity to pay them $1,000/month while they are both alive. However, they believe that when one of them passes away, the surviving spouse will need only $750/month. This would be referred to as a 75% joint and survivor annuity. 100%, 75%, and 50% survivor are all common options.

Table 1 compares the level of monthly benefit payments that might be available for these different types of products, assuming a premium of $100,000. These payments are indicative of the benefits available in June 2022. Payments could be significantly different than these and would vary by current interest rates, mortality assumptions, and other pricing factors used by the life insurance company. For example, if interest rates were 1 percentage point higher, all values would be approximately 10%-12% higher.

Table 1. Comparison of monthly benefit payments.

Monthly Benefit Payments for a Premium of $100,000[5]					
Period Certain—Level Payments					
10 year	$ 988				
20 year	$ 611				
Single Life Annuities—Level Payments—Age 65					
		Male	Female	Unisex*	
Life Only		$ 602	$ 569	$ 585	
10 Year Certain and Life		$ 606	$ 577	$ 592	
Installment Refund[6]		$ 588	$ 563	$ 576	
Cash Refund		$ 581	$ 558	$ 570	
Joint and Survivor—Level Payments					
Percentage to Spouse	Ages 65 and 65				
	100%	75%	50%		
Payable to Retiree[7]	$ 522	$ 535	$ 551		

5 Income Solutions® as of June 13, 2022.
6 These were interpolated between 10 & life and 15 & life.
7 Based on unisex.

Deferred Income Annuity (DIA)—(Qualifying Longevity Annuity Contract [QLAC] if in a tax-qualified retirement plan)

A DIA is similar to a SPIA, except those payments begin at some point beyond one year from the date of purchase, generally five to 20 years in the future. When payments begin at an advanced age, such as 85, a DIA is often referred to as longevity insurance. Its primary use is to provide a lifetime income if the annuitant lives beyond the deferral period and lives a long life. A DIA might be preferable to a SPIA for people who think they are likely to have enough money for a certain number of years in retirement but are concerned about what might happen if their other investments are exhausted or perform poorly.

The deferral of benefit payments can result in a significantly higher monthly income once payments begin than under a SPIA for the same premium.

Table 2. Income comparison[8] for a SPIA and DIAs—$100,000 premium at age 65

Product	SPIA—Income at 65		DIA—Income at 75		DIA—Income at 85	
Sex	Male	Female	Male	Female	Male	Female
Monthly Income	$602	$569	$1,311	$1,205	$4,235	$3,622

A risk is that if the annuitant dies between the date of purchase and the start of income payments, no benefit payments are made. To mitigate against this risk, people can add a death benefit that would provide a payment to a named beneficiary equal to the premium in case of death before payments begin; however, this adds to the cost. In today's interest rate environment, adding this death protection raises the cost by about 11% for a DIA purchased at age 65 with income beginning at age 75; if the income begins at age 85, the cost increase is about 26%.

One special type of DIA is a Qualifying Longevity Annuity Contract (QLAC). These products can allow for deferral of payments to as late as age 85 and are sold exclusively within tax-qualified retirement plans such as IRAs and 401(k) plans.[9] Amounts applied to QLAC purchase are not subject to required minimum distribution (RMD) rules.

Costs of Income Annuities: All costs are built into the single premium that is paid for the benefit payments being provided and guaranteed by the insurance company.

8 Income Solutions® as of June 13, 2022, based on QLAC rates where applicable.
9 The maximum lifetime premium limit for a QLAC in 2022 is the lesser of 25% of retirement savings or $145,000.

Federal Taxation: All income annuities purchased with pre-tax assets, such as assets from traditional IRAs and 401(k) and 403(b) plans, are subject to taxation as benefit payments are received. Benefit payments from income annuities purchased with Roth IRA assets are tax-free. Each benefit payment from an income annuity purchased with after-tax assets, other than from a Roth IRA, is partially a return of after-tax principal and partially taxable income. The percentage of each payment that is principal or interest is based on the Exclusion Ratio, which is typically detailed by the insurance company.[10] Once the total nontaxable benefits paid equals the premium, future payments are fully taxable.

Deferred Annuities

Deferred annuities have two distinct phases: an *accumulation* phase and a *payout* phase. During the accumulation phase, the purchaser's contributions accumulate with interest (or the net investment return in a variable annuity). During the payout phase, the contract owner receives either a single lump sum payment or a series of payments such as the payment options described above. Deferred annuities are different than deferred income annuities, which solely provide an income. Deferred annuities can be purchased with pre-tax funds, personal savings after-tax funds, or funds in a Roth account. The various types of deferred annuities (Fixed, Fixed Indexed, Variable, and Structured Variable) are differentiated by how the value of the annuity grows and the degree of investment risk borne by the owner. Some deferred annuities increase in value based on fixed interest rates and others based on the performance of the underlying investments or an index, or a combination of these. The NAIC Buyer's Guide for Deferred Annuities includes more information about deferred annuities.

Types of deferred annuities:

Fixed Annuity: A fixed annuity is generally the simplest form of deferred annuity. Each year during the accumulation phase, the purchaser's contributions earn interest based on a *fixed* rate (which can change annually), e.g., 3%, set by the insurance company. The initial credited interest rate is frequently guaranteed for one year, but may also be guaranteed for a longer period, sometimes as long as 10 years. Credited rates are subsequently reset periodically, generally annually, but will be no lower than the minimum interest rate set in the annuity contract. Fixed annuities are generally considered a low-risk investment because they are guaranteed by an insurance company and their value can never decrease. These annuities are not structured to provide protection against inflation risk.

10 Internal Revenue Code, Section 72(b).

Fixed Indexed Annuity: A fixed indexed annuity (FIA) credits interest based on, but not necessarily equal to, the change in a stock market index (e.g., S&P 500 without dividends) or an index that is based on some combination of equity and fixed-income investments. The annuity contract often specifies a cap on the amount that will be credited to the account value. For example, if the cap is 8% and index returns are 11%, the account value will increase by 8% over the crediting period.[11] Some contracts use a participation rate (e.g., 60%) that scales down the amount of index increase to determine the credited interest. Another approach credits interest in the amount by which the index increase exceeds a "spread," "margin," or "hurdle." In some cases, an individual can pay extra to get an enhanced crediting basis. The performance of an FIA can be better or worse than that of a comparable fixed annuity. In most states the minimum crediting amount in any year is 0%.[12]

Variable Annuity: A variable annuity allows assets to be invested in a variety of different subaccounts (essentially mutual funds, each of which is characterized by its type of investments), primarily accounts invested in equity and/or bond funds, but possibly also a fixed-interest account. Only a registered representative, e.g., a registered security salesperson, can sell a variable annuity.

The account value in the subaccounts can rise or fall with the performance of the chosen investments, similar to changes in the value of investments in the stock and bond markets. Unlike fixed annuities and fixed indexed annuities, which have account values guaranteed by the insurance company, the value of a variable annuity invested in equity and/or bond subaccounts is not guaranteed; the owner bears the investment risk. These assets are held in an account that is separate from the insurer's assets that back other guarantees; therefore, separate account assets are available only to the owner, subject to any applicable surrender charges. Some variable annuities include index-linked accounts, which are discussed under Structured Variable Annuity, below.

Structured Variable Annuity (also called Registered Index-Linked Annuity [RILA]): A structured variable annuity is a type of indexed annuity.[13] It is a security that acts more like a variable annuity than an FIA. It credits increases like other variable annuities but provides a limited amount of downside protection while leaving some risk to the owner. This contrasts with an FIA, which is not a security, and which typically protects interest crediting against all decreases in the index. Like other variable annuities, it can be sold only by a registered representative.

11 Interest is credited periodically, commonly annually, but sometimes at the end of a multiyear period. No interest is accrued prior to the end of the crediting period.
12 The minimum is 1% for FIAs sold in New York.
13 An indexed annuity is any annuity in which the interest credited is based upon the change in a specified index. An FIA is an indexed annuity that meets the requirements of the Standard Nonforfeiture Law, as specified in the Harkin Amendment to Dodd-Frank (section 989J).

There are two primary variants of structured variable annuities: products with a "buffer" and products with a "guard." A buffer product protects the owner from a specified percentage of decrease, e.g., 10% for a year, after which the owner's account is reduced for any excess decrease. A product with a guard reduces the owner's account for decreases up to a limit, e.g., 10%, but protects against any excess loss.

Fixed, indexed, variable, and structured variable deferred annuities generally share some of the same characteristics, including:

- Tax Deferral. Federal and state taxes on the increase in value of a deferred annuity are deferred (except in the case of a non-natural owner, such as a corporation or a trust), but in exchange for this tax benefit, funds cannot be withdrawn prior to age 59½ without a 10% tax penalty, except in specific circumstances.[14] Taxes are assessed at the ordinary income tax rate when funds are withdrawn. A deferred annuity can be exchanged for a new annuity (known as a "1035 Exchange" for non-qualified annuities, or a rollover for qualified annuities) and the funds will be treated as a continuation of the previous annuity for tax purposes.[15]

  Note that the tax deferral on pretax money does not provide any value beyond what is already provided with an IRA or other tax-qualified vehicle.

- Guaranteed Benefit Riders. Some deferred annuities include Guaranteed Lifetime Withdrawal Benefits (GLWB), Guaranteed Minimum Income Benefits (GMIB), or Guaranteed Minimum Accumulation Benefits (GMAB). Generally, the guaranteed benefits are optional, with an explicit fee deducted periodically from the account value; some products include them automatically with the cost built into the crediting rate or through the method of recognizing the gain or loss on the account value. A GLWB provides the right to withdraw a certain amount annually as long as the annuitant lives, first from the contract value until it is exhausted, then from the general funds of the insurer; but this is seamless to the annuitant. When added to a deferred annuity, the resulting product is comparable to an income annuity, but with the advantage that the owner always has access to the account value. A GMIB provides a floor for the amount of lifetime income. This amount applies at the date of annuitization unless the income amount available from the basic contract guarantee is larger. Unlike the GLWB, a GMIB does not provide the owner access to the contract value. A GMAB provides the guarantee that the account value will not be less than a specified amount at a specified time in the future.

14 These include payment at the time of death or total and permanent disability of owner, amounts used to pay tax-deductible medical expenses, Qualified Domestic Relations Order, and certain periodic payments. At times, Congress has approved other circumstances when this tax penalty is waived during financial crises.
15 These exchanges are allowed under IRC Section 1035 for non-qualified annuities and Section 408(d)(3)(B) for qualified annuities.

All of these guarantees can be valuable in times of low interest rates or poor stock market performance. Conversely, they can provide little to no additional benefit when markets have performed well or interest crediting was high. Insurers may limit the investment choices to manage their risk when a guaranteed benefit is purchased. The owner is required to hold the annuity for a given number of years and/or to a certain age before exercising the guaranteed benefit.

Additionally, many contracts include a Guaranteed Minimum Death Benefit, which will pay the contract holder's beneficiary a minimum death benefit, e.g., the initial deposit regardless of subsequent market performance. The charge for this death benefit is typically included in the "mortality and expense" (M&E) charges (discussed below).

- Annuitization of a Deferred Annuity. In a deferred annuity, assets accumulate as long as the owner chooses and then, when retirement income is desired, the owner can "annuitize" the contract, i.e., turn the annuity into an income annuity as described above. These products provide guarantees with respect to the conversion of account value into income that can be especially valuable in certain interest rate environments. Most policies provide that the annuitant who annuitizes the contract will receive the larger of the amount that is guaranteed under the contract or what would be provided in the company's then current SPIA product.

- Surrender Charge. If the owner chooses to withdraw money or cancel the contract, the insurance company usually imposes a "surrender charge" that is a percentage of the amount withdrawn. This percentage generally decreases annually and eventually disappears.

- Market Value Adjustment. Some deferred annuities have a market value adjustment (MVA) applied to withdrawals, which adjusts the value of the withdrawal. If interest rates have fallen since the purchase of the annuity, the amount of the withdrawal is increased. If interest rates have risen since the purchase, the amount of the withdrawal is decreased. The MVA is generally temporary and commonly disappears at the same time that the surrender charge wears off. Because this passes some of the investment risk to the contract holder, companies are typically able to offer a higher credited rate for contracts with an MVA.

- Free Partial Withdrawal. Deferred annuities generally include a free partial withdrawal provision, i.e., a percentage of the account value that can be withdrawn each year with no surrender charge and no MVA. A commonly provided allowable free partial withdrawal percentage is 10% of the account value.

Costs of Deferred Annuities

The costs for deferred annuities vary from product to product. In some cases, all the costs are embedded in the interest crediting. This structure is common with fixed annuities and FIAs, where the crediting interest rate or the basis for the indexed credits is less than what the insurance company expects to earn on the invested premiums. This margin provides the insurance company with the funds needed to pay all its expenses and earn a profit.

Some deferred annuities, such as variable annuities, will often have explicit charges because these products have no crediting interest rate to adjust. The charge will be a percentage of the account value and will be deducted periodically. Each subaccount in the separate account will generally have its own investment management charge.

Finally, the annuity owner may have to pay a surrender charge (discussed above) upon withdrawing funds or canceling the contract.

Table 3. Summary of deferred annuities

	Type of Deferred Annuity			
	Fixed Annuity	Fixed Indexed Annuity	Variable Annuity	Structured Variable Annuity
Investment Risk Transfer	Transferred to insurance company (possibly with a market value adjustment)	Transferred to insurance company through protection of account value and guarantee that interest crediting is no less than 0% (possibly with a market value adjustment)	Owner retains most investment risk (although riders described above can mitigate this risk)	Owner and insurer share the investment risk when interest crediting would be negative
Inflation Protection	None	None directly, but possible based upon index performance.	Possible based on amount of equity holdings and performance	None directly, but possible based upon index performance.
Upside Potential/	Small	Medium	High	Medium to high
Downside Risk	None (minimum guaranteed rate of at least 1%)	None (0% crediting floor)	High (but can be mitigated with a rider)	Medium, with risk shared with insurer
Can Account Value Go Down?	No	No, but return can be zero (although charges may decrease account value	Yes	Yes
Market Value Adjustment	Some have this	Some have this	Yes, often on funds in a fixed account	No
Cash Surrender Value	Account value minus surrender charge minus MVA, if any	Account value minus surrender charge minus MVA, if any	Account value minus surrender charge minus MVA, if any	Account value minus surrender charge

Conclusion:

When considering retirement, retirees could benefit from having a clear understanding of annuities because the term can have many meanings. Annuities encompass a broad range of products with many different accumulation and payout options and varying fee structures. Individuals considering incorporating these products into their savings/retirement portfolios should understand the particular provisions of any annuity as well as benefits and risks, as each retiree's circumstances and risk tolerance will be unique.

The SECURE Act, passed in December 2019, has provisions that may increase the use of annuities in qualified employer defined contribution plans. This added attention may lead to the development of new products designed with additional features.