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"Suitability in Annuity Transactions"

Satisfies the once in a Lifetime self study course requirement under Title 50; Chapter 1; Subchapter ii; Part 3120

4 hours of CE credit;
25 Questions Nonsupervised Exam

"Suitability in Annuity Transactions"

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Purpose of 3120 Suitability

The purpose of this Part is to **set forth standards and procedures** for recommendations by insurers or insurance producers to consumers that results in a transaction involving annuity products so that the insurance needs and financial objectives of consumers at the time of the transaction are appropriately addressed.

The rule applies **to any** recommendations made to a consumer by an insurance producer for the purchase, exchange or replacement on an annuity. It **also applies to the insurance company** if an insurance producer is not involved in the transaction.

However the **rule does not apply to** recommendations involving:

1- Direct response solicitations where there is no recommendation based on information collected from the consumer and

2- Contracts used to fund the following

- An employee pension or welfare benefit plan that is covered by the Employee Retirement and Income Security Act (ERISA);

- A plan described by sections 401(a), 401(k), 403(b), 408(k) or 408(p) of the Internal Revenue Code (IRC) if established or maintained by an employer;

- A government or church plan defined in section 414 of the IRC, a government or church welfare benefit plan, or a deferred compensation plan of a state or local government or tax exempt organization under section 457 of the IRC;

- A nonqualified deferred compensation arrangement established or maintained by an employer or plan sponsor;

- Settlements of or assumptions of liabilities associated with personal injury litigation or any dispute or claim resolution process; or

- Formal prepaid funeral contracts.

Selected Definitions

• **Annuity** means an insurance product under State law that is individually solicited, whether the product is classified as an **individual or group annuity.**

• Code means the Illinois Insurance Code [215 ILCS 5].

• Continuing Education Provider or CE Provider means an individual or entity that is approved to offer continuing education courses pursuant to 50 Ill. Adm. Code 3119.

• Department means the Department of Insurance.

• Director means the Director of the Illinois Department of Insurance.

• **FINRA** means the Financial Industry Regulatory Authority.

• Insurance Producer means a person **required to be licensed** under the laws of this State **to sell, solicit, or negotiate** insurance, including annuities.

• Insurer means an **entity required to be licensed** under the laws of this State to provide insurance products, including annuities.

• Recommendation **means advice** provided by an insurance producer, or an insurer when no producer is involved, to an individual consumer **that results in a purchase, exchange, or replacement of an annuity** in accordance with that advice.

• **Replacement** means a transaction in which a new policy or contract is to be purchased, and it is known or should be known to the proposing producer, or to the proposing insurer if there is no producer, that by reason of the transaction an existing policy or contract has been or is to be:

Lapsed,

Forfeited,

Surrendered or partially surrendered,

Assigned to the replacing insurer or

Otherwise terminated;

Converted to reduced paid-up insurance, continued as extended term insurance, or otherwise reduced in value by the use of nonforfeiture benefits or other policy values;

Amended so as to effect either a reduction in benefits or in the term for which coverage would otherwise remain in force or for which benefits would be paid;

Reissued with any reduction in cash value;

Used in a financed purchase.

• **Suitability Information** means information that is reasonably appropriate to determine the suitability of a recommendation, including the following:

Age;

Annual income;

Financial situation and needs, including the financial resources used for the funding of the annuity;

Financial experience;

Financial objectives;

Intended use of the annuity;

Financial time horizon;

Existing assets, including investment and life insurance;

Liquidity needs;

Liquid net worth;

Risk tolerance; and

Tax status.

Duties of Insurance Companies and Producers

Prior to recommending the purchase or exchange of an annuity to a consumer both the **insurance company and the insurance producer must have reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer.** These grounds of belief include the consumer's investments and other insurance products. All of the following **suitability elements** concerning the consumer's financial situation and needs must be taken into account to form this reasonable belief by the insurance company and/or producer:

1) The consumer **has been reasonably informed of various features** of the annuity, such as

- the potential surrender period and surrender charge,
- potential tax penalty if the consumer sells, exchanges, surrenders or annuitizes the annuity,
- mortality and expense fees, investment advisory fees,
- potential charges for and features of riders,
- limitations on interest returns, insurance and investment components and
- market risk;

2) The **consumer would benefit** from certain features of the annuity, such as

- tax-deferred growth,
- annuitization or
- death benefit or
- living benefit;

3) The particular **annuity as a whole,** the **underlying subaccounts** to which funds are allocated at the time of purchase or exchange of the annuity, and riders and similar product enhancements, if any, **are suitable** (and in the case of an exchange or replacement, the transaction as a whole is suitable) for the particular consumer based on his or her suitability information; and

4) **In the case of an exchange or replacement of an annuity**, the exchange or replacement is suitable, including taking into consideration whether:

A) The consumer will
- incur a surrender charge,
- be subject to the commencement of a new surrender period,
- lose existing benefits (such as death, living, or other contractual benefits),
- or be subject to increased fees, investment advisory fees or
- charges for riders and similar product enhancements;

B) The consumer would benefit from product enhancements and improvements; and

C) The consumer has had another annuity exchange or replacement and, in particular, an exchange or replacement within the preceding 36 months.

Prior to the execution of a purchase, exchange or replacement of an annuity resulting from a recommendation, an insurance producer, or an insurer when no producer is involved, **shall make reasonable efforts to obtain the consumer's suitability information.**

Except as permitted under elsewhere in the law, an insurance company shall not issue an annuity recommended to a consumer unless there is a reasonable basis to believe the annuity is suitable based on the consumer's suitability information.

<u>Suitability requirements do not apply</u> under the following circumstances:

- No recommendation is made;
- A recommendation was made and was later found to have been prepared based on materially inaccurate information provided by the consumer;
- A consumer refuses to provide relevant suitability information and the annuity transaction is not recommended;
- A consumer decides to enter into an annuity transaction that is not based on a recommendation of the insurer or the insurance producer.

When an insurance company issues an annuity it must be reasonable under all the circumstances actually known to the insurer at the time the annuity is issued.

At the time of sale an insurance producer or, when no insurance producer is involved, the responsible insurer representative**, must do the following:**

1) Make a record of any recommendation subject to this rule;

2) Obtain a customer signed statement documenting a customer's refusal to provide suitability information, if any; and

3) Obtain a customer signed statement acknowledging that an annuity transaction is not recommended if a customer decides to enter into an annuity transaction that is not based on the insurance producer's or insurer's recommendation.

Insurance Companies must shall establish a supervision system that is reasonably designed to achieve the insurer's and its insurance producers' compliance in these areas:

A) The insurer shall maintain and incorporate reasonable **procedures to inform its insurance producers** of the requirements of this regulation into relevant insurance producer training manuals;

B) The **insurer shall establish standards** for insurance producer product training and shall maintain reasonable procedures to require its insurance producers to comply with the insurance producer training requirements of this rule

C) The **insurer shall provide product-specific training and training materials** that explain all material features of its annuity products to insurance producers;

D) The insurer **shall maintain procedures for review of each recommendation prior to issuance of an annuity** that are designed to ensure that there is a reasonable basis to determine that a recommendation is suitable. The review procedures may apply a screening system for the purpose of identifying selected transactions for additional review and may be accomplished electronically or through other means, including, but not limited to, physical review. Such an electronic or other system may be designed to require additional review only of those transactions identified for additional review by the selection criteria;

E) The insurer **shall maintain reasonable procedures to detect recommendations that are not suitable**. This may include, but is not limited to, confirmation of consumer suitability information, systematic customer surveys, interviews, confirmation letters and programs of internal monitoring. An insurer may use sampling to comply procedures or can confirm suitability information after the delivery of an annuity, and

F) The insurer **shall annually provide a report to senior management,** including the senior manager responsible for audit functions **that details a review** with appropriate testing. The testing must be reasonably designed to determine the effectiveness of the supervision system, the exceptions found, and any corrective action that may need to be taken or recommended.

2) **All monitoring** requirements by an insurance company **can be preformed by the company or can be contracted to an outside firm.** However, an insurer is responsible for taking appropriate corrective action and may be subject to sanctions and penalties pursuant to regardless of whether the insurer contracts for performance of a function and regardless of the insurer's supervision of an outside contractor.

3) **An insurer's supervision system shall include** supervision of contractual performance and this includes, but is not limited to, the following:

- Monitoring and, as appropriate, **conducting audits** to assure that the contracted function is properly performed; and

- Annually **obtaining a certification from a senior man**ager who has responsibility for the contracted function that the manager has a reasonable basis to represent, and does represent, that the function is properly performed.

- An insurer is **not required** to include in its system of **supervision** an insurance producer's recommendations to consumers of **products other than the annuities** offered by the insurer.

An insurance producer shall not dissuade, or attempt to dissuade, a consumer from:

- Truthfully responding to an insurer's request for confirmation of suitability information;

- Filing a complaint;

- Cooperating with the investigation of a complaint.

Sales made in compliance with FINRA requirements pertaining to suitability and supervision of annuity transactions shall satisfy the requirements of suitability. This applies to FINRA broker-dealer sales of variable annuities and fixed annuities if the suitability and supervision is similar to those applied to variable annuity sales. However, nothing in this subsection shall limit the Director's ability to enforce (including investigate) to assure suitability requirements were followed. The insurer must

• Monitor the FINRA member broker-dealer using information collected in the normal course of an insurer's business; and

• Provide to the FINRA member broker-dealer information and reports that are reasonably appropriate to assist the FINRA member broker-dealer to maintain its supervision system.

Training Requirements

A producer who solicits the sale of an annuity product must have adequate knowledge of the product being solicited and be in compliance with the insurer's training requirements. Effective July 1, 2012, An insurance producer who engages in the sale of annuity products shall complete a one-time four hour credit training course approved by the Department, as follows

• Effective July 1, 2012, Insurance producers who hold a life insurance line of authority after June 30, 2012 and who desire to sell annuities shall complete the requirements of this Title 50 Section 3120 by July 1, 2012. Individuals who obtain a life insurance line of authority may not engage in the sale of annuities until the annuity training course required under this Section has been completed.

• The minimum length of the training required under this Section on suitability shall be sufficient to qualify for at least four CE credits, but may be longer. If an annuity product also offers any long term care benefits as defined under the insurance code, the insurance producer shall also complete the training requirements pertaining to long term care insurance prior to selling the annuity product. The long term care course requirement is to complete a one time eight hour continuing education course on the topic of Partnership Long Term Care Insurance, approved by the Director for this purpose.

• The **suitability training required under this Section shall include** information on the following topics:

A) The types of annuities and various classifications of annuities;

B) Identification of the parties to an annuity;

C) How fixed, variable and indexed annuity contract provisions affect consumers;

D) The application of income taxation of qualified and non-qualified annuities;

E) The primary uses of annuities; and

F) Appropriate sales practices, replacement and disclosure requirements.

• Providers of courses intended to comply with this Section **shall cover all topics listed in the prescribed outline** and shall not present any marketing information or provide training on sales techniques or provide specific information about a particular insurer's products. Additional topics may be offered in conjunction with and in addition to the required outline.

• The satisfaction of these training requirements in any state that are substantially similar to the provisions of this Section shall be deemed to satisfy the training requirements of this Section in this State.

• An insurer shall verify that an insurance producer has completed the annuity training course required under this Section before allowing the producer to sell an annuity product for that insurer. An insurer may satisfy its responsibility **by obtaining certificates of completion** of the training course **or obtaining reports provided by commissioner-sponsored database systems** or vendors or from a reasonably reliable commercial database vendor that has a reporting arrangement with approved insurance education providers.

Record Keeping

Insurers, general agents, independent agencies and insurance producers shall maintain and be able to make available to the Director records of the information collected from the consumer and other information used in making the recommendations that were the basis for insurance transactions for **7 years after the insurance transaction is completed by the insurer.** An insurer is permitted, but shall not be required, to maintain documentation on behalf of an insurance producer.

Records required to be maintained by this Part may be maintained in paper, photographic, microprocess, magnetic, mechanical or electronic media, or by any process that accurately reproduces the original document.

Violation of the requirements of this Part **may be considered evidence of misrepresentation** under the Illinois Insurance Code and/or a deceptive act or practice prohibited under the Illinois Insurance Code. Both misrepresentation and engaging in deceptive practices can result in suspension, revocation or denial of license and/or a civil penalty of up to $10,000.

Part 2- Annuity (17 Exam Questions)

The main concept behind the annuity is that it is not a death benefit; therefore it is the opposite of what most people think of when they think of life insurance. Although the annuity does not offer a death benefit in the traditional sense it is a life insurance contract and requires that an individual have a valid producer license to offer it for sale to the public.

An annuity is a periodic payment of money made to an annuitant over his or her expected lifetime or for a specific period of time. The annuitant is defined as the person who is receiving the benefits from an annuity payout. Annuitants must be natural persons and may not be any other entity. A simple way to distinguish between an annuity and a traditional life insurance policy with a benefit is:

* Life insurance begins payment upon the insured's death.

* Annuities usually STOP payment upon the death of the annuitant (recipient).

Until the annuitant receives payment, an amount of money is, or has been, invested. This capital (or principal) sum will earn an interest rate on a tax deferred basis. In return for the invested principal amount, the annuitant can receive benefit payment (usually monthly, quarterly, etc.) for the remainder of his or her lifetime.

The concept of the annuity actually dates back to the days of the Roman Empire when citizens could pay a single lump of money and purchase an "annua" which then entitled them to an annual income payment for life. In the late 1600's countries in Europe, especially Great Britain would use a form of annuity to fund expensive and long wars. It was not until early in the 20th century that the annuity would finally be made available for individual purchase to the general public although group annuity had been marketed in the USA as early as at the birth of the Republic.

The first annuity offered was pretty bare bones compared to all the bells and whistles available to consumers today. The annuity gained in popularity near the end of the Great Depression as Americans became very involved in savings and felt that insurance companies were just about the safest place to invest money.

Today the annuity takes many different forms and function from fixed, variable and indexed and is used for retirement funding, legal settlements and even to fund college tuition. The growth of the sale of annuities has been spectacular. It is estimated that annuity sales were about $100 billion in 1995 and then jumped by 50% over the next five years to more than $155 billion, largely due to the increased sale of the variable annuity. Currently it is estimated that more than $200 billion in annuity sales take place in America annually and that number is expected to continue to grow.

Classifications

Annuities are classified in many different ways, one of them being based on the method of investment and growth. The available methods of return on principal are

- Fixed
- Variable
- Indexed

Fixed

In a fixed annuity the insurer is guaranteeing a minimum rate of return on deposited principal for a specified period of time. This minimum percentage guarantee changes at calendar points as described in the contract. It is common for such a guarantee to be readjusted on an annual basis but adjustments may occur at either shorter or even longer intervals of time.

In a fixed annuity the principal funds of the policyowner are deposited into the general investment fund of the insurance company. Investments made by insurers with general funds tend to be conservative in order to protect principal while still producing growth on the principal. Common places these funds are invested into are primarily government bonds, mortgages and some highly rated corporate bonds.

Returns in a fixed annuity, while guaranteed, can tend to produce returns over long periods of time that may not keep pace with inflation. Therefore, due to the inflation factor, future income produced by a fixed annuity may result in reduced purchasing power at the time of annuitization compared with the purchasing power the money had at the original time of placement into the annuity.

Since the insurer is guaranteeing that the stated minimal contractual interest rate will be met, all risk of achieving the financial return is on the company. Therefore if the insurer experiences a return that is less than guaranteed, the extra funds will be supplied by the company.

The main advantage of the fixed annuity to the owner is that principal invested is safe and the periodic rate of return, similar to a bank CD, is always known and guaranteed during the investment period. However, the main disadvantage of the fixed annuity is that the long term return paid after the period of accumulation has ended may be less than the inflation rate over that same period of time. The failure of the principal and interest to keep pace with the inflation rate during accumulation will result in a loss of purchasing power. In other words, the money you receive later will be less than what you could of purchased with invested funds today.

Variable

A variable annuity is an insurance contract between the consumer and an insurer, under which the insurer promises to make periodic payments to the annuity owner at either the beginning or at a future point in time. A variable annuity contract can be purchased either with a single payment or by making a series of payments into the contract over time. At the heart of the variable annuity concept is that the investment is placed in a separate account (not the general account where returns are guaranteed by the insurance company) maintained by the insurer and that all financial risk of loss is borne by the contract owner and not by the insurance company.

There are many investment options available to the owner of a variable annuity. The investment value of a variable annuity will vary depending on the performance of the investment options selected by the consumer. The investment options for a variable annuity are normally mutual funds that invest in stocks, bonds, money market instruments, or some combination of the three. However there are several differences between a just a mutual fund and a variable annuity and how they operate.

There are two parts or “phases” in the variable annuity: the **accumulation phase** and a **payout phase**.

During the **accumulation phase**, the variable contract owner can allocate principal into a number of investment options. For example, a percentage of capital can go into a bond fund, another percentage can be placed into a U.S. stock fund, and the remaining capital could be placed into an international stock fund. The money allocated to each mutual fund investment option will increase or decrease over time, depending on how the fund performs during the accumulation phase. Also, variable annuities may allow you to place part of your payments to a fixed account. Again, a fixed account, unlike a mutual fund, pays a fixed rate of interest.

During the accumulation phase, money can be transferred from one investment option to another without paying tax on investment income and gains. However the insurance company may charge a fee for such transfers. If funds are withdrawn from the account during the early years of the accumulation phase, the contract owner may have to pay "surrender charges," which are discussed below. In addition, federal tax penalties may also be assessed for early withdrawal before reaching the age of 59 and 1/2.

The main source of information about a variable annuity's investment options is provided by the prospectus. The consumer can consider many factors with respect to each fund option, including the fund's investment objectives and policies, management fees and other expenses that the fund charges. Also included in the prospectus are the risks and volatility of the fund as well as whether the fund may help the consumer with the diversification of his or her overall investment portfolio.

At the beginning of the **payout phase**, you may receive your original principal plus accumulated interest and gains (if any) as a lump-sum payment, or you may choose to receive them as payment stream at regular intervals. Payment stream options and taxation are reviewed in this study guide in a later section.

Variable Annuity contract valuation has, as the key concept, a "unit" type of measurement. The value of the investment portfolio of the Separate Account changes on a daily basis and it equals total market value of all portfolio securities (at the market close) minus liabilities. There are two "units" to understand:

1) Accumulation Units determine the share of ownership of the separate account which is attributable to an individual owner during the accumulation phase of the deferred annuity contract. It shows what proportion of the Separate Account is owned by an annuitant.

2) Annuity Units - if **annuitization is selected,** are calculated by incorporating many variables: initial unit value, age and sex of the individual, selected payout option, accumulated value of the account and the assumed interest rate of the company. The insurance company determines the specific number of annuity units which will actually be used to calculate each payment.

The **only element fixed is the number of annuity units** which will be used to calculate each payment to the annuitant. **The annuitant's <u>payment will fluctuate</u>** because the value of the annuity units will fluctuate based on the performance of the investment portfolio of the Separate Account.

<u>Formulas</u>

VALUE OF AN ANNUITY =
VALUE OF ONE UNIT X TOTAL UNITS OWNED

MONTHLY ANNUITY PAYOUT =
VALUE OF FIXED UNITS LIQUIDATED X VALUE OF ONE UNIT

<u>Indexed</u>

The equity-index annuity is a hybrid between the guaranteed fixed and the non-guaranteed variable annuity products. Equity-indexed annuities are different from other fixed annuities because of the way interest is credited to the annuity's value. Fixed annuities generally only credit interest calculated at a rate as set forth in the contract. Equity-indexed annuities credit interest that incorporates a formula based on changes in the index to which the annuity investment returns is linked. This formula calculates how any additional interest may be credited. Any additional interest amount you earn as well as when the credit to your account may be made is based on the specific features of your particular annuity.

An equity-indexed annuity earns interest that is linked to a stock or equity index. The most popularly used index is the Standard & Poor's 500 Composite Stock Price Index (the S&P 500) but other US and even European indices can be used. Sometimes the interest is even based on a blend of two, three, four or more indices that are weighted on some specific basis. Equity-index annuities offer a "floor" rate (commonly set at zero percent) which is the minimum index-linked interest rate the contract holder will earn**. A 0% floor means that even if the linked index decreases in value, the interest that will be earned will equal zero percent but will not result in a negative return.** Therefore the worst the annuity owner can do is no return with the added comfort that negative invest return will not occur.

The two main features that have the greatest impact on the amount of additional interest that may be credited to an equity-indexed annuity are the **indexing method** and the **participation rate**.

The indexing method means the system used to measure the amount of change, if any, in the index. Some of the most common indexing methods include

- annual reset
- high-water mark
- point-to-point.

Annual Reset – Advantages

The interest earned is "locked in" annually and the value of the index "resets" at the end of each year. Therefore future decreases in the index will not affect the interest you have already earned. An annuity using the annual reset method may credit more interest than an annuity which uses other methods if the index fluctuates up and down often during the term. The annual reset design is more likely than others to give you access to index-linked interest before the term ends.

Annual Reset – Disadvantages

The participation rate of the annuity may change each year and will generally be lower than that of other indexing methods. Also, an annual reset design may use a "cap" (a stated maximum percent which is the most interest credit the annuity owner would enjoy, regardless of the actual interest percentage earned) or averaging to limit the total amount of interest you might earn each year.

High-Water Mark - Advantages

Since interest is calculated using the highest value of the index on a contract anniversary during the term, this design may credit higher interest than some other designs if the index reaches a high point early or in the middle of the term, then drops off at the end of the term.

High-Water Mark - Disadvantages

Interest is not credited until the end of the term. In some annuities, if you surrender your annuity before the end of the term, you may not get index-linked interest for that term. In other annuities, you may receive index-linked interest, based on the highest anniversary value to date and the annuity's vesting schedule. Also, contracts with this design may have a lower participation rate than annuities using other designs or may use a cap to limit the total amount of interest you might earn.

Point-to-Point Advantages

Since interest cannot be calculated before the end of the term, use of this design may permit a higher participation rate than annuities using other designs. Since interest is not credited until the end of the term, typically six or seven years, you may not be able to get the index-linked interest until the end of the term.

The equity-index annuity would seem to offer the best of both worlds: protection from huge down market index periods via the guaranteed floor minimums set at no lower than a 0% return, tempered with the ability to earn very nice percentage returns in periods when the equity and security markets are booming. The end result typically expected is a return that should exceed fixed, conservative rates but will not match anticipated long term returns of a variable annuity. Compared with a variable annuity, the equity-index annuity has lows that are not as low, highs that are not as high and none of the investor risk of reduced capital.

Types of Annuity

Single Pay

The single pay option allows a single lump sum of money to be deposited with an insurance company who will then invest it as directed by the annuity contract owner on a fixed, a variable or an equity-index basis. Typically this lump sum of money comes from a deferred retirement program or out of the personal savings of the individual or from an inheritance, or it can even be derived from lottery winnings. Payments from this type of annuity can either be "immediate" or "deferred"

Immediate

When the contract owner wants to take regular payouts that begin as quickly as possible, then the immediate option is selected. Therefore this is called a Single Pay Immediate Annuity. As the payouts take place either for a specified period of time or over the rest of the life of the annuitant, the remaining principal is invested by the insurance company as required by the terms of the contract.

Deferred

The other option available when the individual places a single annuity payment amount with an insurance company is to defer the income until a later period of time. While the money is parked with the company it earns interest as determined by the contract between the parties and principal and income will be distributed at a later point chosen by the annuity contract holder. The reason for this selection is normally because the future annuitant would prefer to wait until an older age to annuitize so they can enjoy greater regular payment amounts. This product is called a Single Pay Deferred Annuity.

Flexible Premium Deferred

Under the terms of a flexible premium deferred annuity, the contract owner places sums of money into the annuity on an intermittent basis for the purposes of growing the money over a long period of time for later payout. Typically the individual choosing this method does not have a large sum to initially invest but wishes to create a pile of money over time. The deposits into the annuity are flexible because the owner can fund them any time while varying the amounts of the deposits to suit their own budget.

Annuity Payout Options

When the annuity owner decides the time has come to take principal and interest out of the annuity they have three basic choices which are:

1- Lump Sum Distribution or
2- Annuitization or
3- Combination of 1 & 2

Lump Sum Distribution

The owner can **take all of the money out (principal and interest)** at once; this is called a "lump sum distribution." Upon taking all of this money at once, the interest that has been earned for the entire accumulation phase of the annuity becomes taxable income in the year it is distributed. If it is a nonqualified annuity, the entire principal is returned income tax free since all the deposits were made originally with "after-tax" dollars. The advantage is the owner takes complete control of their money and can invest it or spend it in any way they see fit. The disadvantage is that all that income tax is due on the interest plus the extra income usually pushes the person into a higher tax bracket making all income from other sources subject to the higher rate as well.

Annuitization

With the annuitization selection, the contract owner is electing to keep the pile of money they have accumulated with the insurance company and to **take period payments either for a specified number of years or for the rest of their lifetime.** The regular payments will be taxable on the portion of each payment that is considered, by tax rules, to be income (these amounts are based on the "exclusion ratio" as discussed below) while the balance of the payments will be a return of original principal.

A mathematical concept of taxation called **"the exclusion ratio"** is used to determine what portion of the annuity payment is taxed and what portion is not. The exclusion ratio is shown as either a fraction or as a percentage and is calculated by dividing the investment contained in the contract by the return that is expected. The exclusion ratio is then applied to each annuity payment and this determines the portion of the payment that will be excluded from gross income.

Therefore the balance of the annuity payment is then included in gross income of the annuitant for the tax year in which it is received.

<u>EXAMPLE:</u> Jones purchases a single premium immediate annuity for $100,000 and he expects to receive 120 monthly payments of $1,000 each. The total number of payments will equal $120,000. The exclusion ratio (amount or percentage that will be returned to the annuitant as "after tax" income) is determined by dividing as follows:

Exclusion Ratio = $100,000 / $120,000 = .83333 (83.33%)

For each monthly payment of $1,000 that Jones receives 83.33% is considered return of principal ($833.33) while $166.67 is considered to be taxable income. The annual amount of income from this annuity that WILL NOT be excluded from income tax will be $2,000.04 ($166.67 X 12). This means that each year Jones will receive monthly payments from the annuity which total $12,000 but will only have to include $2,000.04 as income for tax paying purposes.

There are many annuitization options available to the contract owner and the choice depends on what the needs of the annuitant are. The most common options: life annuity, refund annuity, joint annuity, joint and survivor annuity and period certain (with or without life) annuities are discussed below.

<u>Life Annuity</u>

Under the terms of a life annuity, sometimes called a "pure" life annuity, **the annuitant cannot outlive the money** but will only receive a periodic payment for as long as they are alive. Once the **annuitant dies the payment stops** and any remaining money in the annuity is retained by the company. The advantage to this method is that the **insured will receive the highest guaranteed regular periodic payment possible** out of all the options available. The disadvantage is that no remaining money in the annuity can be passed by the owner to another party of their choosing upon the death of the annuitant since the company then owns the money. This option would be selected by someone who does not care what happens to remaining money upon death but does want the most guaranteed income they can get while alive.

Refund Annuity

The refund annuity guarantees a both a lifetime income to the annuitant and that any remaining balance of funds not paid out upon the death of the annuitant will be passed to a beneficiary selected by the contract owner. The beneficiary generally has two options on how to take these remaining funds. The "installment" option will give the beneficiary a regular and period payment until the funds left are paid out while the "cash" option gives the beneficiary the balance of funds.

Joint Life Annuity

In a joint life annuity there are two or more annuitants who each receive payments until one of the annuitants dies. **Upon the death of the first annuitant all payments stop.** In this selection multiple individuals are getting the highest guaranteed payments offered by an insurance company as long as they are all alive.

Joint and Survivor

The joint and survivor annuity is also geared to two or more annuitants. Each receives a periodic payment and none of the annuitants can outlive their income under the contract. Therefore, unlike the previous choice, joint annuity, **the joint and survivor annuity continues to pay an income to a survivor even after the death of the first annuitant.** However, after the death of the first annuitant the survivor gets a reduced payment from that time forward of usually either 1/2 or 2/3 of the full amount that was paid before the death of the first annuitant.

Period Certain

The period certain option can have two choices: either a straight period certain or life with period certain. In a straight period certain selection of annuitization the annuitant decides on a period of time, usually five, ten or twenty years and the payment will be made periodically for that number of years and then end. The life with period certain annuity will pay for a specified number of years selected or life, whichever is longer. If the annuitant dies before the period certain any remaining money is paid to a beneficiary selected by the annuitant. The straight period certain annuity pays a greater sum periodically than does the life with period of certain annuity.

Combination

In this third withdrawal option, the contract owner can also select a combination of lump sum and the annuitization of the balance of funds. Any money taken as a lump sum is subject to income tax on an ordinary income basis in the tax year in which it is withdrawn on the portion deemed to be interest. Any principal and interest that is annuitized results in just the portion of each payment that is income being taxed.

Parties to the Annuity

Since the annuity is a life insurance contract, the rules pertaining to any type of contract are in force, namely:

- There must be an offer and an acceptance;
- The parties to the contract must be competent;
- There must be consideration and
- The contract must have a legal purpose.

There can possibly be four parties to the annuity contract and they are discussed below.

Owner

The owner of annuity is usually a natural person (but the owner can be a trust or other entity) who is either accumulating a pile of money on a tax-deferred basis over time or has decided to park a sum of money for a period of time for later distribution. Every annuity contract must have an owner. Names given to the owner are customarily the owner, the contract owner, or the annuity owner. The owner of the annuity contract holds certain rights under the contract. The annuity owner has the right to name the natural person who will enjoy the income as the annuitant as well as the individual or entity that will be named as the beneficiary under the contract.

Annuitant

The annuitant is the natural person (other entities like a trust or corporation may own an annuity but they can not be an annuitant since they can have an indefinite life span) named under the annuity contract will act as the measuring life for purposes of determining selected benefits to be paid out under the contract. The Internal Revenue Code defines the annuitant is the individual whose life is of primary importance in affecting the timing or amount of the payout under the contract. The owner and the annuitant can be two different individuals and each plays a different role in the contract.

Beneficiary

In the annuity contract, the named beneficiary is entitled to receive a death benefit when another party to the annuity contract dies. While the beneficiary has the right to receive the death benefit of the annuity, they have no other contractual right. Furthermore, once the settlement option and payout have been selected the benefit payment arrangement cannot be altered by the beneficiary, including being able to take any lump sums or partial surrenders. Beneficiaries can either a natural person or another entity such as a trust, charitable trust or a corporation.

Insurance Company

The insurance company is the party who issues the annuity contract. The insurance company therefore has legal duties to fulfill any financial obligations that have been agreed to with the other parties to the annuity contract. The company will accept all principal payments which are entrusted to it by the owner and invest those funds as promised and credit all income earned into the policy. When the time comes for the owner to withdraw his money, it is the insurance company that pays out the money as selected by the owner to whomever the owner so directs, from the choices that were available.

Contract Provisions Affecting Consumers

As discussed, the annuity is a contract that binds several parties to the terms contained therein. While all parties are bound to each provision in the agreement, some of the provisions have a larger impact on the owner (consumer) of the annuity than do others. Several of these provisions have been selected below for discussion.

Cash Surrender

Annuities should generally be considered as a long term investment financial tool and therefore, once a consumer places their money into one, is it best to consider the money as being tied up for a very long period of time. Modern annuity contracts allow the owner to withdraw a limited percentage of the annuity capital in any given year, usually up to 10%. However, any withdrawal amount may result in income taxation and an additional 10% tax penalty if the owner is under the age of 59 and 1/2 at the time of withdrawal. Taking a small percentage of the capital is referred to a “partial surrender.” If the owner removes more than a stated annual percentage or wishes to take all the funds in the annuity to fully cash surrender the contract such withdrawal may be subject to surrender charges in addition to income taxation and possible tax penalties.

Surrender Charges and Liquidity

An annuity purchase will subject the owner to a stated “surrender charge” as listed in a surrender schedule in the contract. It is very important for the contract owner to understand that money placed in an annuity has limited liquidity, especially in the earliest years of ownership. Often annuities that have longer surrender charge periods offer up-front bonus amounts which are added to the lump sum deposited by the contract owner upon purchasing an annuity with an insurance company. There are also short surrender periods and even no surrender annuities available but these do not usually offer bonus amounts. Also any partial withdrawals can result in both ordinary income taxation and tax penalties as well.

When there is a surrender fee for excessive amounts withdrawn from the annuity as stated in the contract an included fee schedule is applied. While surrender periods with fee charges for early and excessive withdrawals (sometimes called a “back-end” load or fee) can range from as short as a few years and as long as twenty years, they normally steadily reduce in percentage year after year until the surrender fee is completely gone. For instance, a 10 year surrender fee schedule, after which there is no surrender fee, might look like this:

Year	1	2	3	4	5	6	7	8	9	10
Fee	9%	9%	8%	7%	6%	5%	4%	3%	2%	1%

It is very important for the consumer to understand the penalty structure, if there is one, in the annuity they are purchasing and therefore not to commit funds for long periods if they may have a need for liquidity in the near future.

Free Look

The "free look" is the right of an insured to examine an insurance policy for a stated period, often 10 days, and if not satisfied for any reason, the consumer has the right to return the policy and receive a full refund of the initial premium. This is a right conferred under state law can vary from state to state (Illinois has a 10 day free look). The free look period begins on the date the policy is delivered to the owner. After the free look period has ended, a purchased annuity will be subject to all terms and conditions of the contract included any listed surrender fees and withdrawal limitations. Many companies allow up to a 30 day free look period on a voluntary basis.

Changes to Variable Portfolios

Variable annuities can offer hundreds of investment alternatives to the contract owner in dozens of combination and are normally offered to the more financially educated and savvy consumer. Fund choices can include the following general concepts:

- Large Cap
- Mid cap
- Small Cap
- Large, Mid and Small Cap Blends
- Large, mid and Small Growth Stock Funds with Blending
- Global Markets
- Emerging Markets
- Investment in Specified Industry Funds
- Fixed and Guaranteed Alternatives

The consumer needs to be aware of specified fee charges that come with each portfolio as well as potential fees and charges that are assessed when the owner reallocates some or all funds, from one or more alternatives, when allowed periodically to do so. Frequent shifting in and out of various fund alternatives can reduce principal through the fee structures as allowed in the contract. The most valuable asset to the consumer is to read and consult the prospectus of the product and to continually ask their representative any concerns or questions they may have before moving money within the options available in the variable annuity contract.

Participating Index Rates and Caps

Earlier in the equity-index annuity section it was mentioned that the contract offers participation rates and investment return caps. The consumer will benefit greatly by having a working knowledge understand how their particular product operates in these areas.

The participation rate decides the percentage of the increase in the index they are entitled to in calculating index-linked interest. For example, if the calculated change in the index is 10% and the participation rate is 90%, the index-linked interest rate for your annuity will be 9% (10% x 90% = 9.0%). The insurance company can decide to set a different participation rate for newly issued annuities as frequently as daily although a monthly yardstick is more frequently used. The initial annuity participation depends on when it was issued by the company. The company usually guarantees the participation rate for a specific period (this could be for as short as one year to as long as entire term). When that period is over, the company can set a new participation rate for the next period. Annuities can also guarantee that a participation rate will never be set lower than a specified minimum or higher than a specified maximum.

For a discussion on cap rates and investment floors, please refer to the earlier section in equity-index annuities.

Long term Care Riders

Long term care coverage begin initially in the early 1980's, offer by a handful of insurance companies as a rider to life insurance policies. By the early 1990's a shift toward individual and group long term care policies replaced the long term care rider. Currently more and more carriers are abandoning the individual and group long term care policy and replacing it with a long term care rider that is added to an annuity contract.

The **Pension Protection Act of 2006** allowed **all benefits paid out of an annuity for long term care benefits to be considered tax qualified and could be paid income tax free out of annuities**. This has led companies to offer more and more combinations of annuity with long term care as a rider option. The concept is simple: if you don't need any of your annuity money to pay for long term care costs, you can use the funds to supplement your income (that portion which is income is taxable). On the other hand, if you do require long term care, the money in the annuity can be paid, income tax free, for a variety of long term benefits including:

- Assisted Loving Facility Care
- Nursing Home Care
- Adult Day Care
- Home Health Care
- Personal Care
- Homemaker Services
- Respite Care
- Hospice Care
- Care Coordination
- Caregiver Training

Furthermore, long term care riders added to an annuity can offer guarantees of double and triple the amount of principal and interest accumulated in the future if long term care related payments are required by the contract owner. Therefore, once the money in the annuity is exhausted the company will continue to pay for long care expenses normally for a two, four and up to six year period up until the double or triple benefit guarantee is exhausted.

Cost for this rider is usually based on the age of the purchaser at the time of policy issue and benefits for long term care often do not go into effect for the first to or three years. Long term care annuity riders are available on either a health underwritten or guaranteed issue basis.

Guaranteed Income Rider

An income rider on a fixed or fixed indexed annuity gives the annuity owner the opportunity to build a retirement income. The issuing insurance company promises to pay as long as the annuitant lives and bears all investment and performance risks on the guaranteed payout. This means that the purchaser is sheltered from investment and performance risks. Also, the annuitant has access to the annuity's outstanding value and will still be entitled to interest credits that are then added to the annuity's worth. While the annuity has an accumulation value to settle on the death benefit or annuitization, **the rider adds another value - the income value.**

The accumulation value operates normally as the annuity owner's principal earns additional interest that is stated and locked in advance or promised through the performance of an index (or indices) while simultaneously promising a minimum guaranteed interest.

With an income rider, **the income value is separate from the accumulation value.** The annuitant is allowed to withdraw money from principal and interest even after annuitization. While receiving these withdrawals, the annuitant has two guarantees:

1. Even though the yearly withdrawals are subtracted from the accumulation value, the extra interest carries on to be credited to the accumulation value, and the annuitant keeps access to the outstanding accumulation value at all times.

2. Even if the yearly withdrawals eventually reduce the accumulation value, the carrier has to continue making the annual payments so long as the annuitant lives.

Income Taxation Concepts

Taxation concepts starts with the basic idea of qualified versus nonqualified. In other words, are you using after-tax dollars to fund the annuity purchase (this would be a non qualified annuity) or are you using pre-tax dollars allowed through a specific Internal Revue Code (IRC) vehicle (qualified approach)? Since the annuity already allows for tax deferred accumulation regardless of which funding concept the purchaser selects. The chart below highlights the central tax similarities and differences between the two funding approaches.

QUALIFIED	NONQUALIFIED
Tax-deferred earnings	Tax-deferred earnings
Early Withdrawal Penalty of 10% Before age 59.5	Early Withdrawal Penalty of 10% Before age 59.5
Invest Pre-Tax Dollars	Invest After-Tax Dollars
Contribution Limits	No Contribution Limits
Withdrawal must begin by age 70.5	No federal withdrawal age limits

Qualified Annuities

Employers may allow employees to contribute to an annuity program in a qualified plan selection. This becomes an investment option in a salary reduction retirement plan under which the employee can allocate specific dollar amounts, allowed by law, to be taken out of salary without current income taxation to be invested into a variety or long term investment vehicles. Therefore utilization of this concept means that your current taxable salary is reduced and then it accumulates tax-deferred in the selected qualified mechanism. Employees of a non-profit organization are usually able to choose either a fixed or variable annuity or both. Small businesses and the self-employed may invest in a qualified annuity by establishing a Simplified Employee Pension (SEP) or a Keogh. Many financial plans are available that can adopted or the employer, regardless of size, can turn to an insurance professional for guidance in creating a plan.

Most qualified retirement plans are self-directed. That means the employee can choose where they want their money directed depending on what is offered through the employer. The employee then directs the investment in allocated percentages. For example, the employee can put 40% of the investment into one equity investment and then maybe another 40% into a different equity portfolio, and the remaining 20% into a money market or fixed-income account.

Federal law requires that everyone in the company, including the employer, is subject to the same eligibility rules. Employees are all on equal footing and each employee can contribute just as much as any other employee. Employers can require a minimum period of employment, such as one year, before an employee is eligible to contribute through salary reduction. Discussed below are some common qualified plan options in which the annuity can be utilized, if desired.

SEP and Keogh

Both the SEP and the Keogh are designed for the small businesses and the self-employed. The basics of each are:

Simplified Employee Pension (SEP) plans can provide a significant source of income at retirement by allowing employers to set aside money in retirement accounts for themselves and their employees. A SEP does not have the start-up and operating costs of a conventional retirement plan and allows for a contribution of up to 25 percent of each employee's pay.

- Available to any size business
- Easily established by adopting IRC Form 5305-SEP, a SEP prototype or an individually designed plan document
    - If Form 5305-SEP is used, cannot have any other retirement plan (except another SEP)
- No filing requirement for the employer
- Only the employer contributes
    - To traditional IRAs (SEP-IRAs) set up for each eligible employee
    - Employee is always 100% vested in (or, has ownership of) all SEP-IRA money

SEP Pros and Cons:

- Easy to set up and operate
- Low administrative costs
- Flexible annual contributions – good plan if cash flow is an issue
- Employer must contribute equally for all eligible employees

Before a tax law change in 2001, Keogh plans were a popular choice for high-income self-employed people but they have effectively been replaced by SEPs. While Keogh and SEPs have the same contribution limits, the Keogh plan is complicated, has much greater paperwork and therefore higher administration cost. Keogh plans come in two varieties:

Defined-contribution. These plans have two variations: profit-sharing and money-purchase. The profit-sharing version of the Keogh is most like the SEP; the limit on contributions is up to 25% of compensation or $50,000 (in 2012), whichever is smallest but the employee can contribute smaller amounts depending upon what they can afford. The contribution level can be changed each year.

Defined-benefit. This type of Keogh program is like a traditional pension plan, except for the fact that it is self-funded. The individual selects annual pension they desire and then contributes through salary reduction the amount required to reach that goal. This approach allows very high income self-employed people (i.e doctors and lawyers) to save more for retirement than many other plans.

IRA

The Individual Retirement Account was introduced in 1974 and allows individuals within certain income ranges to invest pre-tax dollars, up to annual limits set by the Internal revue Code, that earn income on a tax differed basis and then are fully taxable upon distribution. Without penalty, the holder of an IRA can deduct money out of the account as early as age 59.5 and must start taking withdrawals by age 70.5.

In 1997 federal law allowed for a new type of account called the Roth IRA which allows certain individuals the ability to fund the account with after-tax dollars with the later benefit of tax free distributions. While the Roth IRA also prohibits the withdrawals without penalty before age 59.5, there is no requirement to withdraw by a specific age and the proceeds from a Roth IRA can be passed onto heirs in estate planning.

The annual contribution limits on an IRA are set by the IRC and in 2012 the maximum contributions were 100% of taxable income up to $5,000 ($6,000 for those aged 50 and older). Either type of IRA can use an annuity as the funding vehicle but the main advantage over a bank CD would be that an annuity often offers a greater guaranteed interest rate but cannot offer FDIC insurance like those deposited in a bank.

TSA

A 403(b) plan, also known as a tax-sheltered annuity (TSA) plan, is a retirement plan for certain employees of public schools, employees of certain tax-exempt organizations, and certain ministers.

Individual accounts in a 403(b) plan can be any of the following types.

- An annuity contract, which is a contract provided through an insurance company,
- A custodial account, which is an account invested in mutual funds, or
- A retirement income account set up for church employees. Generally, retirement income accounts can invest in either annuities or mutual funds.

There are three benefits to contributing to a 403(b) plan.

- The first benefit is that you do not pay income tax on allowable contributions until you begin making withdrawals from the plan, usually after you retire. Allowable contributions to a 403(b) plan are either excluded or deducted from your income. However, if your contributions are made to a Roth contribution program, this benefit does not apply. Instead, you pay income tax on the contributions to the plan but distributions from the plan (if certain requirements are met) are tax free.

  Note. Generally, employees must pay social security and Medicare tax on their contributions to a 403(b) plan, including those made under a salary reduction agreement

  The second benefit is that earnings and gains on amounts in your 403(b) account are not taxed until you withdraw them. Earnings and gains on amounts in a Roth contribution program are not taxed if your withdrawals are qualified distributions. Otherwise, they are taxed when you withdraw them.

- The third benefit is that you may be eligible to take a credit for elective deferrals contributed to your 403(b) account.

The maximum TSA contribution in 2012 is $17,000. If you will be age 50 or older this year, you may make up for missed savings opportunities by making “catch-up” contributions. And, if you have at least 15 years of full-time, same-employer service, you may be eligible to set aside up to an additional $3,000 per year.

Nonqualified Annuities

As stated earlier, the nonqualified annuity is funded with after-tax dollars but all income is earned on a tax deferred basis during the accumulation phase. If a lump sum distribution is eventually selected than all income earned during the accumulation phase is fully taxable as ordinary income in the year in whish it is distributed. Otherwise the annuitization option will subject only that portion of regular periodic payments that are considered income, via the exclusion ration calculation, to income taxation. The vast majority of annuities purchased are nonqualified.

IRC Section 1035 Exchanges

Under section 1035 of the Internal Revenue Code, the owner of a life insurance, endowment, or annuity contract is allowed, subject to certain circumstances, to transact a "like-kind" property exchange. When all IRC rules are followed the main advantage is that the gain in the original policy will not be taxed at the time of the exchange. A 1035 exchange can be used by a life insurance contract owner to defer taxable gain on surrender of the old contract or to carry over cost basis from the original contract to the new contract.

Section 1035 allows the following types of exchanges:

- Life insurance contract for an annuity contract, endowment contract, or another life insurance contract.
- An endowment insurance contract for an annuity contract or another endowment contract.
- An annuity contract for another annuity contract.

Exchanges not listed above will trigger taxation of any gain in the original contract.

When one life insurance contract is exchanged for another the contracts must involve to the same insured. Therefore a single life policy may not be exchanged for a joint life policy, and the reverse is also true. When the exchange involves annuity contracts, the regulations require that both contracts involve the same owner.
In a 1035 exchange, the owner's cost basis in the original contract is carried over to the new contract.

Annuity Uses

There can be many reasons why an individual purchases an annuity and the are discussed below:

Retirement Income

The main reason that an individual buys an annuity is for reasons relating to retirement income. Since the annuity allows for tax deferred income accumulation regardless of being qualified or nonqualified it is attractive vehicle for long term growth. Also, with all the modern annuity alternatives: fixed, variable and equity-index, the consumer can find a choice best suited to their needs and comfort level. However, the burden of making certain that the correct annuity alternative has been selected by the consumers is placed squarely on the producer and/or company that is marketing and issuing the contract.

As discussed earlier, the advantage of receiving periodic payments that are guarantee for the life of the annuitant is a benefit unmatched by any other financial vehicle in the investment marketplace. Within this guaranteed context there are again many options available to meet the needs of a variety of consumers.

Immediate Income

The annuity can be also used as an immediate funding vehicle. If an older consumer receives a large sum of money through an inheritance for instance, they can quickly convert it to a single pay immediate annuity and enjoy guaranteed additional income for life. Another common source of funding for immediate annuity is when a retiring worker transfers the value of their 401(k) into an annuity for immediate income.

Long Term Care Funding

The long term care need is quietly revolutionizing the annuity industry. Recent tax law changes allowing the proceeds distributed from an annuity to be tax free is used for qualifying long term care expenses have made the annuity an attractive option. Factor in annuity riders that will double and triple the cash value of the annuity to pay for ongoing long term care cost and you have the opportunity make your hard earned dollars automatically multiple. In the event the annuitant does not have any long term care funding needs the proceeds are then used for retirement only.

Education Funding

Since annuities are long term funding vehicles with tax deferred income growth they can also be an attractive method to save for the future tuition needs of small children. The choices between fixed, variable and equity-index can raise some issue. Although the purchaser may have a 10 to 18 year investment window, a fixed annuity, while safe, may have a hard time keeping up with tuition inflation which has averaged around 6-8% annually for the past 30 years. The selection of a variable annuity has the possibility of yielding returns that may keep pace with or even exceed the inflation rate but what happens if junior is going to college just when securities markets crash? The equity-index solution would seem to make the most sense because it should offer better than fixed long term returns while protecting the principal from equity market blues.

Structured Legal Settlements

Situations arise in which a legal defendant is responsible to pay a large sum of money to an injured party. Often a property or casualty carrier is responsible for this payment when covered by insurance (such as an auto accident, an action under which a homeowner’s policy will pay and in a workers compensation claim). If the lump sum is a very large amount, often a structured settlement will be used under the terms of which the injured party receives a periodic and guaranteed payment for life or a specified period of time (sound familiar?).

There are benefits to both parties in using a structured settlement. The party responsible can use less money to purchase the agreed upon income stream than it would cost to pay fully now in a lump sum. The injured party can receive income for life knowing all their bills will be paid until they die and that they cannot squander some or all of the lump sum and then be financially destitute. Furthermore the IRS allows the period payments offered through the structured settlement to be income tax free when funneled through a qualified vehicle like an annuity or a US government bond.

Part 3- Regulatory Compliance (3 Exam Questions)

Disclosure Requirements

Disclosure rules are designed to prevent an insurance producer from attempting to deceive consumers about the true nature of what the producer is presenting for sale. The main concepts of disclosure are:

An agent (or company) shall inform the prospective purchaser, prior to commencing a life insurance sales presentation, that he is

- acting as a life insurance agent and
- inform the prospective purchaser of the full name of the insurance company which he is representing to the buyer.
- In sales situations in which an agent is not involved, the insurer shall identify its full name.

Terms such as:

- financial planner,
- investment advisor,
- financial consultant,
- or financial counseling

shall not be used in such a way as to imply that the insurance agent is generally engaged in an advisory business in which compensation is unrelated to sales unless such is actually the case. Simply put, if you are being compensated by commission in an insurance transaction, do not try and make it seem that you your compensation has nothing to do with making a sale.

Suitability to Clients Needs

This concept is so crucial to a producer that it is repeated from the first section of this course. REMEMBER:

Prior to the execution of a purchase, exchange or replacement of an annuity resulting from a recommendation, an insurance producer, or an insurer when no producer is involved, **shall make reasonable efforts to obtain the consumer's suitability information.**

Except as permitted under elsewhere in the law, an insurance company **shall not issue an annuity** recommended to a consumer **unless there is a reasonable basis to believe the annuity is suitable** based on the consumer's suitability information.

If you cannot demonstrate that you took the steps necessary to properly determine annuity suitable you will put your producer license in jeopardy.

Replacement Considerations

The purpose of replacement rules are as follows:

•To regulate the activities of insurers and insurance producers when it involves he replacement of existing life insurance or annuities;

• To protect the interests of life insurance and annuity policyowners by establishing minimum standards of conduct to be observed in the replacement or proposed replacement of existing life insurance by:

1) Assuring that **the policyowner receives information** with which a decision can be made in his or her own best interest;

2) **Reducing the opportunity for misrepresentation** and incomplete disclosures.

Replacement means any transaction in which new life insurance or annuity will be purchased, and it is known or should be known to the proposing insurance producer, or to the proposing insurer if there is no insurance producer, that by reason of such transaction, **existing life insurance or annuity has been or is to be:**

•Lapsed, forfeited, surrendered, or otherwise terminated;

•Converted to reduced paid-up insurance, continued as extended term insurance, or otherwise reduced in value by the use of nonforfeiture benefits or other policy values;

•Amended so as to effect either a reduction in benefits or in the term for which coverage would otherwise remain in-force, or for which benefits would be paid;

•Reissued with any reduction in cash value; or

•Pledged as collateral or subjected to borrowing, whether in a single loan or under a schedule of borrowing over a period of time for amounts in the aggregate exceeding 25% of the loan value set forth in the policy.

Duties of Insurance Producers

When replacement is involved, each insurance producer shall submit to the replacing insurer with or as part of each application for life insurance or annuity:

• A statement signed by the applicant, as to whether or not such insurance will replace existing life insurance or annuity; and

• A signed statement as to whether the insurance producer knows replacement is, or may be, involved in the transaction.

Where a replacement is involved, the insurance producer shall also:

• Present to the applicant, not later than at the time of taking the application, a Notice Regarding Replacement of Life Insurance or Annuity in the form and with or as part of such notice, the insurance producer shall list the contract number or numbers which are to be replaced. The insurance producer's signature must be affixed to the notice.

A copy of the notice presented to the applicant, together with the Notice Regarding Proposed Replacement of Life Insurance or Annuity form, signed by the insurance producer, shall be submitted to the replacing insurer with the application;

• Submit to the replacing insurer with the application: a copy of the Notice Regarding Replacement of Life Insurance or Annuity from, signed by the insurance producer.

The key idea with replacement is that it is first and foremost for the benefit of the consumer.