HOW SURRENDER CHARGES PROVIDE PROTECTION FOR ANNUITY OWNERS

Fixed annuity fundamentals

Fixed annuities are purchased for a variety of reasons, including saving money for retirement; leaving assets to business partners, loved ones or charities at death; and preparing for planned and unplanned expenses. Fortunately, in the annuity marketplace there are products to meet every consumer's preferences and unique financial needs and objectives.

There are front-end load annuities, there are lower-interest annuities; there are annuities with an annual fee; there are annuities with surrender charges; there are annuities with multi-year guarantees or with a guaranteed lifetime income withdrawal benefit; there are annuities with inflation protection, long-term care provisions and other measures to address uncertainty; and there are annuities that combine some or all of these features.

Regardless of the specific features and benefits, all fixed annuities provide three insurance guarantees:

1. Interest will be credited to your annuity account, regardless of the performance of the insurance company's investment portfolio: **the minimum interest guarantee**.

2. Your annuity account value will never be less than the premium you paid plus the interest you have been credited, even when the market declines: **guaranteed protection from market risk**.

3. Should you purchase an annuity with a rider that provides guaranteed lifetime income benefits, the insurance contract promises to pay you as long as you live, no matter how long you live: **the guaranteed income payout**.

In addition, fixed annuities can earn additional interest above the minimum interest guarantee. For example, fixed indexed annuities earn interest based on the positive performance of a particular index. The interest rate is guaranteed to never be less than zero, even if the market declines. Non-indexed, or fixed rate, annuities can earn additional interest as contractually determined by the insurance company.

However, these insurance guarantees and the promise to provide additional interest are not free and, therefore, are considered an expense to the insurance company. There are other expenses and acquisition costs as well, including product development, issuing costs, commission expenses, regulatory compliance and mandated reserve requirements.

How insurers address annuity costs

To pay for such expenses and to earn the profit required necessary to remain a solvent and viable business, the insurer invests the premiums it receives. Like any investment, it can only cover the expenses and profit requirements if it retains the investment for a sufficient period of time, often several years. If an annuity contract is cancelled too early, the expenses to issue the annuity will more than likely be greater than the investment returns, and the insurance company will suffer a loss. And, if an insurer suffers too many losses, it risks insolvency.

No prudent saver or investor wants the company from which it purchases a product to operate at a loss — or worse. It is left to the insurance company to determine preventive contract provisions to avoid a loss on the sales of these products. As a result, the question becomes, "*Which loss prevention method is the fairest*?"

- One loss prevention measure to help the insurer cover its costs for early contract cancellations is to impose a "front-end" sales charge on all contracts.
- Another measure is to reduce the interest it would otherwise credit each year, perhaps by imposing annual contract fees on all contracts.
- A third approach is to impose surrender charges on annuity holders who cancel their contracts in the early years of the annuity.

As it relates to annuities with a surrender charge, there are annuities with two-year surrender charges and annuities with 12-year surrender charges — and everything in between. The number of years to which the surrender charge applies is called the surrender charge period. Essentially, surrender charges are a fee that the insurance company charges the annuity owner as a deterrent for withdrawing funds from the contract too soon, particularly given that annuities are designed for long-term utilization by clients. Typically, these charges decline over time to zero after the insurer has recovered the acquisition costs.

All three methods of loss prevention work, and an insurer must use one or more of these methods if it intends to make a profit — and stay in business — because early surrenders will subject the insurer to financial loss if not combined with one or more loss-prevention feature.

Both the front-end sales charge and annual fee/reduced annual interest methods apportion the cost of offsetting the potential loss across all annuity purchasers, whether they surrender their contracts early or not. By contrast, the surrender charge method imposes the burden of unrecovered acquisition costs only upon those annuity buyers who caused those losses by not fulfilling their contractual obligation.

When properly understood, surrender charges are the best tools for ensuring that *all* consumers receive the best interest rate possible within their annuity and that insurers are adequately protected as the guarantors of the product.