



Using Immediate Annuities for Retirement Income

Overview

- With the Baby Boomers entering retirement age, their chief financial planning concern is having enough money during their lifetime
- The media is reinforcing their concerns and touting Single Premium Immediate Annuities (SPIA's) as the solution
- SPIA's are the **only** financial product that can **guarantee** a steady income for the rest of your client's life
- SPIA's are only offered by insurance companies and are primarily sold by independent insurance agents
- This presentation will introduce you to SPIA's and their many uses

Defining a SPIA

SPIA = Single Premium Immediate Annuity

- In exchange for a single lump sum premium, the annuitant receives a secure, tax-advantaged, guaranteed stream of income payments
- Payments can be structured in a variety of ways, for example:
 - Life only: monthly income for the rest of the annuitant's life
 - Joint life: ideal for married couples, there are two annuitants, and monthly income continues as long as either are still alive
 - Certain only: monthly income for a defined period of time
 - Many other options are available
- For retirees who are not receiving traditional pension benefits, SPIA's provide peace of mind by providing steady monthly checks – they have been called “paycheck annuities” by prominent national commentators
- By providing income that cannot be outlived, SPIA's act as longevity insurance for the annuitant

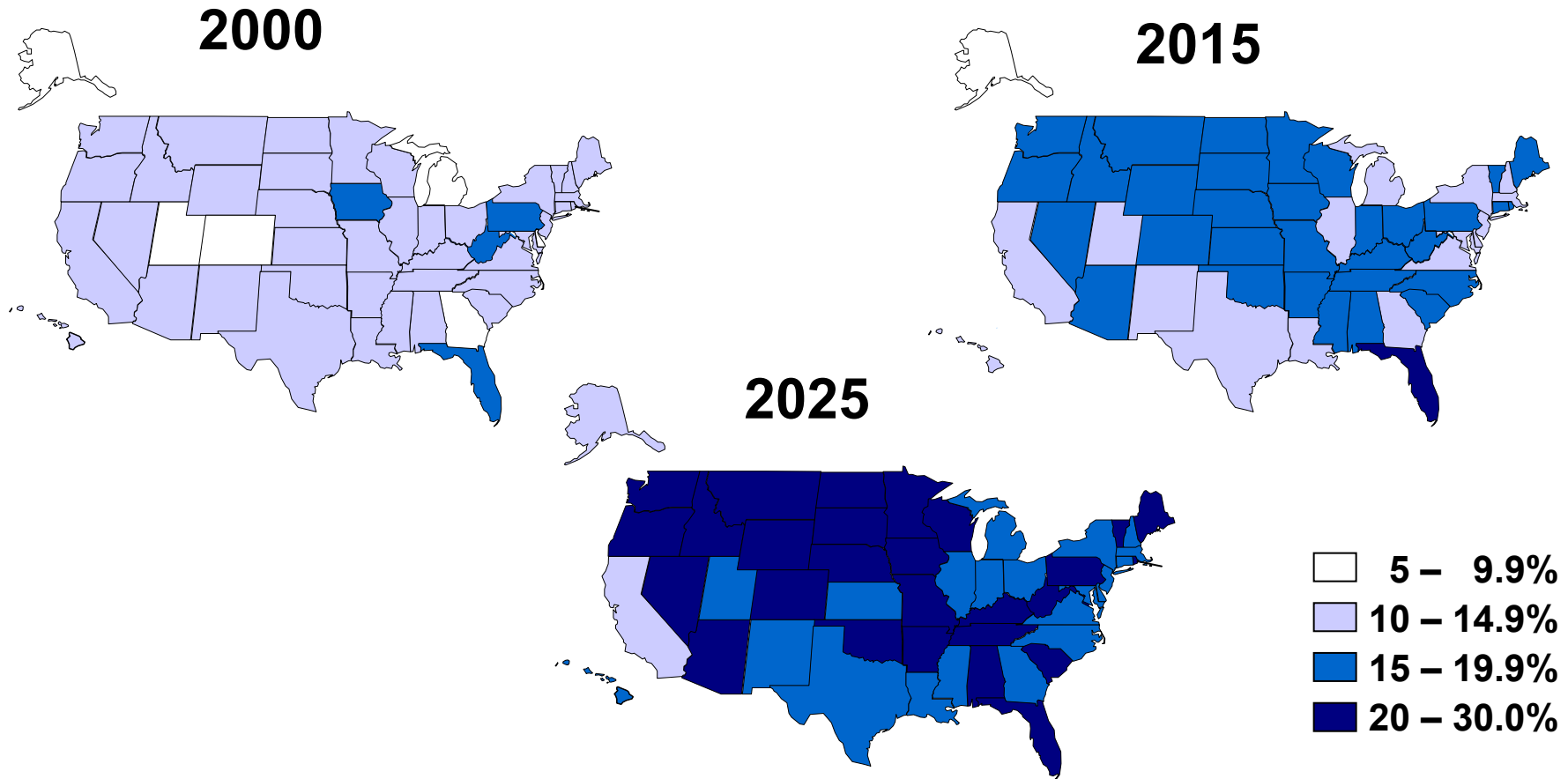
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The Future of Retirement Income

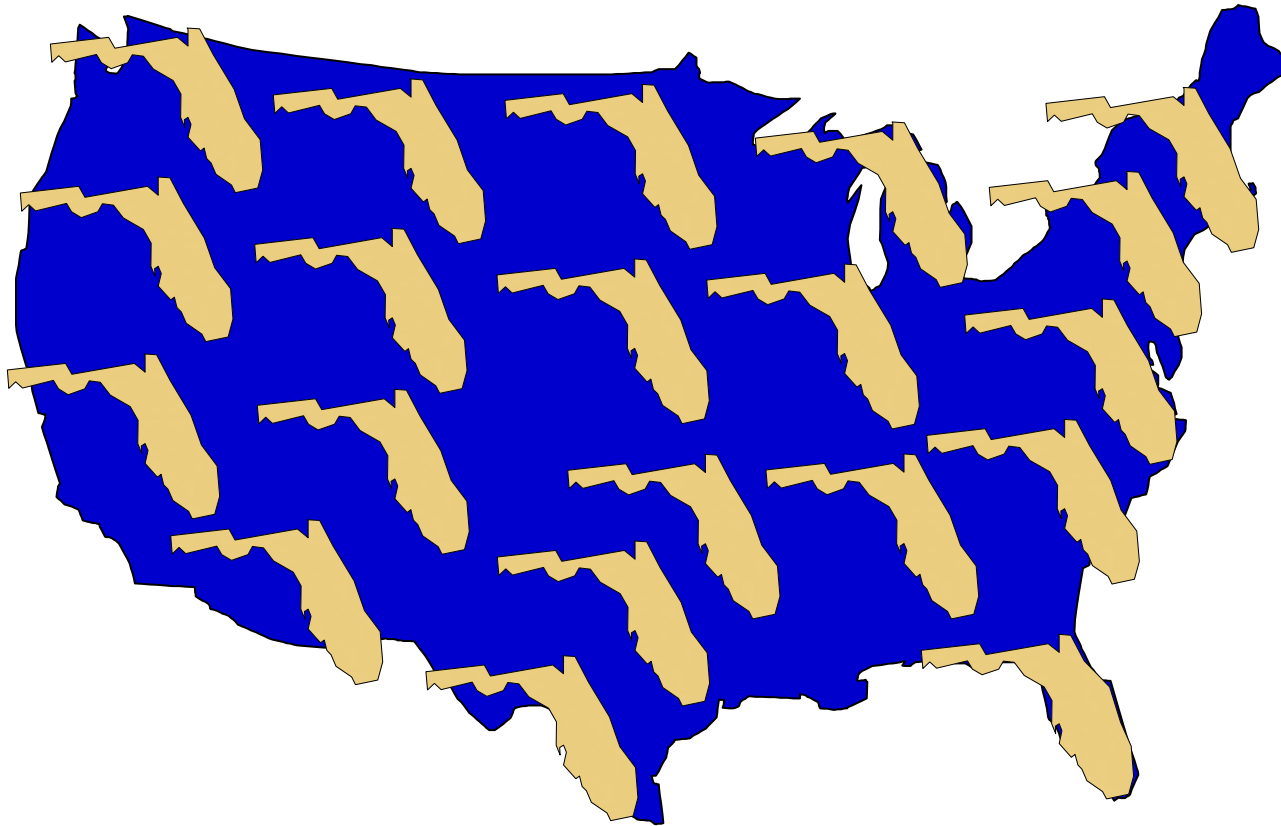
Demographic Trends



Source: "The State of Aging and Health in America 2004" Merck Institute of Aging & Health and the Centers for Disease Control

Demographic Trends *(continued)*

- In 20 years, the whole country will have the demographics of Florida



The Retirement Income Challenge

- Most of the income for a typical working age person comes from wage income
- The income from a retired person comes from where?



The Retirement Income Challenge *(continued)*

What can retirees count on from Social Security?



Social Security

- Its primary purpose is to prevent the elderly from living in poverty
 - It was never meant to be the sole source of income in retirement
 - The average monthly benefit is only \$1,044 for a retired worker
- It is largely a “pay-as-you-go” system with today’s wage earners paying for the benefits of today’s retirees
 - Thus, the ratio of workers to beneficiaries is very important in setting payroll tax rates and benefit levels
 - This ratio was 16.5-to-1 in 1950, has fallen to 3.3-to-1 today, and is projected to fall to 2.1-to-1 in 25 years
- As a result, you can expect ...
 - Adjustments to the program over time such as rising payroll tax rates, reduced benefits, and increased retirement ages

Source: Social Security
Administration

The Retirement Income Challenge *(continued)*

What can retirees count on from company retirement plans?



Company Retirement Plans

- Defined benefit plans are becoming scarce
 - 114,396 – Number of private company pension plans in 1985
 - 30,336 – Number currently
 - Zero – Estimated number of plans created in the past decade
 - \$340 billion – The amount of underfunding in corporate pension plans
- The Pension Benefit Guaranty Corporation ...
 - Is a government agency that takes over pension plans that have terminated
 - Currently has a deficit of \$18.9 billion
- As a result, you can expect ...
 - Even if you have a defined benefit pension plan, it is becoming less and less likely to still be in place when you retire

Source: The Dallas Morning News, Pension Benefit Guaranty Corporation

The Retirement Income Challenge *(continued)*

As a result ...



**Personal
Savings**

- A greater portion of future retirees' income is going to come from personal savings

What are My Clients Thinking About Retirement?

- “When I’m 65, I think I will still need to be working... Hopefully I’ll still have the health to keep working.”
- “The best thing you can hope for at 85 is that you would not be a burden to your children. That you could be self-sufficient.”
- “I wonder if we’re not doing the reverse of what our parents did... they spent the money when they were 60, 70. And we may be spending it when we’re 30, 40, and 50, but I don’t know that we’re going to be as well off when we’re the ages of our parents.”
- And...

When asked to name the first thing that comes to mind when they think of retirement...

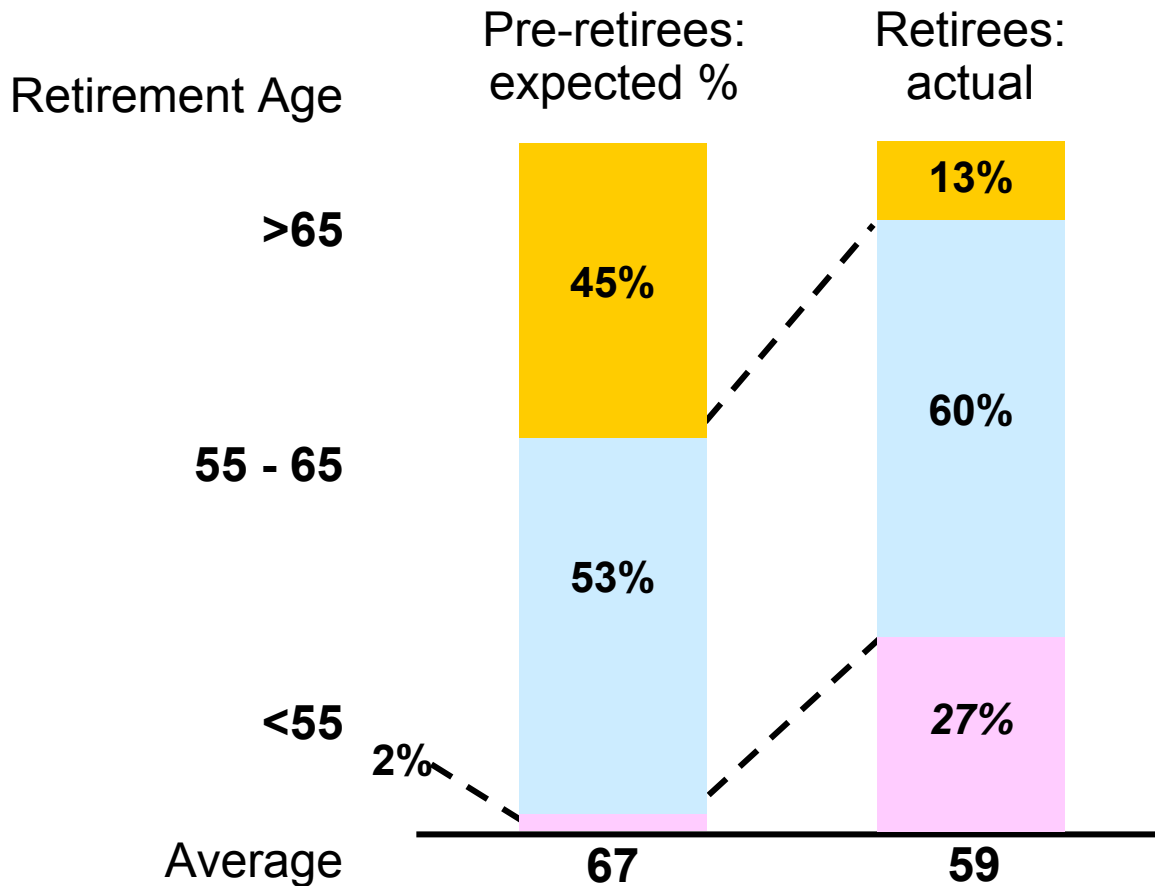
"having enough money/financial security"

is the number one response in an open-ended question!

Source: AARP Boomer Book 2002

What are My Clients Thinking About Retirement? *(continued)*

- People expect to keep working longer. Is this realistic?



The reality is that most people retire earlier than they expected.

Why?

- Health (47%)
- Job loss (44%)
- Care for spouse or other family member (9%)

Source: McKinsey 2006 Consumer Retirement Survey

What are My Clients Thinking About Retirement? *(continued)*

- How do they expect to cover expenses during retirement?

Methods to cover Expenses During Retirement	Pre-retirees: expectation	Retirees: reality
Take on Work	36%	10%
Significantly reduce discretionary spending	32%	10%
Downsize home/relocate	31%	7%
Take on home equity loan/line or reverse mortgage	13%	14%

- Obviously, there is a mismatch between how they expect to cover expenses and how they actually end up doing it

Source: McKinsey 2006 Consumer Retirement Survey

What are My Clients Thinking About Retirement? *(continued)*

- **So, people are concerned about their financial security in retirement.**
- **What is reinforcing their concerns?**
 - Economic jitters, volatility in the stock and bond markets
 - Low interest earnings available on fixed investments
 - Concerns about the future of Social Security
 - Elimination of defined benefit plans
 - Uncertain and increasing health care costs
- **What do they want to address their concerns?**
 - Safe and dependable income
 - Guaranteed income they cannot outlive
 - Peace of mind

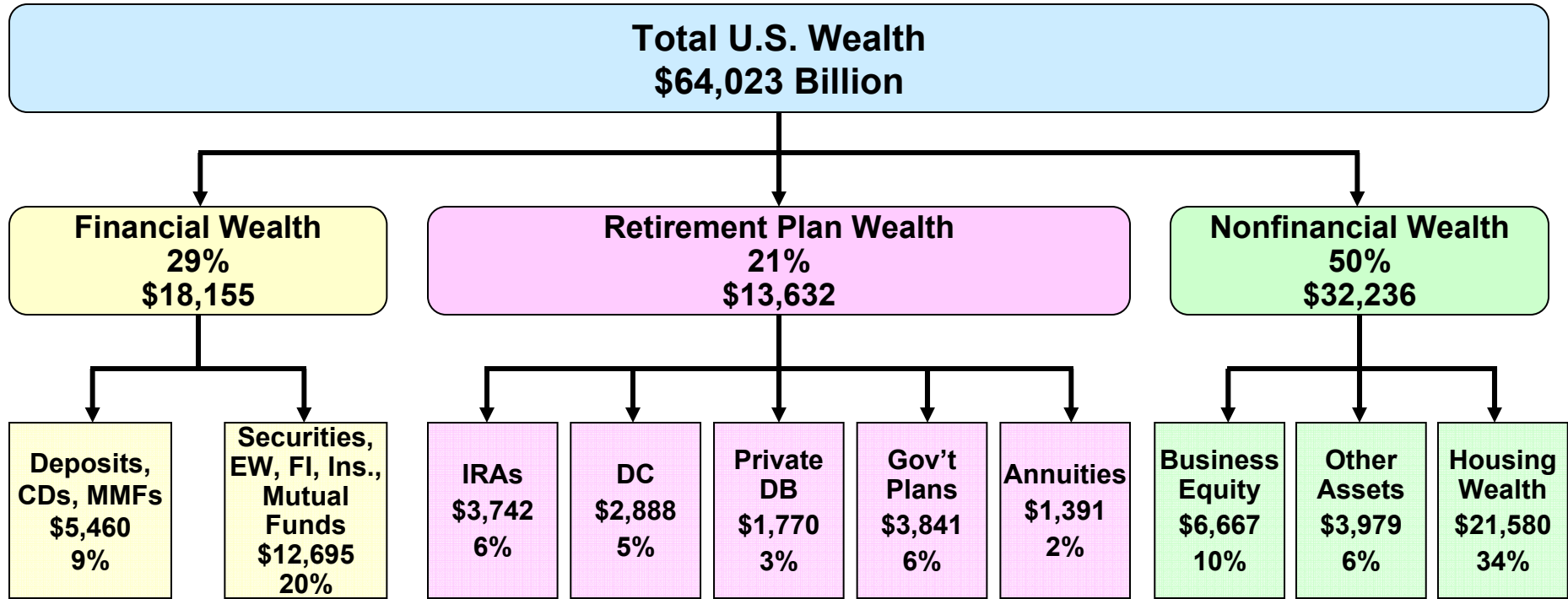
... what a SPIA provides!

What the Media is Saying About SPIA's

- “Retirement is the great financial riddle. Think of the uncertainties. You don't know how long you will live. You don't know what investment returns you will earn. You have only a limited sum of money. And there are no second chances. One possible solution: immediate fixed annuities.” - Wall Street Journal, February 2000
- “An immediate fixed annuity that generates a stream of income for life can be a boon to retirees who want a guarantee that their savings will carry them through a long retirement. Security, peace of mind, and increasing life spans are the main reasons why fixed annuities are making a comeback.” - Kiplinger's Retirement Report, April 2003
- “An immediate annuity, which will give you a check every month for life, is often your best bet for squeezing maximum income out of your savings.” - Wall Street Journal, March 2003

What the Media is Saying About SPIA's *(continued)*

- Where people have their money:



Source: 2005 Federal Reserve Flow of Funds, ICI and Merrill Lynch segmentation estimates

What the Media is Saying About SPIA's *(continued)*

- Experts are saying that SPIA's solve these problems associated with stocks, bonds, CD's, and other forms of retirement savings:
 - The possibility that you will outlive your savings
 - The possibility that a bear market will wipe out your savings
 - The possibility of future reductions in interest earnings on your savings

- But they advise that you should consider:
 - Putting only a portion of retirement savings into a SPIA since SPIA's are not liquid
 - Dividing your retirement savings between a SPIA, which provides safety, and stocks and other investments, which provide growth potential
 - Choosing a payment option that includes a cost of living inflation adjustment and that provides for your heirs



How Do SPIA's Work to Meet Retirement Income Needs?

How SPIA's Work

SPIA = Single Premium Immediate Annuity

- In exchange for a single lump sum premium, the annuitant receives a secure, tax-advantaged, guaranteed stream of income payments
- Defined benefit pension plans have been using SPIA's for years
 - An employer will steadily save money while a worker is working for the employer
 - When the worker retires, the employer now owes the worker a monthly income for the rest of his or her life
 - Many employers will go to an insurance company and give them the sum of money that has been saved in exchange for the insurance company taking over the obligation to pay the worker for life

How SPIA's Work *(continued)*

Suppose that I have a male age 65 who wants a regular income of \$3,000 per month. What payment options could be provided by an insurance company, and how much would the insurance company charge?

- \$1,000 monthly for the rest of his life: \$442,000
- \$1,000 monthly for the rest of his life, increasing by a 3% annual inflation factor: \$587,000
- \$1,000 monthly for the rest of his and his 65-year-old wife's life: \$534,000
- \$1,000 monthly for the rest of his life, but continuing for a minimum of 15 years: \$481,000
- \$1,000 monthly for 15 years and then stopping: \$396,000
- Many other options are available

Please note that all premium quotes are hypothetical.

How SPIA's Work *(continued)*

- Note that the carrier provides a price
 - That price is in part based on what sort of interest rate the carrier expects to earn on the premium paid
 - That price is in part based on the life expectancy of the “annuitant”, that is, the person on whose life the payments are based
 - But the carrier does not tell you the interest rate or the life expectancy
 - So, people ask the question, what is the rate of return on my money?

How SPIA's Work *(continued)*

- The realized rate of return depends upon how long the annuitant lives
 - Suppose that I am a male age 65 and I purchase a SPIA that will pay me \$3,000 per month for the rest of my life, and the premium for that is \$442,000. What is my rate of return?
 - The answer depends on how long I live:

Live to Age	Annualized Rate of Return
75	-3.87%
80	2.79%
90	6.76%
100	7.83%
110	8.20%

- Since the rate of return depends upon how long I live, SPIA's are often referred to as a form of longevity insurance

How SPIA's Work *(continued)*

- Are these rates of return attractive relative to other alternatives?
 - When comparing a SPIA to, for example, a stock market-based investment, you must consider the difference in risks

Risk	Who bears it in a stock market-based investment	Who bears it in a SPIA
Investment Loss	Your Client	Insurance Company
Interest Rate Changes	Your Client	Insurance Company
Very Long Lifetime	Your Client	Insurance Company

- A stock market-based investment may produce a higher return, or it may not, depending upon how these risks play out
- The appeal of SPIA's is safety and dependability

How SPIA's Work *(continued)*

- Strengths of SPIA's
 - Provide the peace of mind that comes from a safe and dependable income
 - Are an excellent supplement to Social Security and pension plan income
 - Eliminate the possibility that you will outlive your savings (eliminate longevity risk)
 - Eliminate the possibility that a bear market will wipe out your savings (eliminate investment risk)
 - Eliminate the possibility of future reductions in interest earnings on your savings (eliminate interest rate risk)

How SPIA's Work *(continued)*

- Disadvantages of SPIA's, that is, why you don't put all of your retirement savings into them
 - SPIA's are not liquid
 - Since you are swapping a lump sum of cash for a guaranteed stream of income, you lose access to the lump sum of cash
 - SPIA's do not provide growth potential
 - You are buying a 100% guaranteed payout, so there is no possibility of extra growth beyond that guarantee
- Also, most retirees should consider choosing a payment option that includes an inflation adjustment and that provides for money to go to their heirs if they die relatively soon, even though those options cost more

How are SPIA's taxed?

- If the source of the initial premium was non-qualified funds:
 - Each payment from a SPIA is considered to be partially interest and partially return of principal
 - As a result, only a portion of each payment from a SPIA is taxable
 - The taxable portion is treated as interest income
 - When you receive a quote for a SPIA, look for the “exclusion ratio”
 - The exclusion ratio is the portion of each annuity payout that will be considered return of principal and therefore non-taxable
- If the source of the initial premium was qualified funds:
 - Since the cost basis of qualified funds is zero, each payment from a SPIA is fully taxable as interest income



How To Choose the Best SPIA

How to Find the Best SPIA

In most situations, SPIA's are commodities with few or no differentiating features.

After determining:

- The type of payout desired, and
 - Either the premium available or the income desired
- ... obtain quotes from various carriers.

The decision of which carrier to choose typically rests upon:

- Which carrier offers the best price or payout and
- The financial ratings of the carriers.

The longer the expected payout stream, the more important the financial strength of the carrier.

State Guaranty Funds

- Obligations of an annuity contract are guaranteed by the insurer
- So, the financial strength of the carrier is a concern in the purchase decision
- Various ratings agencies give opinions of the financial strength of carriers
 - A.M. Best
 - Standard and Poor's
 - Moody's
 - Fitch
- In the event that the financial condition of an insurer becomes impaired, each state has a guaranty fund to help pay claims

State Guaranty Funds *(continued)*

- State laws specify the lines of insurance covered by the guaranty fund and the dollar amounts payable
- The maximum liability for present value of guaranteed payments from a SPIA contract in most states is \$100,000
 - Notable exceptions:
 - \$200,000 in Utah
 - \$300,000 in Arkansas, DC, North Carolina, Oklahoma, South Carolina, Wisconsin
 - \$500,000 in New York, Washington
- Most states restrict insurance companies and agents from advertising, to some extent, the guaranty funds' availability
- An excellent source of more detailed and current information is the National Organization of Life and Health Guaranty Associations website
 - <http://www.nolhga.org>



Other Uses of SPIA's

What are Their Uses?

- **Beside turning retirement savings into guaranteed income, SPIA's are used in these additional situations:**
 - Lifetime gifting
 - Estate planning
 - Providing guaranteed income and principal preservation
 - Funding long term care
 - Medically underwritten annuity – creating a higher income
 - Securing debt
 - Structured settlements
 - Charitable gift annuities
 - Divorce settlements
 - Business buyouts
 - Pension plan terminal funding
- **Let's briefly examine each scenario**

Let's examine each scenario:

- **Lifetime gifting**

- Allows your client to create funds that will last a lifetime for their loved ones
- For example, a \$22,000 gift of an annual pay, life only SPIA with a 4% inflation factor for your client's 1-year old grandchild will generate an initial payout of \$455
- This annual payout will grow to \$959 by the 20th year and \$5,600 by the 65th year, with a total expected lifetime payout of \$380,620
- The grandparents are remembered forever for a gift that grows every year and is guaranteed every year for the grandchild's life

Please note that all premium quotes are hypothetical.

Let's examine each scenario: *(continued)*

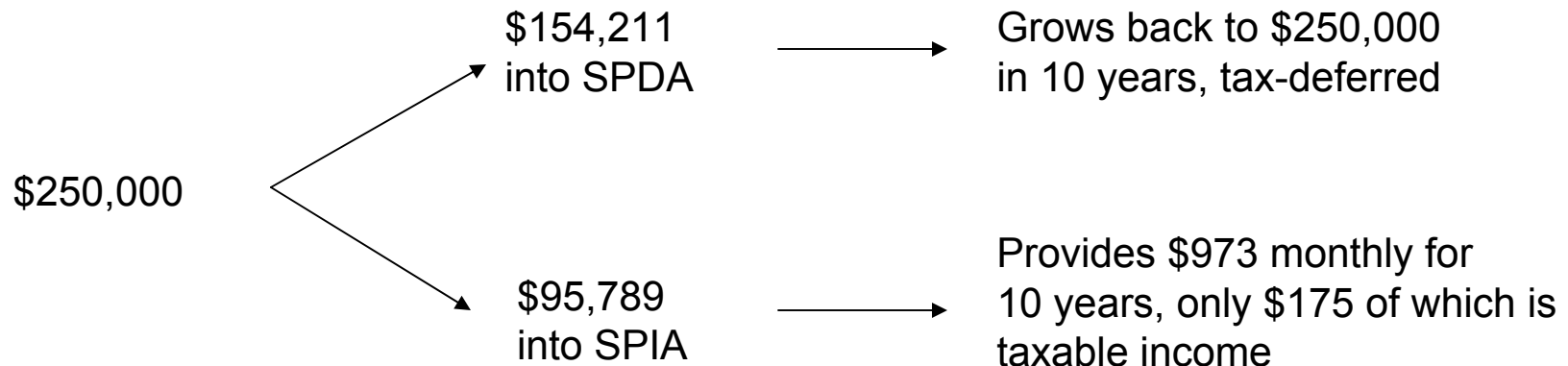
- **Estate planning**

- Many clients use a combination of SPIA's and life insurance to reduce their taxable estate
- The client establishes an Irrevocable Insurance Trust, the trustee applies for a single or second-to-die life insurance policy, the client buys a life only SPIA to fund the life insurance premiums (check with your tax advisor to consider possible gift tax issues)
- At death, the beneficiaries of the trust receive the death benefits of the life insurance policy, and because the trust owns the policy, the benefits are outside the estate and are income tax free and estate tax free

Let's examine each scenario: *(continued)*

- **Providing guaranteed income and principal preservation**
 - A common retirement income planning tool that results in dramatically higher after-tax income to CD owners
 - Divide the retirement savings into two portions
 - Put a portion into an SPDA, which will grow back to the whole in a few years
 - Put the remainder into a SPIA, which will provide income while the SPDA is growing

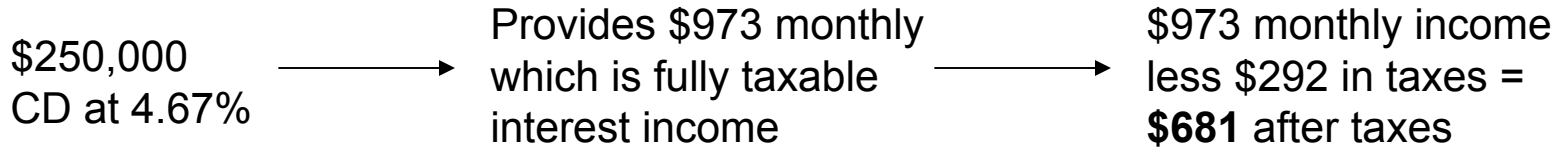
Example (Please note that all numbers shown are strictly hypothetical)



Let's examine each scenario: *(continued)*

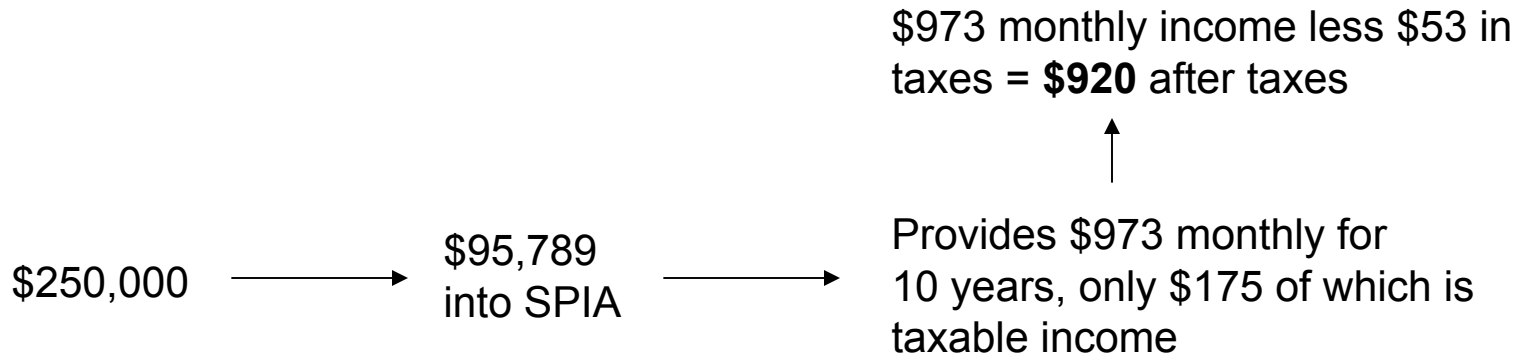
- Providing guaranteed income and principal preservation, *continued*

After-tax income versus a CD (using a 30% tax rate)



The SPDA/SPIA combo gives a 35% increase in after-tax income!

Versus:



Let's examine each scenario: *(continued)*

- **Funding LTC insurance or nursing home costs**
 - Allows clients to set aside a portion of their savings to fund an insurance policy that requires annual premiums for life or to fund a monthly obligation to a nursing home
 - Frees up the rest of their savings for other uses

- **Medically underwritten annuity – creating a higher income**
 - Clients who live with health conditions can receive a higher monthly payout for every premium dollar than those in good health
 - This makes the case for purchasing a SPIA even more compelling
 - Their premium can generate a higher benefit payment than would normally be the case, or
 - Their chosen benefit amount can be obtained with a lower premium than would normally be the case
 - The carrier underwrites the client to verify that he or she is in poor health

Let's examine each scenario: *(continued)*

- **Securing debt**
 - Business planning situations
 - Allows businesses to collateralize loans or fund the payoff of non-callable debt

- **Structured settlements**
 - Alternative to lump sum court awards
 - Often used in personal injury, medical malpractice, or environmental claims to provide a long-term stream of income to offset long-term damages

- **Charitable gift annuities**
 - Offered through charities
 - Allows clients to give a gift to a charity, gain a tax deduction, and receive income for life – all in one package

Let's examine each scenario: *(continued)*

- **Divorce settlements**
 - Frees the payer from having to write monthly checks
 - Assures the receiver that monthly income is guaranteed

- **Business buyouts**
 - Frees sellers from having to manage a large lump sum from the buyout
 - Eliminates market and interest rate risk and secures a steady income
 - If seller is asking a higher price than the buyer is willing to pay:
 - Structure an installment purchase and fund it with a SPIA

- **Pension plan terminal funding**
 - For a business with a defined pension plan that it wants to shut down
 - Allows the business to transfer the financial and administrative obligations of the pension plan to an insurer in exchange for a single premium



Alternative Sources of Retirement Income Offered by Insurance Companies

Alternative Sources

- Remember that the two major disadvantages of SPIA's are:
 - SPIA's are not liquid
 - Since you are swapping a lump sum of cash for a guaranteed stream of income, you lose access to the lump sum of cash
 - SPIA's do not provide growth potential
 - You are buying a 100% guaranteed payout, so there is no possibility of extra growth beyond that guarantee
- As a result, the insurance industry has invented an alternative that helps address these concerns: the Guaranteed Lifetime Withdrawal Benefit on a deferred annuity

Alternative Sources *(continued)*

- A deferred annuity is essentially a retirement savings account offered by an insurance company
- There are three major types of deferred annuities:
 - Fixed interest: your principal is protected from loss, and you are credited a rate of interest declared by insurance company management
 - Indexed: your principal is protected from loss, and your rate of interest is based upon a formula linked typically to a major stock market index
 - Variable: your principal is invested in subaccounts similar to mutual funds, where your return could be higher than a fixed interest or indexed annuity, but your return could be negative

Alternative Sources *(continued)*

- A Guaranteed Lifetime Withdrawal Benefit is frequently offered as an optional feature on an indexed or variable deferred annuity
 - It guarantees the withdrawal of a specified percentage of deposits over the policyholder's lifetime (such as 5% for life), regardless of subsequent account value
 - Many contracts offer both single and joint life options
 - Charges are expressed as a percentage of account value and are typically in the 0.50% - 0.75% range annually
 - On a variable annuity, typically some asset allocation among subaccounts is mandated by the carrier

Alternative Sources *(continued)*

- Compared to a SPIA, this offers the advantages of:
 - The flexibility to start and stop withdrawals
 - Flexibility regarding withdrawal amounts, up to an annual limit
 - Continued access to your remaining account value in event of emergency
 - Death benefit payments if a positive account value exists upon death
 - Guarantee of the withdrawal amount, even in a poor market, but with the upside of good market performance
- Of course, all this flexibility comes at a price
- A SPIA would typically offer a higher guaranteed lifetime payout than a Guaranteed Lifetime Withdrawal Benefit

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