



PAN AFRICA LIFE ASSURANCE LIMITED

FlexiAnnuity

GENERAL FEATURES OF ANNUITY

Annuities are insurance contracts bought by a person, known as the **contract owner**, that will pay the **annuitant**, the person who will receive the annuity, a periodic amount starting at a given date and continuing the rest of the annuitant's life. Usually, but not necessarily, the contract owner and the annuitant are the same person. Although most annuities are for retirement, the payouts can start at any time. The period of time that money is paid into an account is known as the **accumulation period**; the time that the annuitant receives the money is known as the **annuity period**. When the annuity period begins and the account starts paying the annuitant, then the account is said to be **annuitized**. The periodic payment is determined primarily by how much is in the account, how much it earns during the annuitant's life, and how long the annuitant is expected to live.

The earnings in the account are tax-deferred; no taxes are due on earnings during the accumulation phase, but during the annuity period, earnings, but not principal, are taxed as ordinary income. The principal is not taxed because the premium is paid with after-tax shillings.

Fixed Annuities — Variable Annuities

There are different types of annuities that can be classified according to the variability of the periodic payment: fixed, variable, and combination.

Fixed Annuity

A **fixed annuity** guarantees a specific payment starting at an agreed date, and continuing every pay period, which can be monthly, quarterly, semi-annually, or annually. The main advantage of a fixed annuity, unlike other investments, is that the payments are guaranteed for the life of the annuitant.

How can an insurance company guarantee payments to an individual without knowing beforehand how long that person will live? By spreading the risk over a large number of people. A payment for a fixed annuity is dependent, among other factors, on the life expectancy of the annuitant when payments begin. Some will live longer than expected, but others will die sooner. If the annuitant dies sooner, the insurance company keeps the rest of the principal; this will help pay for others who live longer.

The main risk with a fixed annuity is **inflation risk**. Inflation will continually lessen the amount of goods and services the fixed payment can buy. Although there are periods of economic deflation,

most of the time, prices for goods and services continually increases, so this risk will increase the longer the annuitant lives.

Variable Annuity

A **variable annuity** has a variable payout that is contingent on the profitability of the investment portfolio on which the annuity is based, and thus, it can be a hedge against inflation. It is like a tax-deferred mutual fund. Like a mutual fund, the maximum sales charge is 8.5% (for the first 12 years), and has breakpoints, **LOI's**, and rights of accumulation. The premiums for a variable annuity are placed in an account that is separate from the **general account** of an insurance company, because the account is managed more aggressively for more income, but also with the attendant risk.

Variable annuities are an **investment risk** because the payout depends on the performance of a specific portfolio, and are therefore classified as securities by the SEC. If the account doesn't perform well, the annuitant will receive reduced payments, or none at all.

Combination Annuity

The combination annuity combines fixed and variable annuities, guaranteeing the annuitant a specific amount, but also allowing the potential for more money from the variable annuity.

Prospectus

Because a variable annuity is a security and operates like a mutual fund, it is required to issue a prospectus to new investors that has most of the information that a prospectus of a mutual fund would have, in addition to a few features that are unique to variable annuities. One thing that cannot be done with variable annuities is to take dividends and capital gains as a cash distribution.

Mortality Guarantee

This is the guarantee that the annuitant will receive payments as long as he lives.

Expense Guarantee

Expenses affect the separate account as much as a mutual fund. If expenses were allowed to rise over time, this could adversely affect the income that the annuitant was receiving. So annuity contracts usually guarantee that expenses will not be greater than a stipulated amount, generally around 1%.

Death Benefit

Should the annuitant die during the accumulation phase, then his estate is guaranteed to receive no less than what was paid in by the annuitant, minus some fees, which is limited by the expense guarantee.

Non-forfeiture

During the accumulation phase, the money is still the contract owner's. He still has control of the money. If he was paying periodically, he can stop making payments, although this will reduce the annuitant's benefit. He can withdraw some or all of the money—**surrender the contract**—but earnings will be taxed, and possibly be subject to a 10% tax penalty for early withdrawal. The insurance company will also assess a surrender charge that typically decreases the longer the contract is in force.

Not every annuity assesses a surrender charge, but some that do also provide **free withdrawals** for up to a certain percentage of the account value, typically 10%, per year. They may also provide **waivers**, where all or part of the money can be withdrawn without a surrender charge, if the contract owner has an urgent need for the money, such as extended hospitalization, is diagnosed with a terminal illness, or becomes unemployed.

However, when the annuity period begins, the contract owner loses control of the account.

Purchase Options

There are several ways to pay the premiums for the annuity.

Single Payment Immediate

Give the insurance company a single payment, then begin receiving payouts, which will be on the next payment date. Note that this could be as long as 1 year for the first payment, if the contract specifies yearly payments. This would be suitable for an individual with a lump sum of money who is going to retire shortly.

Single Payment Deferred

Same as above, but the payout is deferred, allowing the money to build over the years. Many lottery winners use this method, and sometimes professional athletes receive such an annuity paid for by the employer as a form of future compensation.

Periodic Payment Deferred Annuity

Premiums are paid monthly, quarterly, or annually. The amount can be fixed or variable. There are 2 forms of periodic payment, the **level premium** and the **flexible premium**.

Level Premium

The **level premium** is a fixed premium paid during the accumulation period. The level premium is determined by the annuitant's age and sex, the assumed interest rate, income amount and payment guarantee, and expenses, and obviously for periodic payments, how long the contract holder pays the premium. The more premiums paid, the lower the premium.

Because an annuity is paid for the annuitant's lifetime, life expectancy is an obvious factor to consider when calculating premiums, which in turn, will depend on the annuitant's age at the start of the annuity period and sex, because women generally live longer than men. Some states, however, do not allow the premium to be contingent upon sex; in these states the sex of the annuitant won't matter. Another factor extending the time of the annuity period, for which premiums

will be higher, is when a specific time period for payouts is guaranteed, or it is a joint-and-survivor annuity, which will likely increase the length of the annuity period.

The premium will obviously depend on

1. **assumed interest rate (AIR)**, which is the amount the account is assumed to earn in interest;
2. income amount, which is what the contract holder wants the annuitant to receive periodically;
3. and expenses.

A higher assumed interest rate and lower expenses will lower the premium for a given income level, and vice versa.

Flexible Premium

The **flexible premium** can vary between a minimum and a maximum amount, specified in the contract, which the contract owner can pay during the accumulation period, which would be good for someone whose income can vary considerably. However, the value of the annuity cannot be determined until the final payment, because there is no way to determine how much will be in the account when it is annuitized, although an average premium can be projected.

How Annuity Payments are Calculated

Fixed annuity payments are determined by insurance company annuity tables that give the first payment value per Kshs. 1,000, which depends on the age and sex of the annuitant, the payout options chosen, and deductions for expenses. Thus, if an annuitant has Kshs. 100,000 in his account, and the value is Kshs. 5 per Kshs. 1,000, then the first payment will be Kshs. 500. For a fixed annuity, this will be the value of all subsequent payments.

Variable Annuity Accumulation Units and Annuity Units

During the accumulation period, the variable annuity contract owner's interest in the separate account is measured by accumulation units. Accumulation units track the shares of a variable annuity in the separate account, which is invested more aggressively for greater income. The number of accumulation units in the account is proportionate to the amount of money invested. These accumulation units are simply an accounting method of measuring the contract owner's interest in the separate account.

The **accumulation unit**, which is calculated, is equal to the total value of all securities held in the separate account divided by the number of accumulation units. The number of accumulation units that can be purchased is the net payment, which is the payment after sales charges are taken out, divided by the market value of the accumulation unit. Thus, the contract holder's interest in the separate account at any given time is the number of accumulation units times the value of 1 accumulation unit.

Annuitization

Annuitization is when the contract converts from the pay-in phase to the pay-out phase—the accumulation period ends and the annuity period begins.

At this time, the annuitant selects a settlement option. Then the accumulation units are converted to a fixed number of **annuity units** according to a formula—the number of annuity units will never change. What varies is the value of each annuity unit, which will depend on the value of the portfolio in the separate account. When the performance of the separate account changes, the value of each annuity unit changes, and therefore the payment—which is calculated by multiplying the number of annuity units times the value of one—to the annuitant changes. Variable annuity contracts specify how often the payout can be changed: monthly, quarterly, semi-annually, or annually.

The calculation for the first payment of a variable annuity is the same as for the fixed annuity, but the dollar amount is converted to an equivalent of annuity units. For a variable annuity, the number of annuity units is calculated by dividing the first payment by the current value of an annuity unit. This will yield a number that will not change during the annuity period; what changes is the value of the annuity unit. Thus, the annuitant's payment is equal to the number of annuity units times the value of each unit. So if Kshs. 500 is the first payment, and Kshs. 5 is the value of each annuity unit, then the annuitant has an interest in 100 units, which will not change. The value of the annuity unit, and therefore the payment to the annuitant, will rise and fall, depending on the value of the annuity unit, which in turn, will depend on the performance of the separate account.

Settlement Options

A settlement option, which is selected when the annuity period begins, determines how the annuity will be paid, and what will happen when the annuitant dies.

For both fixed and variable annuities, under the most common settlement options, the annuitant is guaranteed to receive a payment for life—fixed guarantees a specific amount, variable annuities do not.

Insurance companies can do this because the annuitant, through contract, depending on the settlement option, gives up the right to the principal once payments begin. If the annuitant dies earlier than expected, the insurance company keeps the rest of the principal; but if the individual lives longer than his life expectancy, then the insurance company must continue paying, even though the principal is depleted. The insurance company spreads the risk over many individuals—the principal left over from those who died earlier than expected helps the insurance company continue payments to those who are living longer.

Straight Life

This option has the highest payout for the amount of money invested. If the annuitant lives longer than expectant, then he gets more than he paid in, but if he dies earlier, then the insurance company keeps the balance of the principal.

Refund Life Annuity

This annuity guarantees that it will pay at least what the contract owner paid in premiums. If the annuitant dies before getting this amount, then the annuitant's beneficiary will get the remainder either as cash or as installment payments.

Life Annuity with Period Certain

With this option, the annuitant or his beneficiary is guaranteed to receive payments for at least a specified time, such as 10 years. If the annuitant dies before then, his beneficiary receives the payments for the duration of the term, but if the annuitant lives longer than expected, he still continues to receive payments until he dies, but once the term has elapsed, no payment will go to the beneficiary after the annuitant dies. Because of the guarantee, this payout is less than straight life for the same account.

Temporary Annuity Certain

Temporary annuity certain guarantees that payments will be made for a given number of years, usually 10, 15, or 20 years. After that, the payment stops, even if the annuitant lives longer. If the annuitant dies before the period elapses, then his beneficiary receives the remaining payments.

Joint and Survivor Annuity

Typically for husband and wife, when the annuitant dies, a specific percentage is paid to the other spouse until her death. Although the continued payment can be 100%, it is frequently less, because the surviving spouse will have lower living expenses, and therefore doesn't need the entire amount. The annuitant chooses the percentage out of choices provided by the insurance company, when the contract is signed. Naturally, a higher percentage lowers payouts to the primary annuitant.

Investment Income

The annuitant receives the earnings of the principal, but the principal is left intact. When the annuitant dies, the principal goes to the contract owner's beneficiary.

Lump Sum

A lump sum payout gives the annuitant all of the principal plus earnings at one time. However, taxes will then be due on the earnings of the principal, which will be taxed as ordinary income.

If the annuitant took monthly payments, only part of each payment, as determined by a formula, would be taxable.

Installments of Designated Amounts

A specific amount is paid out until the account is exhausted. Obviously this settlement option, the lump sum option, and the temporary annuity certain option does not provide a lifetime of payments.

Two-Tiered Annuities

An annuity can be taken as a lump sum or as periodic payments. However, if taken as a lump sum, the money available will be different than if periodic payments were chosen under another settlement option. A two-tiered annuity has different values for distribution, depending on whether it is taken as a lump sum before annuitization, or is issued as periodic payments.

Tax-Deferred Annuity (TDA) or Tax-Sheltered Annuity (TSA)

Teachers and other employees of non-profit or tax-exempt organizations can benefit from tax-deferred annuities. This contrasts with the regular investor who must use after-tax shillings.

This is a **salary reduction program**—the money is invested before it is taxed. These annuities are available to all employees of qualified organizations, whether they are full- or part-time, but the program only applies to their earnings from the qualified organization. No other wages can be included. All earnings on the account grow tax-deferred. However, during the payout, all of the money is taxed as ordinary income, whereas the ordinary investor only has to pay taxes on any gains of the account, not on the principal.

Retirement Income Annuities

A retirement income annuity is a deferred annuity with a decreasing term life insurance policy whose face amount decreases each year. When the contract is annuitized, the term life insurance expires, and the annuitant begins receiving payments. If the annuitant dies before the annuity period, then his beneficiary receives the death benefit from the term insurance and the value of the annuity, distributed according to the settlement option chosen.

Equity-Indexed Annuities

These fixed annuities offer a guaranteed minimum interest rate and a guarantee against loss of principal if held to term, though charges may apply if surrendered early. The interest rate is linked to an index. If the index moves upward, the interest rate increases by some percentage of it. If it moves down, then the guaranteed interest rate is paid.

However, many insurance companies only guarantee 90% of the premiums paid, plus at least 3% interest. Therefore, if no index-linked interest is earned, because the index declined, then the value of the investment can decline. Also, index-linked interest may be forfeited if the annuity is surrendered early.

Market-Value Adjusted Annuities

This fixed annuity provides liquidity and growth potential if the contract owner surrenders the contract early. When the contract is surrendered, both a surrender charge and a market value adjustment to the account will be made. If interest rates rise, then the market adjustment will be negative, and vice versa. This discourages contract owners from liquidating when interest rates are rising to get a higher rate. The market value adjustment may apply only to the interest if it is not registered, or if it is, then the adjustment may apply to both principal and interest.

Tax Treatment of Annuities

Most payments to annuities are with after-tax shillings. Therefore, the principal is not taxable, but the earnings are when received. The LIFO (Last In, First Out) method to determine what is taxable, which is natural because it yields the most taxes. If you paid Kshs.100,000 into an annuity, and it earns another Kshs.100,000 over the years, then Kshs.100,000 principal is not taxed, but the income it generated is. If you take out Kshs.50,000, the whole amount will be taxed because of the LIFO method of calculation. If Kshs.130,000 is withdrawn, then Kshs. 100,000 of that amount will be taxed; the rest being considered as principal. If applicable, the 10% early withdrawal penalty applies only to what is taxable. If the annuity is used as collateral for a loan, the loan may be taxed just like it was an actual withdrawal. Variable annuity earnings are always taxed as ordinary income, never as capital gains, even if some of the earnings are from capital gains.

An annuity contract can be terminated and the money withdrawn, but all earnings will be taxed as ordinary income, and if withdrawn before the contract owner is 59 ½, then a 10% tax penalty may apply to the earnings.

How Payouts are Taxed

How much of the payouts are taxed is computed by the insurance company and sent to the annuitant as a special Form. When the payments are received periodically, certain tax exclusions apply, one which depends on the settlement option chosen (straight life has the largest exclusion), and another exclusion is dependent on the age and sex of the annuitant—the **Treasury Life Expectancy Multiple**. That proportion of periodic payments considered taxable are spread out over the life expectancy of the individual rather than using the LIFO method of taxing all income over the cost basis.

Death Benefit Provision

If the contract owner dies during the accumulation period, most contracts provide for a death benefit, where all money deposited and earned will be paid to the contract owner's beneficiary, the earnings of which will be taxed as ordinary income to the beneficiary. No tax penalty will apply even if the annuitant is younger than 59 ½. If the variable annuity lost money in its investments, then the beneficiary will receive at least everything that's been paid in by the contract owner.