Center for Retirement & Policy Studies

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Annuities Unveiled:
A Guide to Understanding Annuities

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Introduction

Annuities are a complicated subject for many, and the jargon around them tends to cause further confusion rather than clarification. Some of the confusion even comes from the term "annuity" itself, which actually refers to a broad range of financial products. Given all this, we wanted to provide some guidance on the different types of annuities and discuss common features to make this category of financial products easier to understand.[1]

Starting with the basics, an annuity is a contract between an insurance company and the purchaser. Annuities can be categorized as either an income annuity or a savings annuity. Income annuities provide the owner a steady stream of cash flows for a set period or for the rest of their life. In contrast, savings annuities are an accumulation-focused product with an account balance that may grow over time. While the owner of a savings annuity has the option to convert their account balance into a guaranteed stream of cash flows, this is rarely done. Savings annuities are often referred to as deferred annuities by the industry. We prefer the term "savings annuity," however, because it better encapsulates how they are used.[2] Exhibit 1 below shows the various types of annuities and the most salient differentiating features.

While we discuss annuity costs in more detail below, we want to clarify that all annuities have costs whether explicit, implicit, or both. The overarching principle is that insurers will take a portion of the interest or investment gains of the assets underlying a contract before passing along the rest to the purchaser. Insurers do this to cover their own costs to distribute and administer the product and to hit their profit targets. We also want to clarify that, like with home or renter's insurance, the higher the cost of the annuity, the better the benefits, all else equal.

[1] We do not cover group annuities in this document.
[2] We are not the first to use the term savings annuity: "Guaranteed Income Across Annuity Products: Withdrawal Guarantees Compete with Income Annuities." October 2018. https://www.cannex.com/wpcontent/uploads/2018/10/Annuity_guarantee_study_2018_FIA_VA_SPIA_DIApdf.pdf

Exhibit 1: Types of Annuities

Income Annuities

	Single-Premium Immediate Annuity	Deferred-Income Annuity
Primary purpose	Provide income/guaranteed cash flows	
Liquidity	Limited or unavailable[3]	
Market Upside Potential	Typically no upside potential, but an income annuity can be structured such that payments fluctuate with the market	
Market Downside Risk	Typically no downside risk, but an income annuity can be structured such that payments fluctuate with the market	
Key Guaranteed Elements	Cash flows are guaranteed for a set period or for life. Further, there may be a death benefit with commonly selected payout options	
Cost	Generally lower	

Savings Annuities

	Fixed-Rate Annuity	Fixed Index Annuity	Registered Index-Linked Annuity	Variable Annuity
Primary purpose	Accumulate savings			
Liquidity	Owner has access to annuity balance; there may be a fee or an adjustment on withdrawals			
Market Upside Potential	No; product is similar to a certificate of deposit	Some; growth rate is tied to the performance of an index chosen by the owner	More upside potential than Fixed Index Annuity. Growth rate is based on the performance of an index chosen by the owner	Yes; growth rate is tied to the performance of investments chosen by the owner
Market Downside Risk	No; but the balance can decrease due to fees on optional features	No; but the balance can decrease due to fees on optional features	Balance may decrease due to market performance, but exposure to downside risk is limited or mitigated	Yes; balance may decrease due to market performance
Key Guaranteed Elements	Interest rate is guaranteed for a set period. Product may include optional features that provide income, death benefit, or other guarantees	Cap, participation, or other index rates are guaranteed for a set period. Product may include optional features that provide income, death benefit, or other guarantees	Cap, participation, or other index rates are guaranteed for a set period. Product may include optional features that provide income, death benefit, or other guarantees	May provide a return-of-premium death benefit. Product may include optional features that provide income, additional death benefit, or other guarantees
Cost	Generally lower	Generally higher	Generally higher	Generally higher

[3] Some income annuities offer a commutation feature, which allows the owner to get a portion of their remaining payments.

Income Annuities

Income annuities vary in their design, but they all provide a guaranteed stream of cash flows in exchange for the insurance premium. Income annuities include single-premium immediate annuities, or SPIAs, and deferred-income annuities, or DIAs. The term single-premium immediate annuity is sometimes shortened to just "immediate annuity."

With SPIAs, the purchaser receives payments right away, hence the word "immediate" in their name. With DIAs, the payments start sometime in the future. This start date is agreed upon when the DIA is purchased.[4] DIAs may be referred to as longevity insurance, a longevity annuity, or an advanced life deferred annuity when payments are scheduled to start later in life, typically around age 80 or 85.

A special case of a DIA is a Qualified Longevity Annuity Contract, or QLAC. It refers to a longevity annuity that is purchased with wealth from a qualified retirement account. The designation means that the annuity is exempt from required minimum distributions until income payments start.

Income Annuity Payment Options

Most income annuities provide fixed payments. This means that the payments are set when the annuity is purchased. The payments typically stay the same[5] throughout the lifetime of the purchaser, never adjusting for inflation,[6] but some insurers offer an option in which payments increase by a set percentage, such as 1%, each year. However, the trade-off is that the purchaser will receive a lower initial income payment (assuming the same premium). For example, the purchaser might obtain a payout rate of 7% per year with a level payment option, but the initial payout rate could be something like 5.5% with an option in which the payment increases by 2% per year.

Some income annuities provide variable payments, meaning that the payments are tied to the stock and bond markets. Variable SPIAs are uncommon in the United States, and to our knowledge, no insurer is currently selling variable DIAs. In any case, with a variable income annuity, the purchaser chooses how the money in the contract is invested, as well as an assumed interest rate, or AIR. If the performance of the underlying investments exactly matches the AIR, the payment will stay the same. If the underlying investments provide a higher return than the AIR, the payment will increase. However, if the underlying investments provide a lower return than the AIR, the payment will decrease.

Purchasers can further customize the payments. For instance, the purchaser can structure the payments to last a specific number of years or for life. The former is referred to as a "period certain" annuity, while the latter is referred to as a "life only" annuity. The purchaser can also combine these options, in which case the annuity is referred to as a "certain and life" annuity. For example, the purchaser could choose a 10-year certain and life payout. This means the purchaser will receive guaranteed payments for 10 years and those will continue at the same level until the purchaser dies. If the purchaser dies in the initial 10-year period, beneficiaries will receive payments for the remainder of the 10-year period.

[4] Note that versions of these products offered through workplace retirement plans may allow the purchaser to adjust the deferral period.
[5] A level income stream will provide less purchasing power over time.
[6] Note that the purchaser of an income annuity is typically referred to as the "annuitant." The annuitant is the person on whose life the payments are contingent upon. While we use the term "purchaser" throughout this primer, note that the purchaser and the annuitant do not have to be the same person.

The purchaser could also select a cash refund payout. With this option, beneficiaries will receive a death benefit if the purchaser has not recouped the premium at the time of death. For example, if the purchaser dies after only receiving $20,000 of payments from a $100,000 premium, beneficiaries will receive a death benefit of $80,000. The certain and life and cash refund payout options may be a good option for prospective buyers who are worried they may die without fully capitalizing on their annuity.

The purchaser also chooses whether the payments are contingent on one or two lives. The latter is referred to as a "joint and survivor" payout. With this option, the purchaser can request that payments stay level as long as one person is alive, or the payments can be reduced upon the first death, or upon the death of a specific individual.

The below exhibit contains a comparison of common income annuity payout options.

Exhibit 2: Hypothetical Fixed SPIA Payouts Based on $100,000 Premium Payment at Age 65

Number of Years Since Purchase	**1**	**5**	**10**	**15**	**20**	**25**
Life only ($7,000 per year)						
Cumulative income payments	$7,000	$35,000	$70,000	$105,000	$140,000	$175,000
Net gain	-$93,000	-$65,000	-$30,000	$5,000	$40,000	$75,000
Payout upon death	$0	$0	$0	$0	$0	$0
10-Year Certain + Life ($6,600 per year)						
Cumulative income payments	$6,600	$33,000	$66,000	$99,000	$132,000	$165,000
Net gain	-$93,400	-$67,000	-$34,000	-$1,000	$32,000	$65,000
Payout upon death	$6,600 / year for 9 years	$6,600 / year for 5 years	$0	$0	$0	$0
Life w/ Cash Refund ($6,200 per year)						
Cumulative income payments	$6,200	$31,000	$62,000	$93,000	$124,000	$155,000
Net gain	-$93,800	-$69,000	-$38,000	-$7,000	$24,000	$55,000
Payout upon death	$93,800 death benefit	$69,000 death benefit	$38,000 death benefit	$7,000 death benefit	$0	$0

Notes: For simplicity, the net gain calculations do not incorporate the impact of the time value of money.

Cost of Income Annuities

Generally speaking, income annuities are a lower-cost type of annuity. This is because they are a commoditylike product, unlike savings annuities, which allow for much more variation in the product design. The cost for an income annuity is implicit and is reflected in the guaranteed payout amount that is offered. A variable income annuity may also have an explicit fund management fee that is reflected in the underlying investment performance.

Closing Remarks on Income Annuities

Income annuities are considered an efficient way to generate lifetime income in retirement. This is because they pool longevity risk. Insurance companies put similar purchasers into a group and pay them assuming that they live to life expectancy, with purchasers who die earlier helping to fund the payouts for those who die later.

However, the key trade-off with an income annuity is that the purchaser has to "annuitize" or give up access to their lump-sum premium in exchange for the guaranteed income stream. This means that the purchaser cannot trade in their annuity for cash after income payments have begun.[7] Income annuities are also subject to point-in-time purchase risk,[8] and in many cases, inflation risk.

For those who want to dig deeper, an issue brief published by the American Academy of Actuaries offers a more in-depth discussion of income annuities.[9]

[7] Some income annuities offer a commutation feature, which allows the annuitant to request some percentage of the remaining payments. Commutations are typically limited to a small percentage of the payments because of adverse selection.

[8] Income annuity pricing depends on the interest-rate environment and life expectancy assumptions at the time of purchase.

[9] American Academy of Actuaries. "What Are the Various Types of Insured Annuities?" August 2022. https://www.actuary.org/sites/default/files/2022-08/IB.Annuities.8.22.pdf

Savings Annuities

At their core, savings annuities function similarly to any investment account. They are savings-focused vehicles with an account balance. While there are different types of savings annuities, all of them allow the purchaser to convert their account balance into a guaranteed stream of cash flows, referred to as annuitizing, at a later date. This is tantamount to using the account balance to buy a single-premium immediate annuity. However, in practice, very few people annuitize their account balance. Savings annuities also provide tax-deferred growth (which we discuss later).

Surrender Charges and Market Value Adjustments

Savings annuities allow the owner to withdraw from their account balance at any time during the life of the contract. However, there may be a fee. Most savings annuities are sold with a surrender charge schedule. A surrender charge is a fee that is assessed if the owner withdraws more than the "free partial withdrawal" amount before the conclusion of the surrender charge period. The free partial withdrawal amount is often 10% of the account balance per year. Surrender charges typically decrease over time. The exhibit below shows a hypothetical surrender charge schedule. It also includes an example calculation of the surrender charge for a purchaser who put in $100,000 into a savings annuity.

Exhibit 3: Sample Surrender Charge Schedule and Example

Sample Surrender Charge Schedule

Policy Year	1	2	3	4	5	6	7	8+
Surrender Charge	7%	6%	5%	4%	3%	2%	1%	0%

Surrender in Year 1 Example

Account Balance		$100,000
Free Partial Withdrawal	10% x $100,000 account balance =	$10,000
Surrender Charge	7% x ($100,000 - $10,000) =	$6,300
Amount to the Owner	$100,000 - $6,300 =	$93,700

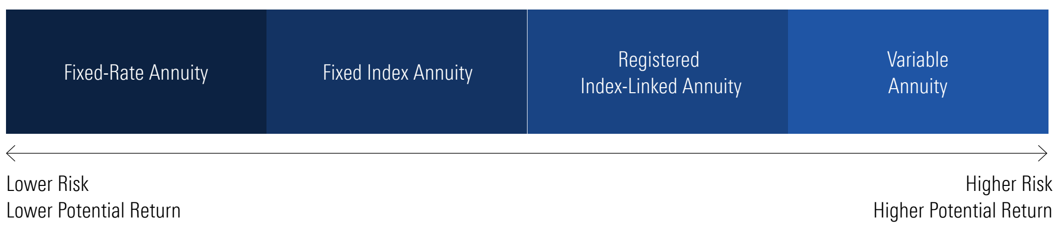
Some savings annuities also have a market value adjustment, which could increase or decrease the account balance as interest rates fluctuate. Typically, the market value adjustment decreases the amount paid out if interest rates increase relative to interest rates at the time the contract was signed. However, the amount paid can increase if interest rates decrease relative to interest rates at contract inception. They mostly occur with fixed-rate and fixed index annuities, which we define below.

Also, note that savings annuities will pay out the account balance—reduced for any applicable surrender charges or market value adjustments—to the beneficiaries upon the owner's death, assuming the owner did not annuitize the balance.

Types of Savings Annuities

There are four types of savings annuities: 1) fixed-rate annuities, 2) fixed index annuities, 3) variable annuities, and 4) registered index-linked annuities. A good way to differentiate between them is the level of investment risk assumed. Fixed-rate annuities have the lowest level of investment risk as the return is specified up front. There is more investment risk with a fixed index annuity, as the return is based on the movement in the underlying index, but risk is still limited as the return is typically floored at 0%.[10] Registered indexed-linked annuities are similar to fixed index annuities but have more investment risk, as the account balance can decrease if the underlying index has gone down in value. Variable annuities have the most investment risk, as the account balance fluctuates with the capital markets like a standard investment account.

Exhibit 4: Risk and Return Profile for Savings Annuities



A fixed-rate annuity is just like a bank certificate of deposit. The principal value does not fluctuate with the market, and the product provides a fixed interest rate.

Fixed-Rate Annuity/Multiyear Guarantee Annuity/Fixed Annuity

Fixed-rate annuities are a type of annuity in which the insurer declares the rate of return on the account balance up front. They are a substitute for a bank certificate of deposit. Typically, the rate of return is guaranteed for multiple years, such as five years. This is why fixed-rate annuities are frequently referred to as multiyear guarantee annuities, which is often shortened to "MYGAs." Sometimes fixed-rate annuities/multiyear guarantee annuities are also referred to as fixed annuities. However, this is not our preferred term, as a fixed-income annuity can also be considered a type of fixed annuity. In any case, once the initial guarantee period concludes, the insurer will set the interest rate at regular intervals, usually annually. The new rate cannot be lower than the minimum guaranteed interest rate in the contract but can be lower than the rate guaranteed for the initial period.

Outside of surrender charges or a market value adjustment, fixed-rate annuities typically do not have any explicit fees. However, there is an implicit cost. The insurer invests the proceeds in bonds, takes a portion of the yield (referred to as the pricing spread) to support the product, and uses the rest of the yield to credit interest to the account balance. For example, if bonds are yielding 6%, the insurer might set a fixed rate of 5.25%, in which the 0.75% difference is the pricing spread. While not exactly the same,[11] a pricing spread for a standard fixed-rate annuity without a rider (we discuss riders later) is similar to an undefined investment management fee.

[10] Insurance companies may offer a floor return of 1% instead of 0%, for example.
[11] The pricing spread also supports guarantees associated with the base product. Note that a pricing spread can also be used to support optional riders.

Fixed Index Annuity

Fixed index annuities are a type of annuity in which the rate of return is based on the movement in a market index, subject to a minimum floor return (typically 0%). Fixed index annuities used to be referred to as equity-indexed annuities, but the name changed because the product's performance is more fixedlike than equitylike. Like fixed-rate annuities, fixed index annuities provide principal protection.[12] However, with fixed index annuities, the money that the insurer would have used to declare a fixed interest rate is instead used to buy derivatives on an underlying index. The amount of interest credited to the account balance is based on the payoff from the derivatives.

Fixed index annuities are similar to fixed-rate annuities, except that the interest rate is based on index performance.

There are a variety of methods that insurers offer to credit interest. A common approach is to cap the return each year. For example, if the cap is 7%, and the index returns 15%, the account balance will increase by 7%. Another common approach is to provide a participation rate. The participation rate represents the percentage of the index return that is credited as interest. So, for example, if the participation rate is 40%, and the index returns 15%, the account balance will increase by 6%. There are other, more complicated methods that are out of the scope of this guide.[13] Also, note that the price return of the index is what matters when calculating index returns, as dividends are excluded.

The owner can typically select from prevalent stock indexes, such as the S&P 500, Russell 2000, and MSCI EAFE. Many providers also offer exotic indexes. These indexes can incorporate both stock and bond performance and frequently use a managed volatility methodology. At a high level, a managed volatility index will target a specific level of volatility (such as 5%), investing more aggressively when future volatility is anticipated to be lower than the target and vice versa when future volatility is forecast to be higher than the target. Exotic indexes also often incorporate an excess return methodology. This means that the performance of the index is calculated net of a benchmark, such as the one-year Treasury.

Fixed index annuities typically do not have any explicit fees, but there is an implicit cost in the form of a pricing spread, just like with fixed-rate annuities. We refer readers to Look (2023) for a much more in-depth discussion on fixed index annuities.[14]

[12] This means that the account balance will not drop below its starting point due to market returns. However, the account balance can drop due to rider fees. Further, if the purchaser surrenders the contract, the amount paid out can be reduced by surrender charges, or a market value adjustment, or both.

[13] Refer to Palmer for more discussion on different credited rate methods. Palmer, Bruce A. "Equity-Indexed Annuities: Fundamental Concepts and Issues." October 2006. Insurance Information Institute. https://www.iii.org/sites/default/files/docs/pdf/EIA_paper.pdf

[14] Refer to Look for much more in-depth discussion about FIAs. Look, S. May 2023. "Under the Microscope: Fixed Indexed Annuities With Guaranteed Lifetime Withdrawal Benefits." Morningstar Center for Retirement and Policy Studies.

Variable Annuity

Variable annuities are a registered security wherein the account balance fluctuates with the stock and bond markets. To be clear, this means that there is no principal guarantee, as the balance in the variable annuity may fall below the initial investment. Variable annuities offer more upside potential than a fixed-rate or fixed index annuity, but there is more investment risk. Fundamentally, a variable annuity can be thought of as a vehicle to invest in mutual fund-type assets with the option to annuitize the account balance at a later date. The owner can typically select from a variety of subaccounts, which are like mutual funds without a ticker. Most variable annuities offer equity, bond, and money market subaccounts.

Variable annuities offer more upside potential than other savings annuities, but there is more investment risk.

Variable annuities have explicit fees that are assessed on a regular basis. There is typically a fee for administrative costs. There are also fees for the underlying subaccounts. These fees are akin to investment fund expenses. Variable annuities also have mortality and expense charges. These charges typically cover the cost of a return-of-premium death benefit rider (which we discuss later) and other expenses, plus a profit margin to support the product. Mortality and expense charges are often something like 1.25% of the account balance per year.[15] Variable annuities also have share classes. The main difference between share classes has to do with the fees that are to be paid and whether there is a surrender charge schedule.

Registered Indexed-Linked Annuity/Structured Variable Annuity

Registered index-linked annuities, or RILAs, which are also referred to as structured variable annuities, are a cross between a fixed index annuity and a variable annuity. A registered indexed-linked annuity is a registered security, and just like with a standard variable annuity, there is no principal guarantee. However, unlike a standard variable annuity, the owner does not allocate the premium to specific subaccounts. Rather, the owner selects an index, and the rate of return is based on the movement in said index, like with a fixed-index annuity. The premium is not invested directly into the index. Instead, returns are achieved through a combination of buying or selling call or put options.

One popular registered indexed-linked annuity design is a "buffer" structure, which protects the owner against losses up to a set limit. For example, if there is a 10% buffer and the underlying index loses 15%, the account balance would decrease by 5%. Another popular design is a "floor" structure, which protects the owner against losses more than a limit. For example, if there is a 5% floor and the underlying index loses 15%, the account balance would decrease by 5%. Note that because a registered indexed-linked annuity allows for losses, it provides for more upside potential than a fixed index annuity.

Registered indexed-linked annuities are a cross between a fixed index annuity and a variable annuity.

Many registered indexed-linked annuities have an explicit fee, such as 1% of the account balance per year. There may be an additional fee for a specific index strategy that may boost the upside. Some registered indexed-linked annuities do not have an explicit fee. In these cases, the cost to support the product is taken from the portfolio yield of the underlying assets in the form of a pricing spread. Further, some insurers split the costs to support the product between an explicit annual fee and a pricing spread.[16]

[15] Note that the basis points needed to support the return-of-premium death benefit is often a very small part of the overall mortality and expense charge.
[16] Deng, G., Dulaney, T., Husson, T., & McCann, C. Sept. 11, 2013. "Structured Product Based Variable Annuities." Social Science Research Network. https://doi.org/10.2139/ssrn.2049513

Savings Annuity Riders

Savings annuities are sometimes sold with a rider, which is a feature that provides some type of guarantee. Riders often have an explicit fee that is assessed on an annual basis.

Guaranteed Lifetime Withdrawal Benefit

A guaranteed lifetime withdrawal benefit, or GLWB, rider is sometimes referred to as a guaranteed minimum withdrawal benefit, or GMWB.[17] The GLWB, when attached to a savings annuity, can provide the owner with guaranteed cash flows for life. Unlike with income annuities, the savings annuity account balance is not annuitized. This means the purchaser is not irrevocably exchanging a lump-sum insurance premium for a guaranteed income stream. Instead, when the owner decides to start taking withdrawals, the insurer calculates and provides the guaranteed lifetime withdrawal benefit. This is the amount that can be withdrawn from the savings annuity for the rest of the purchaser's life, even if the account balance falls to zero.

One of the main benefits of a GLWB is that it allows the owner to retain control of the account balance. The owner can withdraw more than the guaranteed amount at any point in time. However, excess withdrawals lower or reset the guarantee. Further, in many cases, the amount of guaranteed income with a GLWB is less than what is offered with an income annuity.

The insurer determines the GLWB amount by multiplying the "payout rate" and the "benefit base." The payout rate is a percentage, for example 5%, that the insurance company provides. The payout rate depends on what age the owner starts taking withdrawals and whether the guarantee is based on a single life or two lives. GLWB payout rates tend to increase at older ages and decrease if the guarantee covers a couple rather than an individual. GLWB payout rate tables tend to be less precise than the payout rates for income annuity products. The exhibit below demonstrates a hypothetical payout rate table.

Exhibit 5: Hypothetical GLWB Payout Rate Table

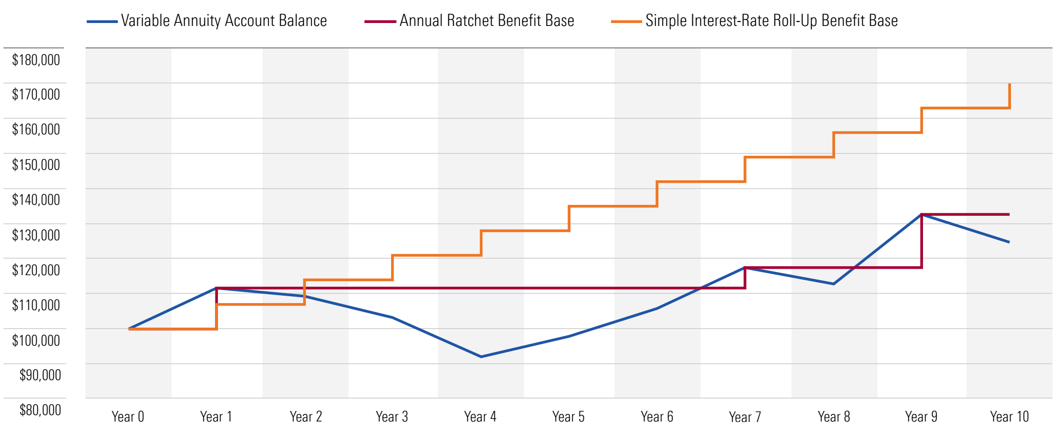
Age at First Guaranteed Withdrawal	Single Life	Joint Lives
55-59	4.25%	3.75%
60-64	4.75%	4.25%
65-69	5.25%	4.75%
70-74	5.75%	5.25%
75+	6.35%	5.85%

[17] GMWB and GLWB are sometimes used interchangeably. However, GMWB can refer to a guarantee that only applies for a specific number of years, not the purchaser's lifetime.

The benefit base can be thought of as a hypothetical balance that the insurer uses to calculate the GLWB amount. The benefit base is typically floored at the premium payment less withdrawals. Some GLWB designs provide a “ratchet” or “step-up” feature, in which the benefit base is stepped up to the account balance of the savings annuity if it is greater than the benefit base. Some designs provide a guaranteed minimum roll-up. With this feature, the benefit base is guaranteed to increase annually. The roll-up is typically calculated via a simple interest or via a compound interest method. In some cases, the benefit base can increase due to a “bonus.” For example, the benefit base might increase by 200% of the first-year premium as long as the owner does not take a withdrawal in the first 10 years.[18]

Exhibit 6 below demonstrates the benefit base increase functionality under an annual ratchet and a simple interest-rate roll-up design on a hypothetical variable annuity contract. While we present them separately to illustrate how they work, they are often combined in practice. This means that the benefit base would be the maximum of the initial premium increased at the simple interest rate and the highest anniversary account balance. Also, while we chose to use a variable annuity for this example, the benefit base mechanics are similar or the same when a GLWB is added to other types of savings annuities.

Exhibit 6: Illustration of GLWB Benefit Base Designs in a Low-Return Environment



Notes: We assume $100,000 is contributed to the variable annuity. Under the simple interest-rate roll-up, the benefit base is guaranteed to increase by 7% of the initial premium each year. We chose variable annuity subaccount returns to illustrate the benefit base increase mechanisms.

[18] There are other benefit base increase features available in the marketplace. Look (2023) covers GLWB benefit base roll-up rates for fixed index annuities that are linked to the credited interest rates.

Exhibit 7 contains two example calculations of the GLWB amount based on the sample payout rate table and the benefit base in Exhibit 6. In the first example, we assume that an individual bought a variable annuity with a GLWB with the simple interest-rate roll-up feature when they were 55 years old. They are now 65 years old and have opted to start guaranteed withdrawals. In the second example, everything is the same except that they bought the variable annuity when they were 65 years old and are starting withdrawals when they are 70 years old.

Exhibit 7: Sample Calculation of GLWB Amount for Single Life

	Example One	Example Two
Age When Variable Annuity Is Bought	55	65
Age When Guaranteed Withdrawals Start	65	70
Applicable Payout Rate (from Exhibit 5)	5.25%	5.75%
Benefit Base	$170,000	$135,000
Guaranteed Lifetime Withdrawal Amount	$8,925 ($170,000 * 5.25%)	$7,763 ($135,000 * 5.75%)

Notes: The numbers we use for this example are reasonable at the time of writing. However, payout rates, GLWB benefit base roll-up rates, and other features vary with the level of interest rates and other factors in the capital markets.

The GLWB benefit is often fixed once guaranteed withdrawals start. This is what we illustrated above in Exhibits 5 and 7. However, with some designs, the guaranteed withdrawal amount can increase over time or start at a higher level before decreasing once the underlying account balance has been depleted. The latter may be referred to as an accelerated income rider, and to be clear, the decrease to the guaranteed withdrawal amount is separate from any change that may apply if excess withdrawals are made above the specified benefit.

While we have covered many common features, there are additional ways that an insurer can structure a GLWB. Also, keep in mind that all features have a cost. There may be an explicit fee, an implicit cost, or a combination of both.

Guaranteed Minimum Death Benefit

A guaranteed minimum death benefit rider is typically referred to as a "GMDB." As implied by the name, they are used to obtain a guaranteed death benefit. In most cases, the insurer will reduce the death benefit for any withdrawals.

The most straightforward GMDB is a return-of-premium benefit. This feature means that the insurer will pay the beneficiaries the greater of the account balance and the premium payments less withdrawals upon the owner’s death. In the case of a variable annuity, the cost for this feature is typically covered by the mortality and expense fee. Similarly, for registered index-linked annuities, the cost may be included in other charges. The return-of-premium feature is effectively built into a fixed-rate or fixed index annuity since the account balance does not decrease due to market performance.

Some GMDBs provide enhanced death benefit guarantees in which the death benefit is equal to the highest contract anniversary account balance up to some age. The guaranteed death benefit could also grow by a guaranteed roll-up rate. This often works in the same fashion described above for the GLWB benefit base. For example, the death benefit might increase by 4% of the initial premium payment per year, regardless of market performance. GMDBs providing an enhanced death benefit are more common on variable annuities than other types of deferred annuities.

Guaranteed Minimum Income Benefit

A guaranteed minimum income benefit, or GMIB, is a rider that provides the owner with a guaranteed income amount at purchase. It was the predecessor of the GLWB, and thus, the way a GMIB works is similar to a GLWB. The insurer calculates the guaranteed income amount based on the payout rate and the benefit base. For example, the benefit base could be the maximum of the account balance, the highest contract anniversary account balance, or the initial premium compounded at a guaranteed roll-up rate. The key difference is that, with a GMIB, the owner annuitizes their balance. In other words, once income starts, the product effectively becomes an income annuity, and the owner no longer has access to the account balance.

GMIBs are sometimes still offered on variable annuities, but not that frequently. They are not generally offered with other types of savings annuities because GLWBs have tended to be a more popular way to provide a lifetime income feature as they do not require annuitization.

Guaranteed Minimum Accumulation Benefit

A guaranteed minimum accumulation benefit, or GMAB, is a rider in which the insurer guarantees a minimum value over a set period. For example, a GMAB could guarantee that the account balance will not be lower than 110% of the initial premium 10 years into the future. To be clear, the GMAB does not cap the upside. This means that the account balance will be equal to the maximum of the GMAB and the account balance that has grown with the capital markets.

A Brief Note on Annuity Taxation

Annuities can be purchased with tax money in a tax-advantaged retirement account, such as a pretax IRA or a Roth IRA. They can also be bought with money that does not have any tax-advantaged status, such as general savings. When pretax money is used to buy the annuity, all income payments or withdrawals are taxed as ordinary income. Annuities bought with pretax money are also subject to required minimum distributions.[19] When an annuity is bought with funds in a Roth account, payments are generally tax-free. When money that is not in a tax-advantaged account is used to fund the annuity, things get more complicated from a tax standpoint.

Starting with income annuities, the amount of income that is taxable is based on the exclusion ratio. The exclusion ratio determines what portion of the payment is tax-free and taxable. The exclusion ratio exists because some portion of the payment is a return of principal. Because the purchaser has already paid taxes on the principal, only the gains are taxed. If the owner lives long enough, they will be taxed on the full payment because the premium put into the contract has been returned and all subsequent payments are considered gains.

With savings annuities, the account balance grows on a tax-deferred basis. However, note that annuity withdrawals taken before age 59 ½ are typically subject to a 10% tax penalty. Lump-sum and partial withdrawals from deferred annuities bought with money outside of a retirement account are taxed on a last-in, first-out basis. This means that any amount withdrawn in excess of the contract's premium are taxed as ordinary income. Below that point, withdrawals are not taxed because they are considered a return of principal. What we just described does apply for guaranteed withdrawals from a GLWB rider. Further, if the account balance supporting the GLWB is depleted, the guaranteed withdrawals are 100% taxable as ordinary income.

There are additional rules, provisions, and circumstances that we do not cover here. We refer readers to the Internal Revenue Service's publications on this topic.[20,21] Readers may also want to consult with a tax advisor.

[19] One special case is a Qualified Longevity Annuity Contract, or QLAC. The QLAC designation means that the annuity is exempt from required minimum distributions until the income payments start.
[20] Internal Revenue Service. "About Publication 939, General Rule for Pensions and Annuities." https://www.irs.gov/forms-pubs/about-publication-939
[21] Internal Revenue Service. "About Publication 575, Pension and Annuity Income." https://www.irs.gov/forms-pubs/about-publication-575

Annuities for Income

The below exhibit contains a comparison of the key characteristics of annuity products that are commonly used to generate lifetime income in retirement. Prospective buyers and any others involved should carefully evaluate the features of the specific product before making the annuity decision.

Exhibit 8: Comparison of Salient Characteristics of Insurance Products Designed to Produce Lifetime Income

Strategy/ Characteristic	Single-Premium Immediate Annuity and Deferred-Income Annuity	Savings Annuity with GLWB
Liquidity before income starts	Not applicable for immediate annuities, and generally unavailable for deferred-income annuities[22]	Full liquidity is maintained. Note that withdrawals typically reduce the guarantee
Liquidity after income starts	Limited[23] or unavailable	Full liquidity is maintained. Note that withdrawals above the GLWB reduce the guarantee in future years
Fee on withdrawals	Not applicable. Withdrawals are not available. Income annuities provide a stream of cash flows	There may be surrender charges or a market value adjustment on withdrawals
Market Exposure	No market exposure for fixed-income annuities. Owner of a variable income annuity chooses how the premium is invested	There is market exposure. With variable, registered index-linked, and fixed index annuities, purchaser has choices on how premium is allocated
Possibility for guaranteed income to increase before income has begun	Not applicable	Yes, benefit base may increase, which increases the guaranteed amount
Possibility for payments to increase after income has begun if underlying investments increase	Not possible for fixed-income annuities. Payments may increase for variable income annuities	Typically no, but some designs allow the guaranteed withdrawals to increase
Possibility for payments to decrease after income has begun if underlying investments decrease	Not possible for fixed-income annuities. Payments may decrease for variable income annuities	With some designs, the guaranteed withdrawal benefit may decrease when the account balance has been depleted
Death Benefit	There is no death benefit with a life-only payout option. There may be a benefit with life with cash refund and life with period certain payout options	The beneficiary receives the remaining account balance, adjusted for the surrender charge and market value adjustment, if applicable
Product Fees	Typically no explicit fee. Instead the payout rate reflects the costs to support the product	There is typically an explicit fee for the GLWB rider. There are additional costs (either explicit fee or implicit in pricing spread) for the base product

[22] In-retirement-plan deferred-income annuities may provide liquidity before income starts.
[23] Income annuities may offer limited liquidity through a commutation feature.

Disclosures

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This should not be considered financial planning advice. Please consult a financial professional for advice specific to your individual circumstances