

How to Create Your Own Pension: A Closer Look at Immediate Annuities

By Julie Jason

Some retirees who face the danger of outliving their money (“longevity risk”) choose to self-insure through conservative investment and cash flow management.

Others transfer longevity risk to an insurance company by purchasing an “immediate annuity.” The insurance company has an advantage over the individual in that it can spread longevity risk across many lives with varying lifespans.

Think of the immediate annuity as a “personal pension.” Like a pension, the immediate annuity can provide lifelong income. And, like a pension, the product carries certain risks that need to be addressed before making a purchase.

This article takes a closer look at immediate annuities. First, we’ll look at why certain retirees might benefit from buying an immediate annuity with part (but never all) of their savings. Then we’ll get to the general concepts—the nuts and bolts, such as when you get your money, how products are sold, costs, taxes, what happens at death and product innovations. We’ll then turn to risk, what can go wrong, and how guaranty associations can come to the rescue. Finally, we’ll review questions to ask before you make a purchase, with some ending thoughts about potential misunderstandings and how to avoid them.

Keep in mind that this is a general discussion that is not intended as financial advice. There are different features and benefits to consider and there is no way around the homework that it will take to determine what product might fit your particular needs, much of which will depend on your



personal savings and cash flows.

If after reading this article you decide to explore immediate annuities further, be sure to get proposals from different companies. Compare features and pricing. Then, assess whether an immediate annuity might be right for part of your overall retirement income plan.

Who Might Benefit?

Immediate annuities can be quite helpful to both individuals of means and individuals with modest savings. These retirement-income vehicles are particularly appealing because of their relative simplicity compared to other retirement income products, especially to those who cannot (or prefer not to) manage their own finances.

Retirees who are in the following circumstances might find a lifelong immediate annuity particularly attractive as part of the overall retirement income strategy.

- **Small or no pension:** If your pension (if you have one) plus Social Security retirement benefits are insufficient to cover your retirement expenses, consider an immediate annuity to cover the shortfall. Ideally, you want your Social Security benefits plus your pension and your immediate annuity payments to cover your essential expenses.
- **No time and/or experience:** If you don’t have time to manage your money—or you are simply averse to tackling the job yourself—consider covering part of your expenses with immediate annuities. You don’t have to monitor how your investments are doing because the

insurance company is obligated to pay you a fixed monthly annuity irrespective of how its own investments perform.

- **No budget:** If you have trouble sticking to a budget and therefore face the danger of using up your retirement savings prematurely, consider the benefits of having a monthly annuity check arrive “in the mail.”
- **Erratic income flows:** Even if you have assets that you are using for spending in retirement, adding an immediate annuity to the mix can smooth out your cash flow. However, you will still need growth investments to offset future inflation.

The Nuts and Bolts

An immediate annuity—also called an “income annuity,” a “fixed immediate annuity,” or a “single-premium immediate annuity”—is an insurance product you buy, not an investment you make.

More specifically, the annuity is the contractual obligation of an insurance company to pay you the quoted amount for the quoted term. The quoted amount is determined by the insurance company at the time of purchase based on your age, current interest rates, costs, and other factors.

While there are many variations on the theme, in its simplest form the traditional immediate annuity works much like a pension—paying you a set dollar amount each month for as long as you live.

The money you pay the insurance company when you buy the immediate annuity (the “premium”—usually a lump sum) becomes the property of the insurance company after the annuity contract is issued. The owner has no claim to the premium after a short “free-look” period during which he or she can cancel the contract—unless there is a specific provision in the contract for a refund, surrender, or commutation feature.

As you can see, the terms of the contract determine how the annuity works.

What Does the Annuity Promise?

A lifelong immediate annuity promises that you will not outlive your money. Just like a pension, it does not promise that you will have enough to live on—that will depend on your spending habits and inflation. As with your pension, normally, nothing passes to your heirs. (There are exceptions, as you will see under “Annuity Innovations” below.)

When Do You Get Your Money?

The terms of the immediate annuity you purchase will determine when you get your money.

Traditional annuities are lifelong promises, meaning you receive a fixed amount each month for as long as you live.

However, you can also buy an immediate annuity that pays out for a limited (not lifelong) term, such as 10 to 50 years; you get nothing if you live longer than the term.

The term can also be combined with a life feature, which is meant to pay your beneficiary should you die during the term. For example, if you purchase an immediate annuity for “life and 10 years certain” with payments beginning on January 1, 2010, and you die shortly thereafter, your beneficiary will receive the monthly payments that would have been paid to you if you had lived, but they will stop on December 31, 2019. If you die after 2019, your beneficiary gets nothing.

How Are They Sold?

It’s important to understand how a salesperson presents any financial product to potential customers. His or her motivation, along with the anticipated ease of sale, may determine which financial instruments you are offered—and how aggressively they are pitched to you.

Salespeople who sell immediate annuities must be licensed to sell life insurance. They need not be licensed as registered representatives (stock brokers), since immediate annuities are not securities.

You would think that a product that solved the retiree’s biggest problem—

the fear of outliving his money—would be a popular and easy sale. That’s not necessarily the case.

Four factors affect sales of immediate annuities:

- Because money (the premium) can be tied up for life, the insurance agent has little opportunity to make subsequent sales;
- Other products may be more lucrative to the agent (commissions on immediate annuities might run 3% to 4% of the premium, which is modest compared to other insurance products);
- Retirees might be reluctant to give up control over the money used to buy the immediate annuity; and
- If interest rates at the time of purchase are low, payouts can be low.

As a result, the immediate annuity is hardly a top seller. But don’t let that stop you from considering an immediate annuity if you find the promise of lifelong income appealing.

You should also be aware that you can purchase an immediate annuity directly from a vendor who sells products to consumers on a non-commission basis, usually on-line, through the mail, or by phone. Here are three examples (these are not recommendations or endorsements):

- The Single Premium Immediate Annuity offered by Berkshire Hathaway Group (www.brkdirect.com),
- The Fixed Income Annuity offered by Fidelity Investments (www.fidelity.com), and
- The Vanguard Lifetime Income Program offered by the Vanguard Group (www.vanguard.com).

Costs and Taxes

When an insurance company decides to sell you an immediate annuity, it has to find a way to pay for its own costs of delivering its promises to you. These costs are built into the product—you don’t see them. The only way to judge costs is to do some comparative shopping among companies. By comparing terms and monthly payments, you’ll get a sense of how the insurance company

is pricing its product.

There is no sales charge to sell an immediate annuity because normally, you cannot go back to the insurer to liquidate your annuity. (An exception is an annuity with a surrender, or “commutation” feature. Typically, there is a charge for commuting the contract.) You should be aware, however, that some annuity owners can find independent buyers for their annuities through the secondary market—but that’s a subject for a future article.

Taxes will depend on whether you use taxable or tax-deferred money to buy the immediate annuity. If you use your traditional tax-deferred IRA to make the purchase, the monthly annuity check you receive will generally be taxable as income, as would withdrawals from the IRA. You will receive an IRS Form 1099-R at the beginning of each year from the insurance company showing the taxable amount that you need to report to the IRS on your prior year’s tax return.

You will report a lot less taxable income if you buy the immediate annuity using money you’ve saved or invested in a taxable account. The Form 1099-R you receive will report the taxable and non-taxable portions of your annuity payment. Only the taxable portion is subject to income taxes. How immediate annuities are taxed is explained in IRS Publication 575 (available at www.irs.gov).

What Happens at Death?

Immediate annuities offer different pay-on-death features. Here are some examples.

- **Single life:** Payments end when you die, even if you die right after you purchase the annuity. However, the contract can be cancelled if death occurs during the free-look period.
- **Joint life:** Payments end on the death of the survivor. For example, you and your spouse can purchase a joint life immediate annuity that pays benefits until one of you dies, then continues to pay the same (or lesser) amount until the surviving

spouse dies.

- **Period certain:** Payments are limited to a certain period of time, such as 10 years. In that case, payments would be made to you (or your beneficiary) for 10 years only, even if you live longer.
- **Life with period certain:** This combines a life payment with a period certain. For example, you can buy a life annuity with 10 years certain. That means that if you die before 10 years have elapsed from the date of purchase, your beneficiary will receive the payments that would have been made to you had you lived.

Make sure you understand all your options—and compare prices for each one—before you make a purchase. For example, the immediate annuity that terminates when you die (the “life only” annuity) is less costly than a life annuity with a guaranteed minimum term, such as “life with 10 years certain.” Thus, the life-only annuity payment will be higher than the life-with-10-years-certain annuity.

Annuity Innovations

Newer immediate annuities are more flexible than the traditional life-only annuities. That flexibility usually comes with higher internal costs and lower payouts.

Here are some examples of the features you can find.

- **Legacy benefits to provide for heirs.** One such example is a “cash-refund guarantee”: If you die before your annuity payments equal your premium, your beneficiary will receive the difference between the premium and the payouts made up to that date.
- **Inflation protection.** This feature increases your payouts yearly—usually by a specific percent chosen at the time you buy the annuity.
- **A survivor benefit.** Some annuities allow you to choose to pay 100% (or a reduced amount) of your payout to a beneficiary for his or her lifetime. Others offer a percent

of premium death benefit, which pays a single lump sum to your beneficiary.

- **A feature allowing you to request limited withdrawals.** For example, one annuity with a “cash-withdrawal feature” allows you to ask for a one-time-only withdrawal limited to a certain amount, which can be exercised on the 5th, 10th or 15th anniversary of your first income payment. If this feature is used, future monthly payments are reduced.
- **A payment acceleration feature.** For example, one annuity allows you to ask to receive six monthly payments in advance as a single lump sum; payments for the next five months are suspended.
- **Some annuities offer a combination of features.** For example, one annuity offers: 1) guaranteed income for life; 2) survivor benefits for the owner’s spouse; 3) legacy benefits that protect against both spouses dying too soon (through a period-certain feature); 4) inflation protection; and 5) withdrawal features (payment acceleration and a cash-withdrawal feature).

How Risky Are They?

If the insurance company that issues the annuity contract becomes financially distressed or goes out of business, your promised monthly stream of income is at risk. While there are some protections (see the sidebar “What if the Insurance Company Goes Broke?” on page 19), it pays to buy from the strongest insurers.

How do you assess the financial strength of the company behind the guarantee?

You can get some comfort from rating agencies, such as Moody’s Investors Service, a producer of independent credit ratings, research and financial information (www.moody.com); Fitch Ratings, a global rating agency (www.fitchratings.com); A.M. Best, a full-service global credit-rating organization that subjects all insurers to the same rigorous criteria, providing a valuable benchmark for comparing insurers

What if the Insurance Company Goes Broke?

Although the life-insurance industry remains one of the most highly regulated, you should be aware that an insurance company can go out of business.

Even large, well-established and highly rated companies can find themselves facing dire financial circumstances from time to time.

Here are two things you need to know:

- Insurance regulation lessens the likelihood of potential insolvencies; and
- When insolvency does occur, state guaranty funds can come into play.

Insurance companies are regulated by the states and are required to calculate reserves—estimates of all future benefits the companies must pay on all types of policies, including annuities and life insurance. Companies need to have assets equal to their reserves, plus a cushion. The cushion is called a “surplus.”

If a company’s surplus falls below minimum levels, state regulators require the company to correct the problem by various means. If that fails, insurance regulators seize the company and a state-appointed receiver takes over the company’s operation. If assets fall below reserves, a form of insurance (state guaranty funds) provides some protection to the policyholder.

Each state has a life- and health-insurance guaranty association that provides continuing coverage to the policyholders of failed insurers. The associations pay for this coverage by assessing (charging) healthy insurance

companies in their states to make up shortfalls in the policies of failed companies.

There are limits to coverage. All state insurance-guaranty associations cover up to \$100,000 of the *present value* of the underlying obligation, and a number provide additional coverage. Many states are considering raising the minimum guarantee level to \$250,000. The present value of an immediate annuity is calculated by adding up the future income stream, then determining what it would cost to pay for that future stream today, using a present-value interest factor.

What happens if your present value is higher than the state’s limits?

As a policyholder of the insurance company that issued the annuity, you are a creditor; as such, you take precedence over general creditors when the insurer’s assets are distributed in a bankruptcy-like proceeding run by the insurance department of the state in which the insurer is domiciled. In such a proceeding, a typical recovery might be 85% of the excess of cap amount.

To research the coverage limits applicable in your state, visit the Web site of the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) at www.nolhga.com. The site’s Guaranty Association Laws section offers contact information for your state’s insurance guaranty association. Most state guaranty associations have their own Web sites; the NOLHGA site provides links to them as well.

(www.ambest.com); and Standard & Poor’s, a source of independent financial data (www.standardandpoors.com).

Although you can’t choose a financial product based on ratings alone, common sense dictates that you avoid lower-rated companies.

Questions to Ask

Of all the retirement-income products on the market, the immediate annuity is probably the easiest for retirees to understand, even if they are inexperienced investors.

That’s not to say you can skip your homework: You need to compare competing products carefully; you have to be aware of pricing, the product’s features and the financial strength of the issuer as we’ve discussed.

When zeroing in on a specific product, you should be sure to confirm that you are indeed being offered an immediate annuity and not another product. One way to tell is to ask for a prospectus: Immediate annuities are insurance products, so there is no prospectus; if the salesperson hands you one, you are being offered a security (for example, a variable annuity), not an immediate annuity.

Also be sure to read carefully any material given to you by the salesperson and any documentation he or she asks you to sign. You will have to read the immediate annuity contract to see how guarantees and other features work, how much of your payment is taxable, and what happens after your death.

Here are some important questions to ask before signing on the dotted line:

- How much will my monthly payments be?
- How long will the payments last?
- What happens when I die? What happens if I die tomorrow?
- Can I get my premium back if I change my mind after the free-look period?
- How strong is the insurance company issuing the immediate annuity, and how can I confirm that independently?
- What else have you considered for me, and why are you recommending this particular product?

Misunderstandings

The immediate annuity is a fairly straightforward insurance product that is easy to understand and hard to

misrepresent. As a result, sales of immediate annuities tend to generate few complaints—unlike deferred, variable and equity-indexed annuities, where misunderstandings can arise.

The press does not always distinguish among annuity types in negative articles about annuity sales practices. You can usually exclude the immediate annuity from most negative press that you see on annuities; the bulk of the criticism is usually directed at other, more complicated types of annuities.

Where can you get into trouble?

You might misunderstand the terms of the annuity, especially if it offers a combination of different features (see “Annuity Innovations”). Or, you could buy the wrong type of annuity if you don’t realize the recommended product is a lifetime income look-alike. If you are looking for a plain-vanilla income-for-life product, avoid the more complicated hybrid (insurance and securities) products sold by prospectus.

Buyer “Aware”

Here are some tips to consider before purchasing an immediate annuity:

- Do not buy an immediate annuity without considering your entire financial situation.
- Do not buy a life-only immediate annuity with money you want to leave to your heirs: This product is not intended to create a legacy. Nonetheless, you should consider features that protect your heirs should you die prematurely (for example, period-certain or survivorship features).
- Do not use all or most of your savings to buy an immediate annuity. While the dollar amount needs to fit your situation, think in terms of limiting your purchase to no more than 40% to 50% of your savings. You’ll need savings to cover emergencies and to offset the effects of inflation.
- You cannot “undo” the purchase after the free-look period—a short period of time during which you can cancel the purchase. Buying a life annuity impacts the rest of your life. Take your time to assess how the benefits of the annuity support your retirement income strategy and understand the drawbacks before agreeing to buy anything. Understand the pros and cons well enough to explain them to a friend.
- Consider limiting your purchase from any single company to an amount that falls below your state’s insurance-guaranty fund.

Do not buy an immediate annuity without considering inflation protection in the form of an annuity payment that increases over time. (Of course, there is a trade-off: An annuity that offers inflation protection will have higher internal costs and a lower initial payout.)

Know the financial strength of the issuing company. Because annuity payments are the obligation of the insurance company, it’s imperative to research that company’s financial stability. When comparison shopping, be sure you are comparing like products and features. And be sure not to confuse the immediate annuity with a variable annuity with a lifelong income payout, which is an entirely different type of product.

Chosen properly, the lifelong immediate annuity can be the cornerstone of a well-designed retirement income portfolio, especially for retirees whose pensions are non-existent or insufficient, people who don’t like to invest, and individuals who have a hard time sticking to a budget.

The promise of lifelong income provides an element of security—the value of which should not be underestimated. ▲

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