NAVA®

2004 Annuity Fact Book

A guide to information, trends, and data in the annuity industry

The Evolution of Annuities

1759: The first annuity in America is offered by a Pennsylvania company to Presbyterian ministers and their families.

1912: The Pennsylvania Company for Insurance on Lives and Granting Annuities is the first American company to offer annuities to the general public.

1930s: Annuities become popular as concerns about the overall health of the financial markets prompt many to purchase products from insurance companies which are seen as stable institutions.

1930s: New Deal programs encourage individuals to save for their own retirement. The group annuity market for corporate pension plans begins to develop.

1952: The first variable annuity is issued by TIAA-CREF for use in college and university qualified retirement plans.

1959: In *SEC v. Variable Annuity Life Insurance Company*, the Supreme Court holds that variable annuities are subject to federal securities regulation.

1960: The first non-qualified variable annuity policy becomes available through the Variable Annuity Life Insurance Company (VALIC).

1977: Revenue Ruling 77-85 is issued stating that individual investments in an annuity cannot be directed by the owner.

1979: Revenue Ruling 79-335 is issued eliminating the tax-free step up in basis at death for variable annuity contracts.

1980: Revenue Ruling 80-274 is issued ruling that bank CDs cannot be wrapped in an annuity.

1981: Revenue Ruling 81-225 is issued stating that publicly traded mutual funds cannot be the underlying investments in a non-qualified annuity.

continued on back cover

Third edition

About NAVA

The National Association for Variable Annuities (NAVA) is a not-for-profit organization dedicated to the growth and understanding of annuity and variable life products.

NAVA represents all segments of the annuity and variable life industry with over 350 member organizations, including insurance companies, banks, investment management firms, distribution firms, and industry service providers. It serves as a valuable forum for the exchange of information, working with the media, the public and other industry groups to educate people on the benefits of the industry's products.

For More Information

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Annuities—An Overview

1

What is an Annuity?

The concept of annuitization can be traced back to the 1st century. In early Roman times, citizens would make a one-time payment to a contract known as an "annua" and then receive income payments once a year for the rest of their lives.

Today, the word annuity can mean both a type of retirement savings plan that lets assets accumulate tax-deferred, and income payments, usually received during retirement, that are guaranteed to last for a specified period, including the lifetime of the annuitant.

When a person buys an annuity, he or she enters into a contract with an insurance company. Similar to life insurance, annuity contracts are based on the principal of risk pooling. Whereas life insurance protects an individual against premature death, an annuity protects against living longer than expected and running out of money. The burden of not knowing how long one will live is thus shifted from the individual to the insurance company which spreads the longevity risk among all annuitants, some of whom will die sooner than expected, some of whom will live longer than expected.

What Types of Annuities Are Available?

There is a wide variety of annuities available today to meet the specific needs of each individual. With a deferred annuity, assets accumulate, tax-deferred, until withdrawals are made, usually during retirement; with an immediate annuity, the contract owner can convert assets into income and start receiving payments right away. Fixed annuities provide income payments that never change; variable annuity income payments fluctuate depending on the underlying investments chosen by the contract owner.

Annuities can be part of an IRA, a qualified retirement plan such as a 401(k) or 403(b), or purchased with after-tax dollars as part of a non-qualified personal retirement account. The following is a more detailed look at various types of annuities.

Deferred Annuities: A Way to Save Money for Retirement

Many people buy annuities because they want their money to grow tax-deferred while they are saving for retirement, and they want a guaranteed income stream once they retire. This type of annuity is called a deferred annuity. A deferred annuity contract has two phases—an accumulation or savings phase, and a payout or retirement income phase.

In the accumulation phase, the owner pays premiums (also referred to as purchase payments) into the contract and accumulates assets. Some contracts are purchased with a single payment and thus are called single premium contracts. With other contracts, payments can be made at any time—these contracts are called flexible premium contracts. The owner can surrender the contract during the accumulation phase, or take one or more partial withdrawals.

In the payout phase, the owner receives income. When he or she wants payments to begin, the insurance company starts sending checks. The effective date of payments is called the annuity starting date or the annuity commencement date. The annuity starting date can be one year or many years after a deferred annuity is purchased.

Immediate Annuities: When You Want to Receive Money Right Away

An immediate, or payout, annuity is purchased with a single premium and annuity payments begin right away. (There is no accumulation period.) If the owner chooses to receive monthly payments, they usually start at the end of the first month but may be scheduled to start any time within one year after purchase. An immediate annuity can be purchased using retirement savings, for example from a 401(k) plan and/or personal savings, as a way to create guaranteed income payments during retirement. It can also be purchased using money from other sources, such as an inheritance or the sale of a business.

Table 1: *Total Industry Annuity Sales: Deferred vs. Immediate*
(dollars in billions)

	1996	1997	1998	1999	2000	2001	2002	2003
Deferred	$107.0	$120.8	$126.2	$158.0	$181.4	$177.4	$207.1	$202.5
Immediate	5.3	5.6	5.6	6.7	8.6	10.2	11.2	11.5
Total	**$112.3**	**$126.4**	**$131.8**	**$164.7**	**$190.0**	**$187.6**	**$218.3**	**$214.0**

Source: NAVA, Finetre/VARDS and LIMRA Int'l

Fixed Annuities: Guaranteed Investment Performance

With a fixed annuity, the owner is guaranteed a specific rate of return. In the case of a deferred fixed annuity, the insurance company guarantees a minimum interest rate on payments made by the owner during the accumulation phase. In some cases, an insurer will credit interest at a higher rate for varying periods. This type of interest is often referred to as excess interest. Payments made by the owner are invested in the insurance company's general account. During the payout phase, the dollar amount of each annuity income payment is fixed and guaranteed.

Generally, fixed annuities are less risky than variable annuities because they offer a guaranteed minimum rate of interest. The minimum interest rate is not affected by fluctuations in market interest rates or the company's yearly profits. Some people like the security of knowing that their annuity payments will never vary. Although they are less risky, fixed annuities offer little investment flexibility, no hedge against inflation, and less opportunity for growth than variable annuities.

Variable Annuities: Investment Performance Based on Investment Portfolios Chosen by the Owner

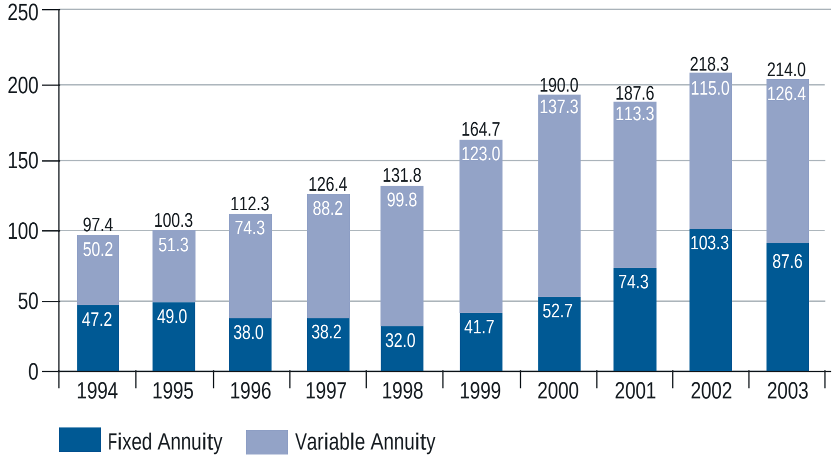
With a variable annuity, the contract owner is able to choose from a wide range of investment options called subaccounts, enabling him or her to direct some assets into investment funds that can help keep up with inflation, and some into more conservative choices or into a fixed rate fund. The funds are similar to, but not the same as, mutual funds that are sold directly to the public in that they invest in stocks, bonds and money market portfolios. Payments are invested and earnings are re-invested in these underlying funds.

As with mutual funds, the investment return fluctuates. That is, during the accumulation phase of a variable annuity, the value of the contract varies based on the performance of the underlying investment funds. During the payout phase of a deferred variable annuity (and throughout the entire life of an immediate variable annuity), annuity payments may change based on the performance of the underlying funds.

In addition to variable investment funds, many variable annuities offer a fixed account or fixed-investment option. This means that during the accumulation phase of a deferred variable annuity, the owner can allocate payments, not only to one or more variable investment options, but to the fixed option as well. The money allocated to the fixed option goes into the insurance company's general account. A minimum rate of interest is typically guaranteed for a period of one or more years.

During the payout phase of some contracts, only fixed annuity income payments are offered. Other variable annuities provide fixed and/or variable payouts. Providing both types of payouts responds to the fact that a contract owner may be willing to take on the added risk associated with variable investment funds while accumulating assets, but may want to reduce risk during retirement by choosing to have the rate of return guaranteed for at least some portion of income payments.

Chart 1: *Total Industry Annuity Sales*
(dollars in billions)



Source: NAVA, Finetre/VARDS and LIMRA Int'l

Equity-indexed Annuities: Market-based Investment Performance With a Guaranteed Minimum Rate of Interest

An equity-indexed annuity is designed for investors who wish to enjoy the benefits of investing in the stock market with a protected investment floor if there is a downturn in the market. This annuity typically provides the contract owner with an investment return that is a prescribed percentage of the return of an index, such as the S&P 500, while guaranteeing no less than a stated fixed return on the investment.

Table 2: *Total Industry Sales of Equity-indexed Annuities*
(dollars in billions)

1995	1996	1997	1998	1999	2000	2001	2002	2003
$0.2	$1.5	$3.0	$4.0	$5.0	$5.5	$6.8	$11.8	$12.6

Source: LIMRA Int'l

Qualified Plans vs. Non-qualified Plans

Annuities can be used in tax-qualified retirement plans, such as pension or profit sharing plans, 401(k) plans, 403(b) plans (for some charitable and educational institutions), and certain governmental plans. These annuities are called qualified annuities and are typically funded with pre-tax dollars. Annuities that are purchased by the public and not used in a qualified plan are called non-qualified annuities and are purchased with after-tax dollars.

The first variable annuity in America was designed and developed for a qualified retirement program for TIAA-CREF. As such, the variable annuity was available only as an investment within a tax-qualified plan until 1960 when the first publicly available annuity outside a qualified plan was developed and brought to market. (See Chapter 5 for more information on annuities in qualified plans.)

An annuity used in a qualified plan provides contract owners with most of the benefits offered by non-qualified annuities, such as a guaranteed death benefit and the guarantee of income payments for the life of the individual or for two individuals. It does not, however, provide any additional tax-deferred treatment of earnings—tax deferral is provided by the qualified plan itself. Other tax aspects of qualified and non-qualified annuities are summarized in Chapter 9.

Table 3: *Total Industry Annuity Net Assets: Qualified vs. Non-qualified*
(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Variable										
Qualified	$168.5	$296.9	$355.4	$434.0	$510.3	$630.5	$604.5	$550.8	$494.6	$598.5
Non-qualified	139.0	103.0	147.0	206.0	261.0	343.0	352.0	335.0	301.0	395.4
Total variable	$307.5	$399.9	$502.4	$640.0	$771.3	$973.5	$956.5	$885.8	$795.6	$993.9
Fixed										
Qualified	$160.0	$191.0	$190.0	$180.0	$210.0	$210.0	$189.0	$170.0	$186.0	$200.0
Non-qualified	196.0	197.0	242.0	249.0	222.0	233.0	209.0	247.0	280.0	313.0
Total fixed	$356.0	$388.0	$432.0	$429.0	$432.0	$443.0	$398.0	$417.0	$466.0	$513.0
Total Annuity Market	**$663.5**	**$787.9**	**$934.4**	**$1,069.0**	**$1,203.3**	**$1,416.5**	**$1,354.5**	**$1,302.8**	**$1,261.6**	**$1,506.9**

Source: NAVA, Finetre/VARDS and LIMRA Int'l

What Fees and Expenses Are Associated With Variable Annuities?

A variable annuity has two types of asset-based expenses—investment management fees for the underlying investment portfolios, and annual insurance charges.

Investment Management Fees

Investment management fees are charged for the management of the different funds within the variable annuity subaccount. These fees will vary depending on the type of investment portfolio chosen, and are typically less than the management fees of publicly available mutual funds. (See Chapter 8 for more information on a comparison of mutual fund and variable annuity fees.)

Insurance Charges

Insurance charges generally include administrative and distribution charges, and mortality and expense risk charges (M&E fees).

The administrative and distribution charges pay for all of the services involved in the maintenance of variable annuity contracts, such as preparation of contract statements and mailings, and other customer services. Some variable annuities also impose an annual contract fee, which is similar to the annual account maintenance fee imposed by many IRAs. This fee generally ranges between $30 and $40 per year. Some insurers waive this fee for contracts with an accumulation or contract value of at least a certain amount (e.g. $25,000). Some contracts impose a fee for transfers exceeding a specified number per year (e.g. 12).

In most contracts, the M&E fee pays for three important insurance guarantees:

- The ability to choose a payout option that provides an income that cannot be outlived at rates set in the contract at the time of purchase.
- A death benefit to protect beneficiaries.
- The promise that the annual insurance charges will not increase.

The Cost of Variable Annuities vs. Mutual Funds

Investment management fees for variable annuities are, on average, lower than those charged for publicly offered mutual funds. These lower fees offset, to some extent, the insurance charges. In 2003, the total expense difference between mutual funds and variable annuities was .863%. For a more detailed look at the real cost of a variable annuity, see Chapter 8.

Table 4: *Fees and Expenses: Variable Annuities vs. Mutual Funds*

	2003 Average Expenses	
	Mutual Funds	Variable Annuities
Fund Expense	1.452%	0.974%
M&E	-	1.014
Administrative	-	.148
Distribution	-	.179
Total	1.452%	2.315%
DIFFERENCE	**0.863%**	

Source: Morningstar, Inc.

"Unbundled" Fees

Some variable annuity contracts permit purchasers to select from a menu of optional product features. Each optional feature has a charge associated with it. The advantage of this "unbundling" approach is that it gives the customer the ability to select and pay for only those features he or she wants.

Optional features that can be added to contracts include enhanced guaranteed death benefits, guaranteed minimum living benefits, shorter surrender charge periods, and "extra value" riders that provide a credit to purchase payments. (See Chapter 3 for more details.)

Premium Tax

A few states impose premium taxes on variable annuity purchases. These taxes range from 1% to 4% depending on the state of residence but, in most cases, do not exceed 2%.

How Are Variable Annuity Sales Charges Structured?

"A-share" Variable Annuities

Like "A-share" mutual funds, "A-share" variable annuities have up-front sales charges instead of surrender charges. Sales charges are calculated as a percentage of each purchase payment.

"A-share" variable annuities offer breakpoint pricing, which means up-front sales charges decrease depending on the cumulative amount of purchase payments that have been made. In addition, the assets a contract owner has in other products in the company's product line may be recognized in the cumulative payment amount used to determine the breakpoint pricing. "A-share" contracts may have lower ongoing M&E annual fees than annuities with surrender charges.

"B-share" Variable Annuities

Most variable annuity contracts are "B-share" products. They are offered with no initial sales charge, but cancellation of the contract during its early years may trigger a withdrawal charge known as a surrender charge. These charges typically range from 5% to 7% in the first year, and subsequently decline to zero, generally after five to seven years (known as the "surrender charge period"). Some annuity contracts impose surrender charges only during the initial surrender charge period that begins after the contract is purchased, while others begin a new surrender charge period that applies to each subsequent premium.

Surrender charges underscore the long-term nature of the product. As long as the contract owner remains committed to accumulating money for his or her retirement through the variable annuity, he or she generally will not incur these charges.

A number of insurers have begun to offer other types of charge structures to meet differing investor needs.

"C-share" or No-surrender Charge Variable Annuities

"C-share," or no-surrender charge annuities, offer full liquidity to clients at any time, without any up-front or contingent sales charges (although tax penalties may apply to withdrawals before age 59½). There are ongoing M&E and administrative fees, however, which may be higher.

"L-share" Variable Annuities

"L-share" variable annuities typically have shorter surrender charge periods, such as three or four years, but may have higher ongoing M&E and administrative charges.

How is the Value of a Variable Annuity Measured?

The value of a variable annuity fluctuates with the performance of the underlying funds. This performance is passed on to the annuity owner through the use of "unit values." (Each investment fund has a separate unit value.) When a fund is first opened, it is assigned an initial unit value. As the value of the fund changes over time, this is reflected in a change in the unit value. The investment management and insurance charges are also reflected in the unit value. Separate values are usually used for the accumulation and payout periods. They are known as the accumulation unit value and the annuity unit value.

Who Are the Parties to an Annuity Contract?

The insurance company is the issuer of the annuity contract. When the purchaser completes the application to buy an annuity, the contract owner, annuitant and beneficiary are designated and identified as such in the contract.

Contract Owner

The owner of an annuity contract pays the premiums. He or she has certain rights under the contract such as the right to add more money, withdraw part or all of the contract value, or change the parties to the contract. The owner is usually an individual or couple but can also be a non-natural person such as a trust or a partnership. Special rules apply to annuities owned by non-natural persons.

Annuitant

The annuitant is the person upon whose life annuity payments are based. Often the contract owner is also the annuitant so payments continue as long as the owner is alive. It is also possible for two people, such as an owner and spouse, to be designated as joint annuitants so that income can continue throughout both of their lives. This type of annuity is called a joint and survivor annuity.

Beneficiary

The beneficiary is the person designated under the contract to receive any payments that may be due upon the death of the owner or annuitant.

Respective Rights of the Parties

Annuity contracts offer a great deal of flexibility in setting up income payments. Therefore, contracts vary as to the respective rights of the owner, annuitant, and beneficiary. Under one contract, the owner may be entitled to receive annuity payments. Under another, the annuitant may receive annuity payments.

Insurance Company Ratings

Annuity guarantees are subject to the claims-paying ability of the issuing insurance company. It is therefore important to consider the financial soundness of each company before making a purchase. Most companies are rated by independent industry analyst A.M. Best Company, but may also be rated by Standard & Poors, Fitch, and Moody’s Investor Service. Insurance company ratings do not apply to the underlying variable accounts, which are subject to market risk and will fluctuate with changes in market conditions.

Retirement Readiness

2

Like the distant rumble of stampeding buffalo which can be heard long before they actually appear, the impact of 77 million baby boomers approaching retirement can already be felt as those on the leading edge turn 60 in less than two years. This unique group of individuals will enter their golden years better educated, healthier, and with longer life expectancies than any generation before them. At the same time, far fewer will be able to rely on the safety net of Social Security and company pensions which provided for the bulk of their parents' retirement income needs.

Will this generation, which has been characterized by self-reliance, independence and indulgence, be able to live comfortably in a retirement which could last 20 to 30 years or longer? Will they be able to manage their own resources once they retire so their money lasts as long as they live?

Boom to Bust—A Wakeup Call

After a decade of "irrational exuberance," the recent bear market served as a wake up call for tens of millions of people who stood by helplessly watching $3.5 trillion in equity wealth disappear.[1] Pre-retirees who had counted on ever-expanding stock portfolios to provide a large portion of their income in retirement, are now being forced to re-evaluate their retirement plans; current retirees, who depend on systematic asset draw-down for their cash flow, are looking for additional sources of income and a more secure way to manage their money.

[1] *The New Frontier of Retirement Cash Flow Management,* by Ernst & Young's Insurance and Actuarial Advisory Services Group, 2003.

Baby Boomers Head for Retirement

In the year 2000, there were 35 million Americans age 65 or older representing 12.4% of the population. By 2025, as the last wave of the baby boomers enters retirement, this number is expected to jump to 62 million people representing 18.5% of the population.[2] Just how prepared will this generation be to live, perhaps for decades, in a retirement largely funded by their own savings and investments? Part of the answer lies in an analysis of three key factors: income sources, income needs, and money management in retirement.

Income Sources in Retirement

A generation ago, Social Security and pensions took care of most people's needs during retirement, which lasted an average of only 12 years. Today's pre-retirees face a double-edged sword. Not only will they live longer in retirement, but traditional sources such as Social Security and conventional defined benefit pension plans are predicted to play a considerably smaller role in providing retirement income in the future. Given this environment, it is clear that tomorrow's retirees will need to take a more active role in providing their own retirement security.

Social Security

Social Security currently protects 153 million American workers, with 46 million people receiving benefits at the end of 2002. While many people think Social Security tax contributions are held in interest bearing accounts to be used for payments to future retirees, in reality taxes paid by today's workers are used to fund benefits for today's retirees. Currently, Social Security is taking more in taxes than it is paying out in benefits, with excess funds credited to the Social Security Trust Fund. By 2018 however, tax revenues are projected to fall below program costs; by 2042, unless changes are made, trust fund accumulated reserves will be exhausted.

Today there are 3.3 workers paying into the system for each person collecting benefits. This will drop to 2 to 1 in less than 40 years. At this rate, there will not be enough money coming in to cover scheduled benefits at current tax rates.[3]

The current "replacement rate" (the amount of pre-retirement income received from Social Security) for the average worker retiring at age 65, is about 41%. However, the age of entitlement for full benefits is scheduled

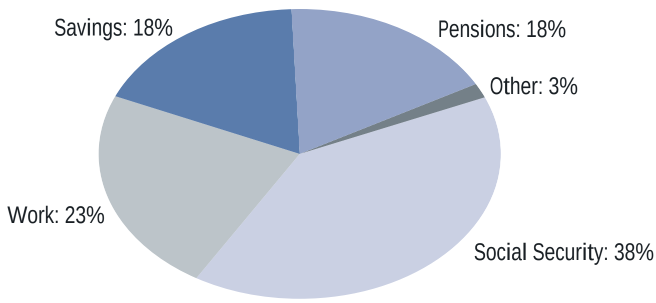
[2] *Retirement Savings and Household Wealth in 2000: Analysis of Census Bureau Data,* CRS Report for Congress by Patrick J. Purcell, updated December 12, 2002.

[3] *The 2003 Annual Report of the Board of Trustees of the Federal OASDI Trust Funds,* March 17, 2003.

to rise to age 67, premiums for Medicare will soon increase, and more people will have to pay taxes on their benefits in the future. Given these three factors, plus the assumption that in order to remain solvent Social Security will have to both raise taxes and decrease benefits, a 65 year old retiring in 2030 may receive as little as 27% of pre-retirement income from Social Security.[4]

Social Security currently accounts for 38% of total income resources for those age 65 or older. As Social Security replacement rates decline, however, other sources of income must increase if individuals are going to avoid a sharp decline in their living standards. Clearly, pre-retirees today will need to look beyond Social Security as a source for funding retirement income.

Chart 1: Percent of Retirement Income by Source, for Those Age 65 and Older, 2000



Source: Social Security Administration, 2002.

Pensions[5]

Along with Social Security, many of yesterday's retirees relied on company pensions, also known as defined benefit (DB) plans, for financial support in retirement. Under these plans, the employer typically promises a lifetime stream of income to retirees based on their salary, years of service, and age at retirement. The employer guarantees these payments no matter how well the underlying investments perform or how long the retirees live—thus shouldering both the investment and the longevity risks. Unfortunately, the availability of this source of reliable retirement income is diminishing.

[4] *Just the Facts On Retirement Issues, The Declining Role of Social Security,* by Alicia H. Munnell, February 2003, Number 6, Center for Retirement Research at Boston College.

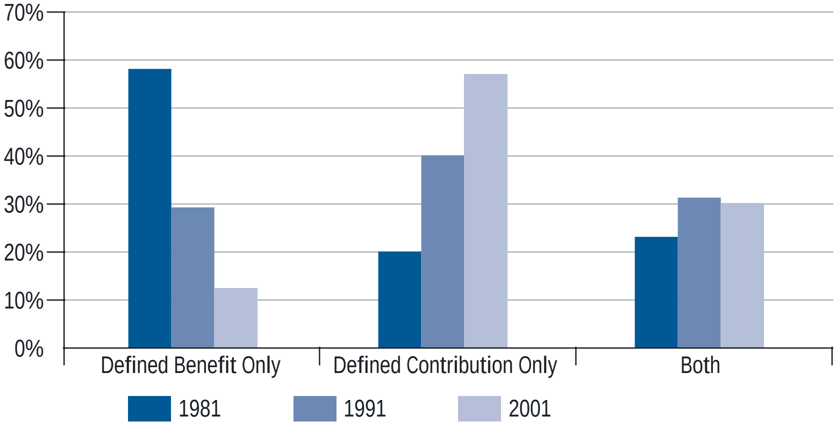
[5] Information in this section is from the U.S. Department of Labor, Pension and Welfare Benefits Administration, Private Pension Plan Bulletin, *Abstract of 1998 Form 5500 Annual Reports*, No. 11, Winter 2001-2002.

In 1978, legislation was passed in the form of the Revenue Act of 1978, which permitted certain types of defined contribution (DC) plans to allow employees to defer part of their income on a pre-tax basis until retirement. Plans which included this new arrangement became known as 401(k) plans. Over the past 25 years, these plans have radically changed the American pension system by gradually shifting responsibility for the financing and investment of retirement benefits from employers to employees. Since their introduction, 401(k) plans have come to dominate the DC portion of the private pension system.

As participation in 401(k) plans has grown, coverage in DB plans has declined. Few new DB plans are being formed, small and medium sized plans are being terminated, and there is little growth in employment among large unionized manufacturing firms that maintain DB plans.

In 2001, just under 50% of all private sector workers were covered by a DB or DC plan. Of those covered, the percentage with only a DC plan increased from 20% in 1981 to nearly 60% in 2001.[6]

Chart 2: Percent of Wage and Salary Workers With Pension Coverage by Type of Plan, 1981-2001



Source: U.S. Department of Labor (2002). Percentages for 2001 are based on calculations from Survey of Consumer Finances (2003) data.

As mentioned earlier, a major consequence of the growth of DC plans has been a shift in the risk and financing of plan benefits from the employer to the employee. In 1998, 47% of all contributions to pension plans were made by employees compared to only 11% in 1978. In real dollars, employer contributions to all types of pension plans were 18% lower in 1998 than in 1978, while employee contributions were 480% higher.

[6] *How Has the Shift to 401(k)s Affected the Retirement Age?* by Alicia H. Munnell, Kevin E. Cahill, and Natalia A. Jivan, September 2003, Number 13, Center for Retirement Research at Boston College.

Along with higher contributions, employees in DC plans also bear the burden of security. While DB plans are insured by the federal government through the Pension Benefits Guarantee Corporation, employees with DC plans are left unprotected from either stock market volatility or corporate fraud. In addition, many defined contribution plans don't give employees the option of receiving lifetime income when they retire.

As with Social Security, the decrease in company pension plans over the past few years has greatly increased the burden on individuals to take charge of and carefully plan for their own retirement income needs.

Savings

With so much of the responsibility for saving for retirement now shifted to the employee, how well are workers doing in both calculating their retirement needs and actually putting aside the funds required?

Among the 47.8 million families who owned any type of retirement savings plan in 2001, the mean value of all the families' accounts was just over $95,000. The median (with half of all families having more and half less) was $27,000. For workers aged 55-64, the median was $55,000.[7] But, even with $100,000 saved, a retiree would exhaust his principal in only 20 years if he spent $5,000 each year. This is a frighteningly small amount considering that most retirees will live 20-30 years in retirement and need 75-100% of their current income to maintain their standard of living.

Despite the increasingly urgent need for individuals to plan and save for their own retirement, the savings rate in the United States continues to plummet. From a high of 10.6% of disposable income in 1975, the rate fell to 2.3% in 2001 before heading up to 3.7% in 2002.[8]

So how worried are pre-retirees about their "retirement readiness"—a state of financial independence where decisions are made based on choice, not economic necessity? According to the *2003 Retirement Confidence Survey,*[9] 21% of workers feel very confident about having enough money to live comfortably in retirement and 45% feel somewhat confident. These figures demonstrate that many people are overestimating their ability to live comfortably in retirement.

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[7] *Retirement Savings and Household Wealth: A Summary of Recent Data,* CRS Report for Congress by Patrick J. Purcell, updated December 11, 2003.

[8] U.S. Department of Commerce, Bureau of Economic Analysis.

[9] *2003 Retirement Confidence Survey,* conducted by Employee Benefit Research Institute (EBRI), American Savings Education Council (ASEC), and Mathew Greenwald & Associates, 2003.

Once they retire, most pre-retirees (70%) plan to work to supplement their income. This is almost three times the number of retirees who actually work for pay once they retire (28%). Declining health, a changing economy, and other factors often keep those who want to work from actually doing so.

Also, while 44% say they have given a lot of thought to the need for health insurance in retirement, far fewer have considered the need for long-term care insurance for nursing home or home health care.

Despite the recent bear market, Americans continue to exhibit a great deal of confidence in their retirement prospects. Much of this is due to the fact that many do not know how much money it takes to maintain their standard of living in retirement, and many have not tried to figure it out. Unless workers begin to take a more active role in managing their finances and saving more vigorously for retirement, many will find their retirement years are far from golden.

Inheritance

Along with diminished Social Security benefits, a decline in DB plans, and a lack of adequate savings, baby boomers are going to get hit with one more reality check—lower than expected inheritances.

While the estimated amount of potential bequests is subject to heated debate by the experts, there is one point all seem to agree on—most baby boomers will not receive any inheritance at all.[10] If they happen to be part of the small percentage of the population that does receive money from their parents, few will receive more than $25,000.

A recent study by AARP indicates that only 14.9% of baby boomers in 2001 expect an inheritance from their parents, down from 26.9% in 1989. Among post-boomers (those born after 1964), the figures are even lower—only 5.8% expect an inheritance vs. 10.8% in 1989.

One of the reasons for these dwindling numbers is the cost of nursing home care. It is expected that 46% of those over 65 will live in a nursing home for some period of time over the next 20 years, costing as much as $100,000 per year. Another is the fact that many of today's seniors simply don't feel that leaving money behind is a priority. To add to this dilemma, there is a good chance that today's baby boomers may find themselves not only foregoing an inheritance, but supporting their parents as well as themselves during some of their retirement.

[10] "Great Expectations," by Michael J. Weiss, *American Demographics,* May 1, 2003.

Table 1: *Most People Don't Inherit*

Amount of inheritance ($)	Percentage of Americans (%)
0	91.9
1 - 25,000	4.3
25,000 - 50,000	1.1
50,000 - 100,000	1.1
over 100,000	1.6

Source: Jagadeesh Gokhale (Federal Reserve Bank of Cleveland) and Laurence Kotlikoff (Boston University); calculated from the 1998 Survey of Consumer Finances.

Income Needs in Retirement

Given the growing uncertainty of traditional retirement income sources, it is increasingly important for individuals to not only analyze where their money will come from, but just how much they will need.

Many financial experts today suggest that retirees will need approximately three-quarters of their pre-retirement income to maintain their current standard of living in retirement. This is based on the premise that spending on such items as commuting, clothing, etc. will decline when they leave the workforce. According to the *2003 Retirement Confidence Survey*, half of all workers (49%) expect they will need less than 70% of their pre-retirement income to live comfortably in retirement. Only 16% anticipate needing 70-79%, while 18% feel they will need 80% or more, and 17% "don't know."

One large, often unanticipated, drain on retirement funds, is health-related expenses. In the *2003 Retirement Confidence Survey*, more than four in ten workers (44%) say they have given a lot of thought to the need for health insurance coverage in retirement. But only three in ten have given the same thought to the possibility of having to pay health expenses not covered by Medicare; and just two in ten have given a lot of thought to the need for long-term care insurance for nursing home or home health care (18%) which, as noted earlier, can run as high as $100,000 per year.

A study, conducted by Chicago-based Aon Consulting, finds that average spending actually declines very little in retirement.[11] While some costs such as shelter decrease, others, such as healthcare mentioned above, increase. The study also finds that post-retirement spending is on the rise, while saving by active workers as a percentage of income is declining.This has many retirees wondering if they will have to reduce their living standard or if, perhaps, they will run out of money altogether.

[11] *Replacement Ratio Study*, AON Consulting, 2001.

Table 2: *Changes in Spending: Pre-retirement vs. Retirement*

On average, retirees' overall spending doesn't drop much from their working days, with decreases in shelter costs offset by increases in healthcare.

	Pre-retirement annual income			
	$40,000		$90,000	
Category	Working	Retired	Working	Retired
Reading and education	$427	$397	$794	$722
Healthcare	1,616	2,689	2,430	3,714
Utilities	2,543	2,478	3,335	3,217
Other household expenses	300	519	548	1,005
Shelter	7,136	5,674	11,167	8,816
Entertainment	1,409	1,667	2,465	2,977
Food	4,832	4,728	6,965	6,919
Apparel and services	1,082	1,011	1,952	1,908
Transportation	6,267	5,965	11,368	10,674
Total change in spending	**-$484**		**-$1,072**	

Source: Aon Consulting

Managing Money in Retirement

For decades, the focus of both pre-retirees and financial advisors has been on asset accumulation as the key component of a sound retirement plan. The goal—to acquire enough money before retirement to enable the systematic draw-down of assets during retirement to supplement Social Security and pensions. But all that has changed. Traditional guaranteed retirement income sources are diminishing at the same time income needs are increasing, leaving the responsibility of both providing and managing retirement cash flow squarely on the shoulders of the retiree. In this new world of uncertainty, retirement planning needs to go beyond accumulation to focus on managing money wisely *during* retirement.

Longevity Risk

In 1900, an average American male could expect to live 40.4 years while an average female could expect to live 43.1 years. Fifty years later, this figure increased to 62.6 years and 67.4 years, respectively. By 2001, life expectancy for men reached 74.7 years and 79.8 years for women—almost double what it had been 100 years earlier.[12] Due to constant improvements in healthcare, medical technology, and lifestyles, there is little doubt that this trend will continue. While this is good news, it also places an ever increasing burden on retirees to create income strategies that will stand the test of time.

[12] Social Security eNews: http://www.ssa.gov/enews/2003/may/enews2003may.htm.

In planning for retirement, many people use "life expectancy" to calculate how long their income will need to last. However at age 85 (an age used by many as a typical assumed life expectancy), over 50% of females and 40% of males will still be alive. If this age had been used to calculate retirement income needs, those that live beyond life expectancy run the risk of using up their resources (other than Social Security and pensions) long before they die. This "longevity risk," (the risk of running out of money before running out of time) is a key factor to consider when determining how best to manage retirement income.

Financial Market Risk

Along with longevity, a second important risk factor which investors must consider when making retirement decisions is financial market risk. Volatility in the capital markets, as was so clearly exemplified during the recent downturn, can wreak havoc on a retirement strategy based on a constant rate of return. Market drops or corrections, especially during the early years of retirement, can greatly reduce the ability of a portfolio to generate sufficient income to meet retirement needs in the future.

As baby boomers become more dependent on their own personal savings for retirement income, and as they begin to liquidate assets in retirement, taking both these risks into consideration may make the difference between a comfortable retirement and one of mere subsistence.

Tools for Today’s Complex Retirements

Retirement today is not a one-size-fits-all situation. It is a constantly changing mosaic of different lifestyles, health needs, risk tolerances, and life spans. Traditional methods of forecasting wealth and income in retirement that use only systematic withdrawal strategies and assume a constant rate of investment return, can lead investors to believe they face little or no risk in funding retirement income needs. New analytical tools, however, are being developed which take a person’s unique characteristics into consideration along with longevity and market factor risks. One such tool, Monte Carlo simulation, is a computerized analytical model which considers thousands of pieces of data, such as inflation, interest rates, and market returns, and presents a range of probabilities that various outcomes might actually occur.

A recent study by Ibbotson Associates, commissioned by NAVA,[13] uses Monte Carlo simulation to demonstrate the probability of running out of money in retirement using a systematic withdrawal program. In the hypothetical case of a 65-year-old man with $100,000 to invest who wants to generate $5,000 annually, the analysis shows there is a 10% chance the portfolio would be depleted by age 84; a 25% chance it would be depleted by age 89; and a

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[13] *Why Investors Should Consider Lifetime Payout Annuities in Retirement,* commissioned by NAVA, research conducted by Ibbotson Associates, Inc.

50% chance it would be depleted by age 100. The study then analyzes the change in these probabilities when various combinations of fixed and/or variable annuities are added to the retirement portfolio. The results indicate that fixed and variable lifetime payout annuities provide an effective hedge against longevity risk, considerably reducing the likelihood of running out of money at any age. Thus annuitization helps investors achieve a sustainable income throughout retirement, regardless of how long they live.

Filling the Need for Sound Advice

As the focus of retirement planning shifts from asset accumulation to distribution strategies, there is a growing need for experts who understand the unique complexities of today's retirees. Issues of longevity, market fluctuation, medical and long-term care needs, as well as inflation, make planning for retirement a particularly difficult challenge for most individuals. Developing a financial strategy which provides for a retirement of uncertain length and expense is significantly different and more complex than creating a plan which focuses on accumulating a specific amount of money by a specific date. Despite this fact, there are currently few training programs specifically geared to those who want to acquire an expertise in this area.[14]

In an effort to address this problem, NAVA, in conjunction with InFRE, the International Foundation for Retirement Education, has developed a certificate course. Those who complete the course will be knowledgeable in all the areas surrounding retirement income, including issues such as longevity and investment risk, healthcare and long-term care, living expenses, and inheritance. The course represents a major step forward as more and more people begin to transition their savings into retirement income that will last as long as they live.

More Education Needed

A dramatic change is taking shape in the retirement industry. The largest group of people ever to retire will begin to reach age 60 in the next two years. As they enter their golden years, traditional sources of retirement income are diminishing, savings as a percent of disposable income are near an all-time low, and the need for retirement income is steadily increasing as retirees are living longer than ever before. While many Americans feel they are adequately prepared for retirement, most greatly underestimate the amount of money they will need to continue their current lifestyle once they leave the work force.

The financial services industry is addressing the challenges facing so many of today's pre-retirees, as well as those already in retirement. As the

[14] *Retirement Income Management Course Introduced at NAVA's Marketing Conference, NAVA Outlook*, January/February 2004, volume 13, Number 1.

focus is shifting from accumulation to decumulation, tools are being developed to more realistically analyze various retirement scenarios, and new courses are being created to provide specific knowledge in the area of retirement income.

More education on the part of the financial services industry, the press, and employers, however, is clearly needed to alert pre-retirees to the urgent need, not only to save more for retirement, but to carefully manage those savings once they retire. Only by planning and preparing ahead of time will today's baby boomers be able to reach a state of retirement readiness which will enable them to maintain their standard of living in retirement—no matter how long they live.

Saving for Retirement

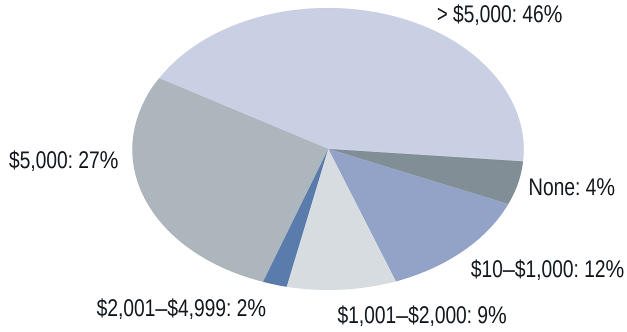
3

Annuities can play a vital role in helping investors achieve financial security in retirement. This chapter discusses how a deferred annuity contract operates during the savings or accumulation period. The information does not apply to an immediate annuity which starts benefit payouts right away and does not have an accumulation period.

Premiums

The accumulation period begins when the initial purchase payment (premium) is made by the policy owner and the contract is issued by the life insurance company. The contract owner can purchase an annuity with a modest or a substantial payment, subject to any insurance company limits. Typically, companies have minimum requirements for initial and additional premiums. However, sometimes a life insurance company that has a minimum initial payment requirement, for example $1,000, may permit a smaller initial amount if the purchaser agrees to pay premiums on a regular basis, e.g. through automatic payroll deduction. In addition, insurers may have lower minimum premium requirements for annuities in tax-qualified programs, such as 403(b) plans. An annuity owner can use gifts, an inheritance, or any other source of income to add to the contract. As is true for all qualified plans, contributions to annuities used to fund qualified plans such as 401(k)s must come from earned income.

Chart 1: *Variable Annuity Contracts by Minimum Initial Investment*
(percent of 2003 variable annuity contracts)



Source: NAVA and Finetre/VARDS

Under a flexible premium annuity, additional purchase payments of various amounts may be made on a regular basis or as personal financial circumstances permit. The government does not limit the total annual amount of purchase payments that can be made to a non-qualified annuity. Annuities used with qualified plans, however, are subject to annual contribution limits. Insurance companies may impose maximum premium limits, but these limits are typically very high and do not constrain most contract owners. Because of this feature, many retirement savers view non-qualified annuities as valuable personal retirement accounts to which they can contribute as much as they need for retirement.

Purchase Payment Credits or "Bonuses"

Some companies offer bonuses or credits on variable annuity purchase payments. Under this feature, the purchaser receives an immediate credit to his account equal to a percentage of the purchase payment. Bonus amounts generally range from 1% to 6%. For example, with a 3% bonus feature, a contract owner paying $10,000 in premium would have $300 credited immediately to his balance. Such bonuses may be credited to premiums paid only in the first year, or to premiums paid in any year. Variable annuities with bonus credits may have higher ongoing expense charges than variable annuities without bonus credits. Some contracts provide for the recapture of all or part of the bonus if the contract is surrendered within the first few years. Approximately 21.3% of the variable annuity contracts available in 2003 offered bonuses.

Dollar Cost Averaging

Contract owners who are wary of investing at a market peak can take advantage of dollar cost averaging programs, which are offered under many variable annuity contracts. For example, an owner may choose to allocate a substantial portion of purchase payments to a particular stock fund. If the allocation is made at one point in time, it is possible that a single purchase price could be locked in when asset values of the stock fund are relatively high. With dollar cost averaging, the premium is systematically transferred (typically from the variable annuity's fixed account option or money market investment option) to the stock fund over a specified period of time, with the goal of investing at lower as well as higher prices. While dollar cost averaging does not ensure a profit or protect against a loss, it can be an effective investment technique.

It is noteworthy that in a taxable account (e.g., a stand-alone mutual fund), there may be tax consequences to dollar cost averaging. Each time a transfer occurs, the investor sells the shares of one fund and uses the proceeds to buy shares of another. Any gain on the sale is subject to federal income taxes. When a variable annuity contract owner uses dollar cost averaging, however, such transactions are not taxed. Further, the owner does not need to keep track of purchase and sale prices for tax reporting purposes.

Types of Investment Options Offered in Annuities

Fixed Investment Options

As discussed in Chapter 1, annuities can be fixed or variable. Fixed annuities offer a rate of return that is determined by the insurance company for a set period of time, subject to a specified minimum. When the applicable period is over, typically after 1, 3, 5, 7, or 10 years, the company will offer a new rate for the next period, which can be for a different length of time. Fixed annuities generally specify a minimum credited rate for the lifetime of the contract.

Variable Investment Options

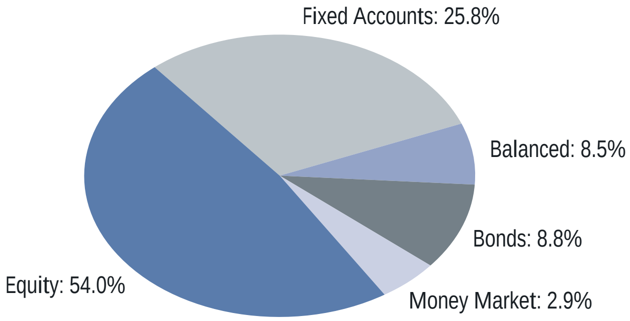
In a variable annuity, investment choices are offered through subaccounts, which invest in a selection of funds similar to mutual funds that are sold to the public. The value of the subaccounts will fluctuate over time, with the variable annuity's return based on the investment performance of these subaccounts.

A variable annuity contract will generally permit the owner to choose from a range of subaccounts with different investment objectives and strategies. The choices may include stock funds, bond funds, balanced funds, money market funds, and specialty funds such as asset allocation, international and sector funds. The average number of funds per variable annuity contract in 2003 was 38, compared to 34 in 2002.

The subaccounts are often managed by different investment advisors, who may or may not be affiliated with the insurance company. In fact, a number of well-known mutual fund companies offer subaccounts that serve as investment options for variable annuities.

In their basic form, no minimum return guarantees apply to these subaccounts, although in recent years, insurers have offered the ability to select various forms of return minimums.

Chart 2: *Variable Annuity Net Assets by Investment Objective*
(percent of 2003 net assets)



Source: NAVA and Finetre/VARDS

Many variable annuities offer a fixed account (effectively an embedded fixed annuity) within the variable contract. Even though these fixed options may be available, at the end of 2003, 54% of variable annuity assets were invested in equity portfolios with an additional 8.5% in balanced or asset allocation portfolios, which themselves have a substantial weighting in equities (typically 40% to 60% depending on the fund manager's investment style and current market conditions).

Transfers

During the accumulation period, variable annuity contract owners may transfer money from one investment option to another, tax free. Certain restrictions usually apply with respect to the number and amount of transfer payments that may be made in any one year from a fixed account contained inside a variable annuity contract. Restrictions may also apply to the number of transfers that may be made among the variable investment options within a specified period of time. Sometimes, a nominal administration charge applies to excess transfer transactions.

Tax Deferral

Tax deferral, a key feature of deferred annuities, allows funds to grow tax-deferred until withdrawn, usually upon retirement. Such deferral can make a significant difference in the amount of money accumulated over time. The longer the investment is held, the greater the impact tax deferral has on the amount of retirement savings. (See Chapter 9 for more information on tax deferral.)

A recent study by PricewaterhouseCoopers[1] assessed the impact of the May 2003 Jobs and Growth Tax Relief Reconciliation Act on the after-tax performance of deferred load variable annuities and mutual funds held outside qualified retirement accounts. The research found that, even after the changes brought about by the 2003 Tax Act, tax-deferred annuities are still an attractive investment for long-term savers.

Asset Allocation Programs

Determining the Right Investment Options

Variable annuities offer investors a wide variety of funds to choose from to match their risk tolerance and views of the market. But choosing the right mix can be a challenging process. There are different types of asset allocation programs available to help variable annuity purchasers analyze their risk tolerance and decide on a specific mix of funds.

Portfolio Rebalancing

Once the desired investment mix has been chosen, purchase payments are allocated in accordance with those percentages. However, as time goes on, market performance may alter the percentage of the variable annuity's contract value held in certain subaccounts (either higher or lower). Many variable annuity issuers offer programs that automatically maintain a specified investment diversification based on the particular investor's needs. These programs, referred to as portfolio rebalancing programs, periodically reallocate variable annuity contract assets among fixed and variable investment options to reflect the proportions originally selected.

Importance of Tax Deferral to Rebalancing Programs

Tax-deferral benefits are vital to rebalancing programs. In taxable accounts, each time an investor sells a stock, mutual fund or other investment and replaces it with another in order to reallocate assets, the investor can be required to pay short- or long-term capital gains tax on any growth the investor has enjoyed. In a variable annuity, an owner can rebalance between funds as desired, without paying taxes, thereby maximizing his or her investment potential.

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[1] *Annuitization vs. Systematic Withdrawals After the 2003 Tax Act,* Pricewaterhouse-Coopers, October 20, 2003.

Optimizing Portfolio Allocations

While traditional asset allocation models help pre-retirees manage their assets according to their individual risk tolerance, a new NAVA study conducted by Ibbotson Associates[2] questions the effectiveness of models which do not take longevity risk, (the risk of outliving one's assets) as well as financial market risk (the risk of market volatility), into consideration. Using Monte Carlo simulation analysis, the study compares ways of converting personal savings into lifetime income (i.e., systematic withdrawals vs. lifetime payout annuities). The study shows that incorporating fixed and variable lifetime payout annuities into traditional asset allocation models can significantly reduce the chance of running out of money during retirement.

Surrenders

Deferred variable annuity contracts permit the contract owner to surrender the annuity contract during the accumulation period and receive a cash payment from the insurance company. This amount is called the cash value or cash surrender value of the contract. It equals the sum of premiums paid and subsequent earnings, minus prior withdrawals and charges deducted. The owner may take partial withdrawals or fully surrender the contract during the accumulation phase. Federal income taxes apply to any gain in the contract.

The amount paid to the contract owner on surrender may be subject to surrender charges. Some deferred annuity contracts impose surrender charges only for an initial period after the contract is purchased; others start a new surrender charge period for each individual premium paid. Surrender charges usually decline to zero over a period of time such as five or seven years.

A partial surrender is a withdrawal of an amount less than the entire cash surrender value of the contract. Partial surrenders can also be taken as a pre-scheduled series of payments under a systematic withdrawal plan. Many contracts permit annual withdrawals of an amount, such as 10% or 15% of the contract value, that is free of a surrender charge. Contracts also generally waive surrender charges for withdrawals associated with events such as confinement to a nursing home or the contraction of a critical illness. Tax penalties may apply, however.

[2] *Why Investors Should Consider Lifetime Payout Annuities in Retirement*, commissioned by NAVA, conducted by Ibbotson Associates, Inc., 2003.

Guaranteed Minimum Death Benefits

Deferred annuity contracts usually provide for a death benefit payable to a named beneficiary if the policy's owner dies while the contract is still in the accumulation phase. A death benefit may also be offered upon the death of an annuitant, or the contract may provide that a new annuitant take the place of the deceased annuitant. The contractual payout of the death benefit varies by contract. The death benefit can be payable as a lump sum payment or as periodic annuity payments. (The tax treatment of death benefits is discussed in Chapter 9.)

Variable annuity contracts have traditionally offered a guaranteed minimum death benefit (GMDB) during the accumulation period that is generally equal to the greater of (a) the contract value or (b) premium payments less any prior withdrawals. The GMDB gives contract owners the confidence to invest in the stock market, which is important in order to keep pace with inflation, since they know that their family will be protected against financial loss in the event of an untimely death.

Over the past ten years, many insurers have offered enhanced GMDBs. Some type of enhanced death benefit is now available with 58% percent of variable annuity contracts. The different types of enhanced GMDBs are described below, some of which have additional associated charges.

Contract Anniversary Value, or "Ratchet"

Some life insurance companies offer ratchet GMDBs that are equal to the greater of (a) the contract value, (b) premium payments less prior withdrawals or (c) the contract value on a specified prior date. The specified date could be a prior contract anniversary date such as the date at the end of every seven-year period, every anniversary date, or even more often. A ratchet GMDB locks in the contract's gains on each of the specified prior dates.

Initial Purchase Payment With Interest, or Rising Floor

Some insurers offer a rising floor GMDB that is equal to the greater of (a) the contract value or (b) premium payments less prior withdrawals, increased annually at a specified rate of interest.

In some cases, a ratchet and a rising floor may be available within the same contract. Some contracts offer a choice of a ratchet or a rising floor.

Enhanced Earnings Benefits

Not all variable annuity death benefits are associated with protecting against falling markets. Some more recent variable annuity contracts offer enhanced earnings benefits (EEB), which provide a separate death benefit to offset the federal income taxes on any gains in the contract. With this feature, beneficiaries will receive not only the base death benefit amount, but also an additional amount which is usually equal to a percentage of the contract's earnings at death (e.g. 40%).

Guaranteed Minimum Living Benefits

Until recently, principal protection under variable annuity contracts was offered only in the case of death. Insurers now offer living protection against investment risks under variable annuity contracts by guaranteeing the level of a variety of different benefits.

Various types of guaranteed minimum living benefits are described below. Besides being offered in new contracts, some companies allow them to be added to existing contracts. Charges typically are asset-based (i.e., expressed as a percentage of account value).

Guaranteed Minimum Income Benefit

A guaranteed minimum income benefit (GMIB) guarantees that if the owner annuitizes the contract, income payments on the annuity starting date will be based on the greater of the actual contract value or a minimum payout base. This payout base generally equals premiums credited with some interest rate or the maximum anniversary value of the account prior to annuitization. At the end of 2003, approximately 27% of variable annuity contracts offered a form of GMIB.

GMIBs are typically offered as a rider to variable annuity contracts for an optional charge ranging from 30-75 basis points per year. Contracts with GMIBs usually require a waiting period, typically seven to ten years, before the guaranteed benefit can be exercised. Age limits may also apply.

Guaranteed Minimum Accumulation Benefit

A guaranteed minimum accumulation benefit (GMAB) guarantees that a policy owner's contract value will be at least equal to a certain minimum amount after a specified number of years, regardless of actual performance. Many GMABs guarantee a return of premium after a ten year period.

The cost of the GMAB feature typically ranges from 25-50 basis points if the contract requires an asset allocation be followed. If asset allocation is not required, then the cost generally ranges from 65-75 basis points or more. At the end of 2003, approximately 12% of variable annuity contracts offered a form of GMAB.

Guaranteed Minimum Withdrawal Benefit

A guaranteed minimum withdrawal benefit (GMWB) guarantees the systematic withdrawal of a certain percentage (usually 5%-7%) of paid premiums annually until premiums paid are completely recovered, regardless of market performance.

The cost typically ranges from 30-75 basis points annually. GMWBs, first introduced in mid-2002, have shown a steady gain in popularity. At the end of 2003, approximately 15% of variable annuity contracts offered a form of GMWB.

Long-term Care Protection

Some variable annuity contracts have features designed to address aging Americans' concerns about long-term care. Many contracts permit owners to withdraw money from their contracts for long-term care needs without incurring surrender charges. Surrender charges may be waived if, for example, a contract owner has been confined to a nursing home for a minimum period or has suffered a critical illness. Additional benefits may be offered such as eldercare resources, referral and consultation services, and discounted long-term care services from a group of providers.

Receiving Retirement Income

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While much of the focus on variable annuities in recent years has been on their value as a savings vehicle for retirement, their value as a source of lifetime income during retirement is equally important. Traditional sources of guaranteed retirement income are diminishing at the same time retirees are living longer, more active lives. This places the burden on individuals to not only save carefully for retirement, but to wisely manage their investments during retirement so their money lasts as long as they live. The choices retirees make about how best to receive income from their annuity can play an important role in these decisions.

Income Options

Once a person is ready to retire, annuities offer a number of retirement income options. The contract owner can choose to receive all the assets in the annuity vehicle at once, opt for a series of withdrawals at his or her choosing until all the assets are exhausted, or decide to exercise the annuitization features of the contract.

Lump Sum Option

With this option, the annuity is surrendered and all assets are withdrawn. Taxes will be due on all earnings in the year the money is received. Individuals are still faced with the need to generate an income stream.

Systematic Withdrawal Plan

With a systematic withdrawal plan, the assets are left in the annuity and the contract owner receives distributions at regular intervals until the assets have been exhausted, or the contract owner elects to suspend the operation of the plan. All earnings on the investment are considered to be distributed before any return of principal and are taxed at ordinary income tax rates. Assets remaining in the annuity continue to grow tax-deferred until withdrawn.

The principal advantages of a systematic withdrawal plan are the flexibility provided to the contract owner and the ability to maintain full ownership of the assets. The principal disadvantage is that the contract owner retains the risks associated with both uncertain longevity and investment fluctuations, particularly the exposure to adverse market performance during the early stages of retirement.

If a specified dollar amount is withdrawn each period, whether adjusted for inflation or not, the contract owner assumes the full risk of market cycles. The very principles that recommend dollar cost averaging as a successful strategy for entering the market, work against the contract owner in a liquidation strategy. Withdrawal of a fixed dollar amount means that a higher percentage of assets will be liquidated in a down market than in an up market. A number of studies have demonstrated that this can be a very dangerous strategy, even if long-term investment performance meets anticipated targets, since the withdrawal of assets in earlier years prevents the overall portfolio from achieving the projected return.

The withdrawal of a specified percentage of assets rather than a specified dollar amount can reduce this risk. Studies suggest that, nonetheless, withdrawals of more than 5% per year may cause depletion of the asset base. This rate of withdrawal may not be sufficient to maintain the desired lifestyle.

Annuitization

By exercising the annuitization provisions of the annuity contract, the contract owner can transfer the longevity risk to the insurance company and, depending on whether a fixed or variable annuitization option is chosen, the investment risk as well.

Annuitization involves a series of payments that an insurance company makes over a specified period of time. The company guarantees that it will provide payments for the duration of the time period. With a deferred annuity, money is saved and invested during the accumulation period, and then annuity payments are received in the payout period. With an immediate annuity, annuity payments begin immediately, or within one year after the annuity is purchased.

There are many different types of annuity payments to choose from. For example, the company may promise to make payments for a certain period, such as 10 years, or for the life of the annuitant. This latter type of annuity payment stream, called a life annuity, provides lifetime income and can be an important risk management tool for individuals. Period certain and lifetime income payment guarantees can be combined to assure a minimum return regardless of how long the annuitant lives.

The essential feature of a life annuity is that it can generate a higher income payment than would be the case for an individual systematic withdrawal plan, even if the underlying investment performance were the same for both situations. As discussed in Chapter 1, this is due to the pooling of risk. The individual who lives beyond a normal life expectancy, receives an excess principal return; while the person who does not survive until his or her projected life expectancy, forfeits the remaining undistributed principal. As shown below, there are a number of options for mitigating this risk. Each of these options, however, results in a lower basic periodic payment.

Types of Annuity Payments

Different types of annuity payments are available to address the varied needs of individuals. As discussed above, these payments can be categorized as "period certain annuities" or "life annuities."

Period Certain Annuities

Under a period certain annuity, payments continue for a specified time, for example 10 years, no matter how long the annuitant lives. If the annuitant dies before the period has expired, payments continue to designated beneficiaries for the remainder of the period. Period certain annuity payments typically are available for periods from 5 to 30 years.

Life Annuities

A life annuity provides an income stream that lasts as long as the annuitant lives. Under a straight or pure life annuity, annuity payments stop when the annuitant dies. A joint and last survivor annuity provides income for as long as either of the two annuitants is alive, although the amount of each payment is less than if the payment were based on a single life. Couples often choose this type of annuity. After the death of the first annuitant, payments may stay the same or decrease. For example, under a joint and two-thirds annuity, each payment made after the death of the first annuitant is two-thirds of the amount paid while both annuitants were alive.

Refund Annuities

With a pure life annuity, payments stop when the annuitant dies. In the most extreme case, an annuitant could die after one payment is made, forfeiting the balance of the account. Some annuitants prefer to hedge against this possibility by setting up a life annuity with some form of refund feature, e.g. a period certain provision, such as 10 years. As indicated earlier, such hedge provisions reduce the amount of the basic lifetime payments.

In determining whether to elect a life annuity, and how much to commit to it, individuals must determine their risk tolerance with respect to their possible longevity, and the relative importance to them of lifetime income versus leaving money to their heirs. For people who live beyond normal life expectancy, a life annuity will generate higher income but will lower the value of their residual estate. The following table helps illustrate the trade-off decisions involved in weighing the alternatives.

Table 1: *Risk Tolerance vs. Bequest Motive*

	Low Bequest Motive	High Bequest Motive
Low Risk Tolerance	Full annuitization	Annuitize essential living expenses
High Risk Tolerance	Annuitize essential living expenses	Annuitize essential living expenses

Liquidity Options

Historically, once a contract had been annuitized, the stream of payments could not be altered. Some insurance companies have begun offering life annuities under which annuitants, who have also selected a period certain option, can elect to receive an advance of a given percentage of the payments. These liquidations will reduce the remaining annuity payments during the balance of the period certain term, but the payments will return to previous levels if the annuitant survives beyond the period certain.

Determining Variable Annuity Payments

With a fixed annuity, the insurance company sets a given rate it will pay for the term of the contract. With a variable annuity, the amount of each payment is not guaranteed; it will vary with the performance of the underlying portfolio selected by the contract owner.

Since the investment return of the portfolio can not be determined in advance, some assumptions must be made in order to calculate the amount of the initial payment under the contract. This is accomplished by selecting an assumed interest rate or "AIR." After the initial payment, each subsequent payment is determined by adjusting the previous payment up or down based on the actual performance of the underlying portfolio for the period of time in question. If the portfolio earns more, then the subsequent payment will increase. If the portfolio earns less, the payment will decrease. If it earns the same amount, the payment will stay the same.

Some contracts set the AIR, but most allow the contract owner to choose from a range (usually 3%-6%), the outside limits of which are set by state regulations. Selecting a low AIR will cause payments to increase faster with good performance, or decline more slowly with poor performance, than if a higher AIR were selected.

Levelized Annuity Payments

Some variable annuity contracts provide payment streams that can be adjusted at periodic intervals of up to 12 months, rather than on a monthly basis, in order to provide the annuitant with an element of certainty. This allows the annuitant to plan on a given level of payments for the period in question. When the periodic adjustments are made, however, they are likely to be more substantial than if the adjustments had been calculated more frequently.

Payment Stabilization Guarantees

Some variable annuity contracts offer payments supported by "floors." These floors guarantee that subsequent payments will never be less than a given percentage of the original payment, regardless of the performance of the underlying portfolio. These provisions often limit the choices of subaccounts underlying the annuity to portfolios such as an S&P 500 fund, providing the insurance company with the opportunity to hedge its guarantee with derivative instruments. These floors provide contract owners with a safety net that may make them more comfortable in having their annuity payments subject to the variability of stock market performance. If a contract owner chooses this feature, however, payments will be lower than if no floor were elected.

Taxation of Annuity Payments

Current federal income tax law provides that annuitized payments are taxed at ordinary income tax rates.

If the annuity was purchased with non-qualified, or "after-tax" dollars, a portion of each payment is considered to be a tax-free return of principal. The remainder of the payment is subject to taxation to the extent it represents earnings. The insurance company makes the underlying calculation based on a formula known as the "exclusion ratio."

If the annuity was purchased with qualified, or "pre-tax" dollars, using funds from an IRA (other than a Roth or an after-tax IRA) or 401(k) account, the full amount of each distribution is taxable, even the amount attributable to principal.

Qualified assets, once they have been annuitized, are not subject to the required minimum distribution rules of the Internal Revenue Code since the insurance company is considered to have already made the appropriate calculation for a lifetime distribution of the underlying assets. (See Chapter 9 for more details on taxation.)

Qualified Retirement Plans

5

The landscape for retirement planning has changed dramatically over the past 30 years. As mentioned in Chapter 2, people are living longer in retirement than at any point in history. With traditional sources of retirement income diminishing, individuals need to take a more active role in their own retirement planning.

In recognition of this need, the government has permitted a number of tax-favorable retirement plans which allow individuals to save for their own retirement. These "qualified retirement plans" must meet specific requirements of various provisions of the Internal Revenue Code and, in some cases, the Employee Retirement Income Security Act of 1974. While it is important to understand the various retirement plans available, they can be very confusing. Some of the most common types of qualified retirement plans are described below.

Types of Qualified Retirement Plans

Individual Retirement Arrangements (IRA)

The most common types of IRAs are traditional IRAs and Roth IRAs, which are the ones we will cover here. Other types include SEPs and SIMPLEs. An IRA is a tax-deferred retirement plan, typically set up through a bank, mutual fund, brokerage firm, or life insurance company, which allows an individual to contribute money each year (subject to certain limits), and invest it in stocks, bonds, mutual funds, or annuities. In 2004, for example, individuals younger than age 50 can contribute up to \$3,000 to an IRA, while individuals age 50 and older can contribute up to \$3,500. Earnings on the contributions (investments) grow tax-deferred. If the money is withdrawn before age 59½, there is generally a 10% early-withdrawal tax penalty.

- Traditional IRA

  Only those who do not participate in an employer-sponsored pension plan, or who participate in such a plan but meet income guidelines, can make tax-deductible contributions to a traditional IRA. However, anyone with earned income can make contributions on a non-deductible basis. If contributions are made on a tax-deductible basis, all distributions are taxable to the recipient in the year they are received. If contributions are made on a non-deductible basis, only the income portion of the distributions is taxed. Income distributions from a traditional IRA generally must begin by April 1 following the year the owner turns 70½.

- Roth IRA

  The general parameters of the Traditional IRA also apply to the Roth IRA, including the 10% tax penalty and the contribution limits. However, there are very important differences between the Traditional and Roth IRAs. Contributions to a Roth IRA are *never* tax-deductible when made, an individual can contribute to a Roth IRA even if he is participating in an employer-sponsored retirement plan, and all withdrawals from the Roth IRA after age 59½ are tax-free, as long as the funds were held in the Roth for at least five years. Only individuals with annual income below certain amounts can establish a Roth IRA.

401(k)

A 401(k) is an employer-sponsored retirement plan which allows employees to make pre-tax deferrals of a portion of their employment compensation (according to set limits, which are considerably higher than those for IRAs). In many plans, a portion of the employee's contribution is matched by the employer. Withdrawing funds before the specified retirement age may trigger a tax penalty. Income distributions from a 401(k) plan are taxable to the recipient in the year in which they are received. Distributions must begin by the later of April 1 following the year the employee turns 70½, or retirement.

403(b)

A 403(b) plan is similar to a 401(k) plan but is offered by educational organizations such as universities, and charitable organizations such as hospitals. The contribution limits for 403(b)s are generally the same as for 401(k)s. Also like 401(k)s, there is a 10% tax penalty for early withdrawal from a 403(b) plan. Earnings in a 403(b) plan grow tax-deferred until they are withdrawn, at which point they are taxed as ordinary income. Income distributions must begin no later than age 70½ or the year of retirement, whichever is later. Section 403(b) plans can invest only in annuities or mutual funds, and most are invested in annuities.

457

A 457 plan is a tax-exempt deferred-compensation plan, similar to the 401(k) plan, which is available only to employees of state and federal governments and tax-exempt corporations. Unlike 401(k) plans, 457 plans do not allow employer matching contributions. Contributions to a 457 plan come exclusively from the employee. Participants can defer the same amount of their employment compensation as in a 401(k) plan, and contributions and earnings are tax-deferred until withdrawn, at which time they are taxed as ordinary income.

Defined Benefit Plans

Defined benefit plans are a form of employer-sponsored plan under which the employer contributes sums sufficient to guarantee the employee (and his or her spouse) a lifetime income of a certain dollar amount, e.g., $1,000 a month for life. Unlike a 401(k) plan, employees rarely contribute any of their own money to a defined benefit plan. "Defined benefit plans" are often contrasted with "defined contribution plans" such as a 401(k) plan, under which the employee’s benefit simply equals the sum of employee/employer contributions, plus invested earnings.

Shift in Retirement Plan Assets

As of the end of 2002, Americans had nearly $10 trillion in assets invested in qualified retirement plans. This represented a 6.5% decrease from $10.69 trillion in assets at year-end 2001.

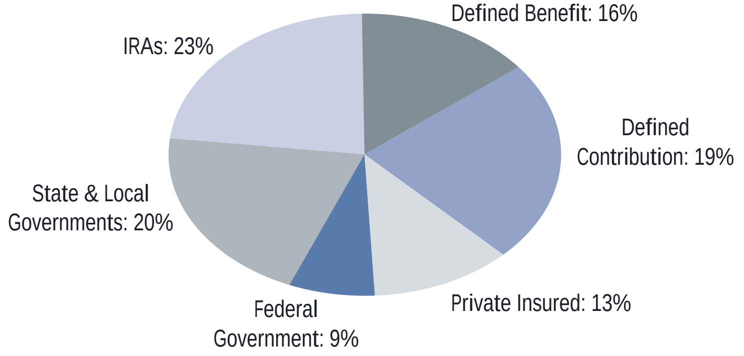
The percentage of assets held in various types of retirement plans has changed significantly over the last 23 years, reflecting a shift from employer-sponsored defined benefit plans to employee-funded accounts, such as 401(k) plans.

Over the period of 1979 to 1998, the Department of Labor reported that the percentage of workers who participated in defined benefit plans decreased by 16%, while the percentage participating in defined contribution plans rose by 20%.[1] It is estimated that today less than 25 million workers are covered by a traditional employer pension plan.

At the end of 2002, assets held in individual retirement accounts (IRAs) and Keogh plans accounted for the largest segment of the market, accounting for $2.23 trillion, or 23% of total retirement plan assets. Assets in defined contribution plans were $1.87 trillion, or 19% of total assets. In contrast, assets held in employer-sponsored defined benefit plans decreased from 34% to only 16% of total retirement plan assets from 1985 to 2002.

[1] Department of Labor; GAO report on private pensions, July 2003.

Chart 1: *Total U.S. Retirement Plan Assets 2002*
(100% = $9.98 trillion)



Source: EBRI Pension Investment Report: First Quarter 2003 and Federal Reserve Board, Flow of Funds Accounts: Second Quarter 2003.

The Use of Variable Annuities in Qualified Plans

In 1952, the Teachers' Insurance and Annuity Association—College Retirement Equity Fund (TIAA-CREF) developed the first variable annuity for use in college and university retirement plans. Since then, annuities have become an increasingly popular funding vehicle for these and other tax-qualified arrangements such as individual retirement accounts and 401(k)s.

At the end of 2003, variable annuity assets invested in qualified retirement plans totaled $598.5 billion, a 20% increase over 2002. Yet despite this continued growth, critics continue to question the value of using variable annuities to fund qualified plans. Why, they ask, should investors put one tax-deferred vehicle (a variable annuity) inside another tax-deferred vehicle (a qualified plan) particularly when fees for variable annuities are higher than those of other investments such as mutual funds?

Using a variable annuity to fund a qualified retirement plan will not provide any additional tax-deferred treatment of earnings beyond the treatment provided by the qualified retirement plan itself. However, variable annuities offer other benefits besides tax deferral that can make them suitable for use in qualified plans, such as lifetime income payments, family protection through the death benefit, and guaranteed fees.

The primary goal of a retirement plan isn't to obtain tax deferral but, rather, to provide retirement income that will last for the life of the recipient. Variable annuities are designed to accomplish this goal by providing for the accumulation of assets during the owner's income-producing years, and guaranteeing payments in retirement that last for as long as he or she lives.

Many defined contribution plans don’t otherwise offer their participants this option, so for people who want an income they can’t outlive, a variable annuity can be very valuable.

Variable annuities were specifically created and designed for the qualified market and have been recognized by Congress in the Internal Revenue Code to be legitimate funding vehicles for qualified plans. When used to fund a qualified plan, these payments can also be used to satisfy the Internal Revenue Code's minimum distribution rules. Their use in this market is both long-standing and widespread.

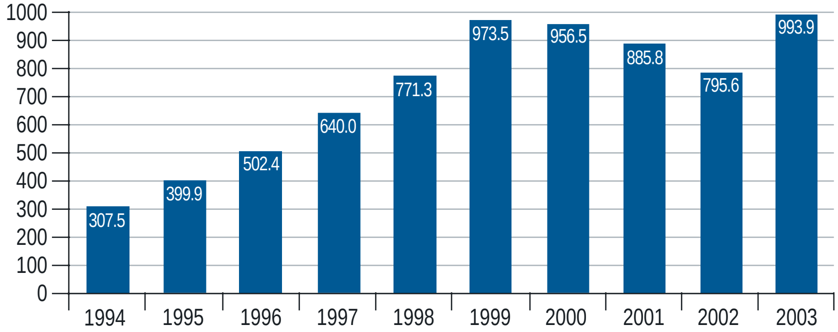
Variable Annuity Developments

6

Factors Impacting the Variable Annuity Industry

Two themes best describe the variable annuity market in 2003: recovery in the equity markets, and ongoing concern with equity market volatility. Coming on the heels of a strong equity market recovery in 2003 (the S&P increased 26.4%, the NASDAQ increased 50%), variable annuity total sales[1] moved ahead at a brisk pace, growing 9.9% over 2002. Total variable annuity assets also rebounded strongly in 2003, reaching $993.9 billion. This represents a 24.9% growth over total assets as of the end of 2002, reflecting both the equity market upturn and growth in net sales (see page 49). The level of variable annuity assets is now close to its all time high of just over $1 trillion dollars which occurred in the first quarter of 2000.

Chart 1: *Variable Annuity Net Assets*
(dollars in billions)



Source: NAVA and Finetre/VARDS

[1] *Total Sales* (also called total premium flows) represents the sum of new sales (all first-time buyers of a contract, including inter- and intra-company exchanges) and additional premiums from existing contract owners. *Net Sales* (also called net flows) represents Total Sales minus surrenders, withdrawals, inter- and intra-company exchanges, and benefit payments.

Despite the equity market rally, memories of the recent three-year bear market appear to be still fresh in the minds of consumers. A contributing factor to the strong growth in the variable annuity market in 2003 was the presence of attractive living benefit guarantees, including guaranteed minimum withdrawal benefits (GMWBs), and guaranteed minimum income benefits (GMIBs). Over 50% of new sales in 2003 were from annuities which provided some form of living benefit guarantee. Many companies, and the distributors they sell through, relied on these features as a key part of their product offering.

The GMWB product, in particular, attracted considerable attention in the market. Although there are numerous designs available through multiple companies, the core concept of this benefit is a return-of-premium feature which permits partial withdrawals (typically 7%) over approximately 15 years. This provides contract owners with both early income and protection against equity market downturns. Contract owners have embraced this benefit.

The recent bear market also appears to be fresh in the minds of many industry stakeholders (life insurance companies, life insurance industry investors, stock analysts, and rating agencies). This has led to careful scrutiny of companies' risk management policies. In the past, companies relied primarily on reinsurance to manage their equity market exposure. Now, however, reinsurance availability has largely dried up, and companies have been forced to explore other options. An increasing number of companies have begun to implement hedging programs to mitigate their exposure to equity market volatility. Although this is not a panacea (cost is one issue), utilizing a hedging program allows companies to better control their equity market exposure.

There were other events that impacted the variable annuity market in 2003. A new tax law was passed—The Jobs and Growth Tax Relief Reconciliation Act of 2003. A key aspect of the new law, reducing the tax rate on equity dividends and long-term capital gains to 15%, benefits mutual funds, but not variable annuities. Despite concerns that variable annuities would be perceived as less tax-advantaged, however, the new law appears to have had minimal impact so far on variable annuity sales, as evidenced by the nearly 10% growth in sales in 2003. This is most likely due to variable annuities' increased focus on guarantees, as well as the ongoing shift of sales to the qualified market (where relative tax rates are less of an issue in comparing values) now at 59% of total, up from 49% in 1998.

Another factor that impacted the industry in 2003 was the continued consolidation in the life insurance industry. This was evidenced in part by the decline in the number of companies offering variable annuities which reached a high of 78 in 1998, but dropped to 50 by 2003. The impact of consolidation can also be seen in relative market share—the top 25 variable annuity issuers accounted for 94% of total sales in 2003, up from 89% in 2002. The result is fewer, but larger, companies which have a greater chance of achieving minimum scale requirements in the areas of distribution, operations, and fund management. (The premise is that larger size operations drive lower unit costs.)

Again this year the industry pressed its case for the use of payout annuities, also called immediate annuities, by individuals to meet their retirement income needs. Payout annuities are the only financial instrument that can guarantee consumers income for life.

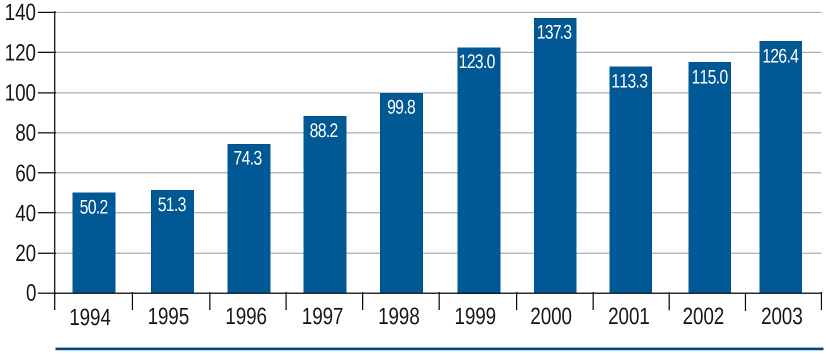
NAVA continued its work on National Retirement Planning Week (held in November each year), raising awareness of the ability of payout annuities to meet retirement needs. Work also continued urging Congress to adopt legislation that would provide for more favorable tax treatment for payout annuities. Despite these efforts, sales of variable payout annuities remain small, accounting for only $500 million of sales in 2003.

Finally, the industry continued to introduce a variety of new products to distributors and consumers. It is not unusual now for a company offering variable annuities to provide various share class choices (see Chapter 1), product series, and guarantee features. For example, companies may offer B-share, C-share, L-share and bonus products, under two (or more) different plan series (perhaps a single fund manager product and a multiple fund manager product). Then for each of these, they may offer a variety of riders such as enhanced GMDB, GMIB, GMWB, as well as an earnings enhanced death benefit (EEDB), which credits additional amounts as a percentage of earnings on death.

2003 Variable Annuity Statistics

As noted earlier, variable annuity total sales grew 9.9% in 2003, reaching $126.4 billion by year end. This continues the strong long-term growth trend of variable annuity sales. In fact, variable annuity total sales have increased nine out of the past ten years, and have grown over this period at a 10.8% compound average annual growth rate, which is among the highest of any life insurance product.

Chart 2: *Variable Annuity Total Sales*
(dollars in billions)



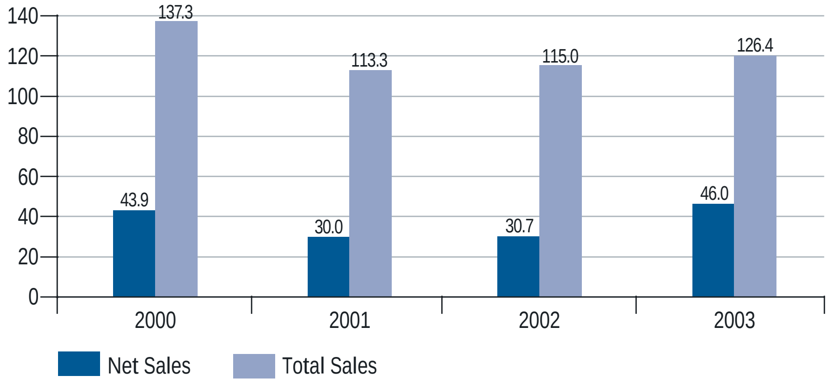
Source: NAVA and Finetre/VARDS

An increasingly important measurement in the variable annuity business is net sales which deduct redemptions and transfers from total sales. Long used in the mutual fund industry, the use of the net sales metric in the variable annuity industry is growing. Net sales in 2003 were $46.0 billion, up significantly from 2001 and 2002 levels, both at approximately $30 billion. Growth in net sales in 2003 was due both to higher total sales as well as lower redemptions. The latter is most likely due to several factors, including ongoing efforts by insurers to retain a greater portion of business after the surrender charge period expires, a lower dollar amount base of variable annuity assets in 2003 that could be transferred, and less competition from fixed annuity products due to lower interest rates.

The ratio of net sales to total sales has generally declined over time, from an estimated 85% in 1994 down to 36% by 2003. This decline is not unexpected. When total assets grow (both because of net sales and asset appreciation), there is a larger base for redemptions. Thus, net sales have to grow at an increasing rate to maintain a level net-to-total-sales ratio (assuming asset appreciation).

Chart 3: *Variable Annuity Net Sales and Total Sales*

(dollars in billions)

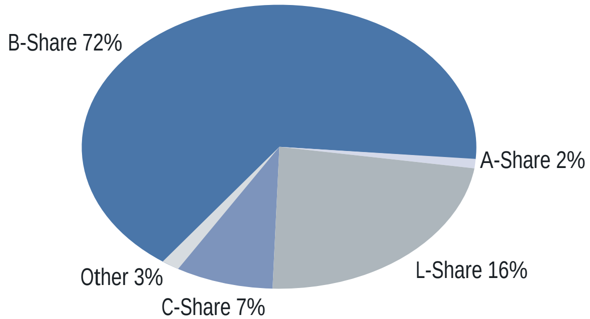


Source: NAVA and Finetre/VARDS

Variable annuity products continue to be offered in a variety of share types. Traditional B-share contracts, containing surrender charge periods of approximately seven years, continue to be the leading seller with 72% market share. (This also includes most bonus products as they typically employ a B-share chassis.) 2003 saw continued growth in popularity of L-share contracts (which have shorter surrender charge periods, typically three to four years) which increased their market share 4% to reach 16%. The growth in L-shares came largely at the expense of C-share products (which have no surrender charge period) as market share dropped from 14% to 7%. The shift reflects both decline in usage of the fixed account on C-share products (which helped drive their sales in 2002 but which some companies have eliminated or made less attractive), as well as the ongoing popularity of L-share products (reflecting both their shorter surrender charge period and attractive asset-based trailer).

Chart 4: *Variable Annuity Share Class Distribution*

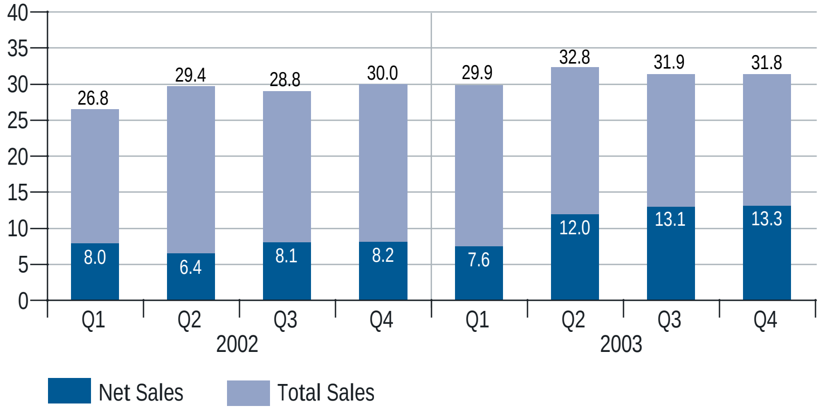
(Non Group New Sales—YTD 12/31/03)



Source: NAVA and Finetre/VARDS

Quarterly variable annuity sales were reasonably stable by quarter in 2003, ranging from a low of $29.9 billion in the first quarter to a high of $32.8 billion in the second quarter. Having variable annuity sales peak in the second quarter is not unusual as this has occurred in three of the past four years (and just missed in 2002). This is likely due to the April 15 deadline for certain qualified plan transactions, including IRAs.

Chart 5: *Variable Annuity Quarterly Sales*
(dollars in billions)



Source: NAVA and Finetre/VARDS

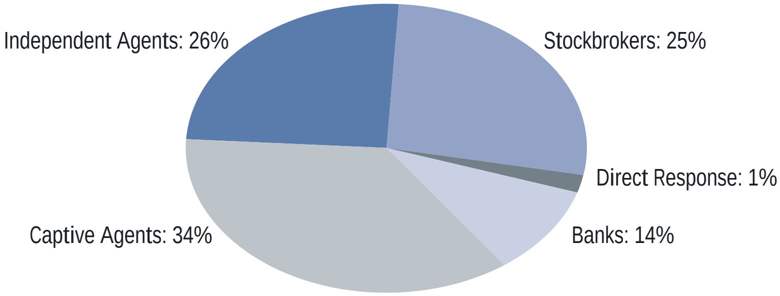
Investment returns and the flow of funds among investment objectives over the years have resulted in significant shifts in asset allocation. Prior to the passage of the Tax Reform Act of 1986, variable annuity buyers were primarily from the 403(b) marketplace. They traditionally were more conservative in their allocation of assets, often putting a large share of their money into the fixed account. In the mid 1980s fixed accounts and money market funds together held almost 50% of total variable annuity industry assets. The tax act increased the number of variable annuity buyers looking for tax-deferred investments as it eliminated many tax shelters. New products, with increasing numbers of investment options, were steadily introduced and by the end of 1995, assets held in fixed accounts and money market funds had declined to a collective market share of 37.7%. In subsequent years, the percentage of assets held in these conservative options continued to decline as investors took advantage of the enormous increase in the value of equities in the 1990s bull market.

During the 2000-2002 bear market, fixed accounts and money market funds saw a steady increase in their percentages of industry assets as more sales were directed into these accounts and as negative equity returns reduced the equity fund assets.

In 2003, however, this trend was reversed. Collectively, the share of assets in the fixed account and money market funds dropped 5.7%. Virtually all of the change flowed into the equity accounts, which is not surprising given the equity market upturn. In aggregate, the amount of assets in equity funds grew by slightly over $150 billion. Almost 75% of this growth came from two equity categories: Growth, and Growth & Income. Although still equity funds, these two categories are somewhat less risky than other, more volatile, equity categories, such as Aggressive Growth and International Equities. This may reflect consumers' lingering concerns over equity market volatility.

Significant changes in variable annuity sales by distribution channel have occurred since 1995. For example, while sales by the captive agency channel have declined from 55% of total to the current 34%, sales in the banking channel have risen from 3% to 14%. It is also worthy of note that bank sales grew significantly in 2003, moving from 11% in 2002 to 14%. This appears to be driven by bank customers' interest in guarantees (and, to a lesser extent, continued use of the fixed account). Direct response has declined over the past several years, and now accounts for only 1% of total sales. Independent agents (which are primarily financial planners) have increased their share over the period from 17% to 26%. The share of sales by stockbrokers (including both New York wirehouses and regional firms) has also increased, but to a lesser extent, moving from 21% to 25%. The shift away from the captive channel most likely reflects the lower growth rate in career sales force, as well as the industry's ability to attract non-traditional distributors.

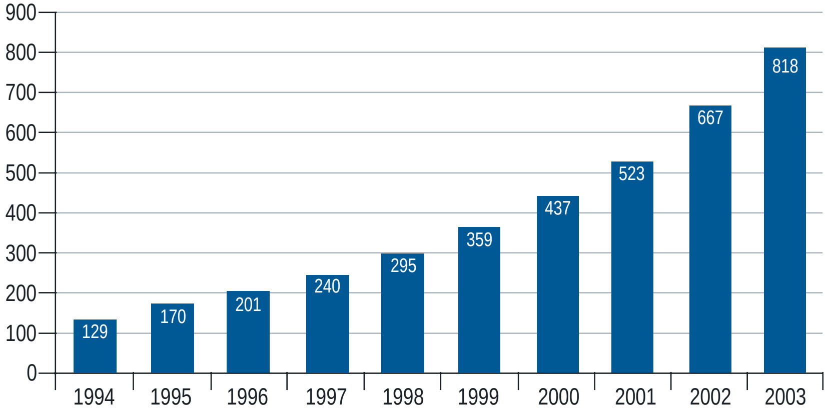
Chart 6: *Variable Annuity Total Sales by Distribution Channel*
(as of 12/31/03)



Source: NAVA and Finetre/VARDS

Since 1994, the number of unique variable annuity contracts offered has increased over 500%. The chart on the next page illustrates this growth. The number of contracts grew 23% in 2003 despite a decrease in the number of companies selling the product. This reflects the growth in companies' product lines.

Chart 7: *Number of Unique Variable Annuity Contracts Offered*



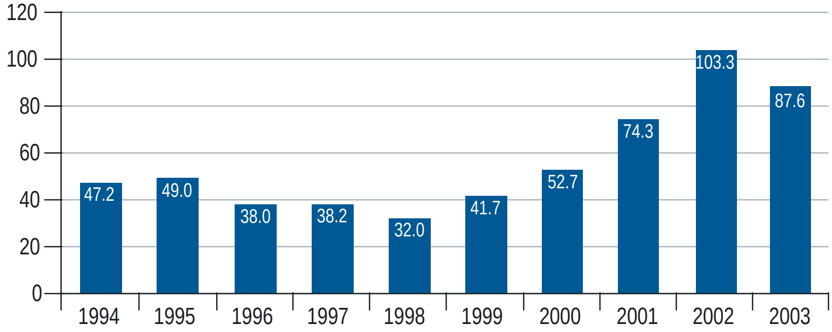
Source: NAVA and Finetre/VARDS

Fixed Annuity Developments

7

Fixed annuities, in their various forms, have been around for a very long time—much longer than their variable annuity counterparts. Fixed annuities were also the dominant annuity product until about ten years ago when the increased popularity of variable annuities, coupled with the booming stock market, caused variable annuity sales to soar. Sales of fixed annuities peaked at $47.7 billion in 1990 and remained relatively flat for the decade that followed. The 1990 level increased only slightly during this time, first in 1995, when sales reached $49.0 billion, and again in 2000 with a new record of $52.7 billion. Despite declining and near-record low interest rates, fixed annuity sales nearly doubled by 2002 to $103.3 billion, a third consecutive annual record. The record streak ended in 2003 when sales dipped 15% to $87.6 billion, still the second highest sales year on record.

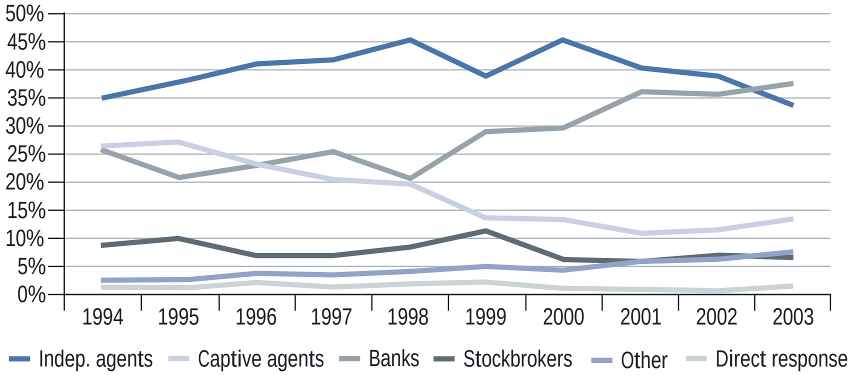
Chart 1: *Fixed Annuity Sales*
(dollars in billions)



Source: LIMRA Int'l

The distribution of fixed annuities is dominated by independent agents and banks. While independent agents have long been the leading sales channel for fixed annuities, banks have significantly increased their market share in recent years, surpassing independent agent sales in 2003. These channels tend to attract or cater to a greater number of older clients (who are more likely to use annuities to fund qualified retirement plans) than captive agents. Older clients are generally more conservative with their investments. One departure from this logic is the stockbroker channel, whose client age profile is similar to that of banks. However, stockbrokers' clients tend to have more assets than bank clients and may be more willing to take on additional investment risk.

Chart 2: *Fixed Annuity Market Share by Distribution Channel*



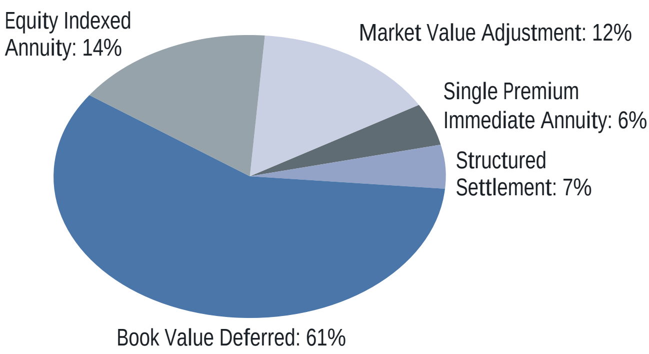
Source: LIMRA Int'l

Because annuity sales are influenced by the financial markets, forecasting fixed or variable annuity sales is very difficult. Predicting total annuity sales is more reliable. With total annuity sales forecasts in hand, estimating the respective shares of fixed and variable annuities is only as good as the economic forecasts of interest rates and stock prices being used to predict sales by product type. Historically, the market share of fixed annuities has been very closely correlated with bond yields. The market share of variable annuities has been inversely correlated with interest rates. Variable annuity market share has also been correlated with investment returns on equities but, due to the volatility of stock prices, the relationship does not appear to be as strong as with interest rates. A partial explanation for this is that interest rates and stock prices tend to move in opposite directions.

This relationship has not held true, however, since the stock market peaked in early 2000 with both stock prices and interest rates falling simultaneously. Instead of fixed annuity market share declining with interest rates, sales of fixed annuities grew at a record pace, even matching variable annuity sales during the second quarter of 2002. The last time fixed annuity sales matched or beat variable annuity sales was during the second quarter of 1995 after the government increased the federal funds rate seven times, beginning in 1994.

The variable annuity market saw a great deal of product innovation during the 1990s. For many companies, this was a shift in emphasis from their fixed annuities to their variable annuity product portfolios. While variable annuities added death benefits, living benefits, asset allocation programs, and new ways to structure product costs (e.g., A-, C-, L-share, etc.), fixed annuity product development was relatively quiet. The major fixed annuity innovation of the 1990s was the equity-indexed annuity (see Chapter 1 for a description). There were certainly other innovations, but none that received the attention of a large number of companies. The last few years however, changed this. Companies once again began placing emphasis on fixed annuity product development, and a few companies which before offered variable but not fixed annuities, entered the fixed annuity marketplace for the first time. The major trend in new fixed products was the inclusion of a longer interest guarantee period or a choice of multiple guarantee periods, and a market value adjustment (MVA) feature. With MVA, an adjustment is added or subtracted from the accumulated value upon surrender based on changes in interest rates since the time of purchase. In general, if interest rates have fallen (risen) since purchase, the adjustment will tend to be positive (negative). With book value deferred on the other hand, surrender values do not fluctuate with market conditions.

Chart 3: *Fixed Annuity Sales Components—2003*



Source: LIMRA Int'l

While fixed annuity sales grew in 2001 and 2002 amid declining interest rates, 2003 was a different story. Interest rates continued to fall, reaching levels around mid-year not seen for decades. The low levels of interest rates made profitably crediting an interest rate above state-mandated minimums (3% in most states), very difficult in most situations and impossible in others. The result was many companies had no choice but to pull specific products or interest rate guarantee periods from the market. Fortunately, most states have enacted one of two types of relief, either in the form of a 1.5% minimum guaranteed interest rate or an indexed rate that moves with prevailing interest rates. Eighteen states and the District of Columbia have passed regulations lowering the minimum rate to 1.5%. As Florida and Mississippi have no annuity Standard Nonforfeiture Law (SNFL), the 1.5% minimum guarantee rate is allowed in these states as well.

The National Association of Insurance Commissioners recently adopted a new annuity SNFL model which ties the minimum interest rate which must be paid by fixed annuities to current yields. Instead of 3%, the new rate would float to between 1% and 3%. The new standard will not become effective until adopt by the individual states. So far, 29 states have implemented this approach (as of April, 2004). Despite this new SNFL, the earlier proposal continues to be important. In the 18 states mentioned previously, contracts will be approved currently with the 1.5% minimum guaranteed interest rate.

One interesting development with respect to product innovation is that the last few years have seen a cross-pollination of product ideas between fixed and variable annuities. Variable annuities borrowed up-front bonuses from fixed annuities. Some fixed annuity products have added earnings-related death benefits, which many companies added to their variable annuities in recent years. There are even fixed annuities that offer the investor a choice of several investment options, much like a variable annuity. The difference is, in a fixed annuity, the options are typically fixed rate and equity-indexed accounts.

The Real Cost of a Variable Annuity

8

A great deal of press coverage today focuses on the expense of variable annuities. An apples-to-apples comparison, however, shows that the real cost differential between variable annuities and mutual funds in 2003 was only 86.3 basis points (.863%).

Many articles exaggerate this difference. They assume that management fees for funds underlying variable annuities are identical to fees for publicly available mutual funds, when in fact fees for variable annuity funds are usually much less. This erroneous assumption leads to the equally erroneous conclusion that the cost differential between variable annuities and mutual funds is approximately equal to the insurance charges.

According to 2003 Morningstar data, the average investment fund expense for mutual funds is 1.452% or .478% higher than the comparable figure for variable annuities (.974%). The lower expense of funds underlying variable annuities offsets, to some extent, the additional insurance charges so that the actual cost differential of the two products, on average, is .863% (2.315% minus 1.452%).

Why is the mutual fund’s investment expense charge higher than the variable annuity’s? It has to do with the expenses related to the handling and administrative aspects of individual accounts. For a variable annuity, most of these functions are handled by the insurance company and are reflected in the insurance charge. The insurance company, in effect, is one "account holder" of the underlying mutual fund. With a publicly available mutual fund, fund management involves a multitude of individual accounts making administration more expensive and difficult than for a comparable fund underlying a variable annuity.

Thus while there is an additional charge for the valuable insurance features of a variable annuity, the total cost differential between mutual funds and variable annuities is far less than is often reported.

It is important to remember that this data is for a limited time frame, and caution is required in using the results. While it would be appropriate to cite this data in general discussions about variable annuities, the results, which are industry averages, are not necessarily reflective of individual product lines.

Table 1: *Comparison of 2003 Average Expenses—Mutual Funds vs. Variable Annuities*

	Mutual Fund Fund Expense	Variable Annuity Fund Expense	Variable Annuity Total Expense
Average Percentage	1.452%	0.974%	2.315%
Mutual Fund/Variable Annuity Difference	0.478%		
Total Difference	0.863%		

Source: Morningstar, Inc.

Table 2: *Average 2003 Expense Analysis by Investment Objective*

	Mutual Fund Fund Expense	Variable Annuity Fund Expense	Variable Annuity Total Expense
Balanced/Hybrid			
Conservative Allocation	1.275%	0.870%	2.124%
Moderate Allocation	1.318%	0.765%	2.118%
World Allocation	1.502%	0.874%	2.367%
Core Bond			
Intermediate-Term Corporate	1.068%	0.756%	2.074%
Intermediate-Term Government	1.106%	0.722%	2.026%
Long-Term Corporate	1.046%	0.718%	2.034%
Long-Term Government	1.059%	0.819%	2.299%
Short-Term Corporate	0.892%	0.616%	1.980%
Short-Term Government	0.981%	0.557%	2.009%
Domestic Stock			
Bear Market	2.124%	1.875%	3.207%
Large Cap	1.425%	0.903%	2.249%
Mid Cap	1.598%	1.044%	2.395%
Natural Resources	1.787%	1.923%	2.725%
Real Estate	1.644%	1.206%	2.468%
Small Cap	1.659%	1.092%	2.418%
Specialty	1.900%	1.268%	2.628%
Utility	1.566%	1.109%	2.458%
High Yield/Specialty Bond			
Bank Loan	1.476%	1.470%	2.943%
High Yield	1.319%	0.880%	2.217%
Multisector Bond	1.427%	0.951%	2.245%
International Stock			
Developed Markets Stock	1.804%	1.183%	2.465%
Emerging Markets Stock	2.061%	1.690%	3.007%
Japan	2.136%	1.890%	3.378%
Pacific	2.367%	1.704%	3.234%
International Bond			
Developed Markets Bond	1.357%	1.003%	2.371%
Emerging Markets Bond	1.568%	1.378%	2.607%
Money Market			
Money Market	0.644%	0.605%	1.905%

Source: Morningstar, Inc.

Regulation and Taxation of Annuities

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Annuities are insurance contracts and as such are regulated under state insurance laws. Variable annuities are securities as well. As a result, the Securities and Exchange Commission (SEC) regulates them under the federal securities laws. The SEC and the National Association of Securities Dealers, Inc. (NASD) regulate firms that sell variable annuities.

REGULATION BY THE STATES

Overview

All fixed and variable annuities are governed by a comprehensive state regulatory framework. State laws govern the organization and licensing of insurance companies, and state insurance departments oversee insurance company operations. Generally, annuity contracts and amendments must be filed with and approved by each state in which contracts are sold. Insurance agents must be licensed in each state in which they operate. Only licensed insurance agents may sell annuity contracts.

Insurance Company Licensing

In order to offer annuity products in a state, an insurance company must be licensed in that state. A company must be licensed regardless of whether it is a "domestic" insurance company (i.e., organized in the state) or a "foreign" insurance company (i.e., organized in another state). To be licensed, an insurance company must be organized according to specific state laws. Before it is granted a license, an insurance company must demonstrate compliance with strict capital, surplus and financial requirements. In addition, the state scrutinizes the experience and character of the company's management. The state issues a license only if it determines that the company is organized in such a way that it will protect the interests of its contract owners.

Agent Licensing

State insurance departments must license insurance agents. Applicants must submit an application to the state, providing information about their experience, character and financial responsibility. They also have to pass a written examination. (As discussed below, agents selling variable annuities are also subject to NASD requirements.)

Contract Requirements

Annuity contracts and related forms generally must be filed and approved in every state where they will be sold. While there is no standard required form for annuity contracts, states mandate that certain provisions be included in all contracts, such as a free-look provision that allows a contract owner to examine the contract for a period of time and return it for a refund if dissatisfied for any reason. Generally, contracts must be readable and cover all of the contract's basic features before the state will approve the contract for sale. Amendments to contracts also must be filed and approved. If the amendment could adversely affect existing contract owners' rights, the state may require prior approval from the contract owners.

State Guarantee Funds

All states, the District of Columbia, and Puerto Rico have guarantee funds to protect contract owners against insurance company insolvency. Insurers doing business in a state must contribute to that state's guarantee fund. The actual coverage provided for annuity contracts varies from state to state, but cash values and annuity benefits generally are protected for at least $100,000. Coverage is not provided for variable annuity contracts (other than assets invested in the fixed account option under a variable annuity contract). However, as discussed below, variable annuity contracts are issued through life insurance company separate accounts, which are insulated from the general creditors of the insurance company in the event of insolvency.

Variable Annuity Asset Protection

When a contract owner allocates purchase payments to a variable investment option under a variable annuity contract, those assets are held in the insurer's separate account. The assets of a separate account are insulated against the creditors of the insurance company in the event of the company's insolvency. In some states, annuity assets are shielded from a contract owner's creditors as well.

Advertising and Unfair Trade Practices Rules

Most states have adopted advertising rules governing the marketing of annuity contracts. State insurance departments review advertising materials periodically. Advertising rules are designed to prevent misleading, deceptive or confusing advertisements, as measured against the impression a person who is not knowledgeable in insurance matters may receive from the materials.

All states have adopted unfair trade practices acts with provisions that apply to an insurer's activities. These laws define and prohibit unfair methods of competition and unfair or deceptive business practices, including those involved with the issuance, sale and administration of annuity contracts.

National Association of Insurance Commissioners

The National Association of Insurance Commissioners (NAIC) is an association that promotes fairness and uniformity in state insurance laws. It has developed numerous "model laws" and "model regulations" that, while non-binding, have been adopted in one form or another by many states

REGULATION UNDER THE FEDERAL SECURITIES LAWS

Introduction

Besides being governed by the state regulatory framework, variable annuities as securities are regulated under federal securities laws. The primary federal securities laws that regulate variable annuities and the separate accounts through which they are issued are the Securities Act of 1933 (1933 Act), the Securities Exchange Act of 1934 (1934 Act) and the Investment Company Act of 1940 (1940 Act). The SEC administers these acts. Fixed annuities, where the insurance company guarantees a specific rate of return to the contract owner, generally are not subject to these laws.

In summary, the federal securities laws require certain disclosure documents, including a prospectus, to be given to investors. Certain disclosure documents must also be filed with the SEC. In addition, written marketing materials such as advertisements are subject to regulation under SEC and NASD rules. Certain periodic reports must be filed with the SEC and delivered to investors. These requirements are discussed in more detail on the following pages.

Securities Act of 1933

Registration of the Contracts

Because variable annuities are securities, they must be registered with the SEC under the 1933 Act before they can be offered to the public (with two exceptions noted below). The SEC staff reviews and comments on registration statements, which usually must be amended in response to staff comments before they will be declared effective. (The SEC does not, however, approve or disapprove of any securities, including variable annuities, and does not pass on the accuracy or adequacy of any prospectus.) A "post-effective" amendment updating the variable annuity's registration statement generally must be filed at least annually.

The first registration exception is for annuity contracts that are issued in connection with certain qualified plans such as 401(k) plans. The second exception is for "privately offered" annuities, which are contracts that, among other things, are offered only to sophisticated investors that meet certain requirements under federal security laws (and not to members of the general public). Even with these exceptions, however, issuers and others involved in marketing non-registered variable annuities, remain subject to the anti-fraud provisions of the 1933 Act.

Prospectus Delivery

When someone purchases a registered non-qualified variable annuity, he or she receives a prospectus. These prospectuses are updated regularly. Separate prospectuses describe underlying investment options—the funds to which the purchaser may allocate his or her investments. This can result in a purchaser receiving numerous prospectuses. However, the SEC recently adopted a rule permitting fund "profiles," which are shorter, user-friendly summary prospectuses, to be given to prospective investors. The SEC also permits limited use of variable annuity profiles.

Disclosure of Fees and Expenses

Variable annuity prospectuses contain fee tables that disclose the maximum guaranteed charge for all contract transaction expenses and recurring charges. These amounts are expressed in dollar amounts or percentages of the contract value so purchasers will know what they will pay if they buy the contract. The fee tables also list the range of total operating expenses for all of the underlying funds offered by the contract. In addition, variable annuity prospectuses contain numerical examples showing in dollar amounts per $10,000, what a contract owner would pay for the contract and the maximum fees and expenses charged by any of the funds over 1-, 3-, 5-, and 10-year periods. These examples assume a 5% return and that the contract is surrendered at the end of the relevant period. Additional examples are required that assume the investor does not surrender the contract if a sales load or other fee is charged upon surrender. This format shows the effect of any surrender charge.

Securities Exchange Act of 1934

The 1934 Act generally requires variable annuities to be distributed through registered broker/dealer firms and their registered representatives. Broker/dealers and their representatives are subject to extensive operational and financial rules that cover minimum net capital requirements, reporting, record-keeping, supervision, advertising, and sales activities.

In addition to the broker/dealer regulatory framework established by the 1934 Act, registered broker/dealer firms that sell variable annuities also must be members of the NASD. The NASD is a self-regulatory organization overseen by the SEC. It has an extensive body of rules with which broker/dealers must comply. For example, examinations are required; fingerprints must be provided; and numerous supervisory, suitability, advertising, record-keeping, and reporting rules apply.

A 1934 Act rule requires broker/dealers to send confirmation statements to contract owners after each purchase and sale transaction made involving a variable annuity contract. In addition, insurance companies send contract owners periodic account statements showing a beginning balance, transactions during the period, and an ending balance so that the owner will have a record of all activity in his or her contract.

Investment Company Act of 1940

The 1940 Act imposes an extensive federal regulatory structure on investment companies, including separate accounts and underlying funds. (Some separate accounts and funds however, such as those used in connection with tax-qualified retirement plans, are not subject to the 1940 Act.) For example, the act governs how variable annuities and shares of underlying funds are issued and redeemed. There are also corporate governance requirements and prohibitions against self-dealing.

Each separate account regulated under the 1940 Act must file a report on its operations annually with the SEC. In addition, an annual and semi-annual report containing information about the underlying mutual funds that serve as investment options for the variable annuities must be sent to contract owners. In some cases, these reports also contain information on the variable annuities themselves.

The SEC inspects variable annuity separate account operations regularly. The SEC also inspects various locations, such as broker/dealer offices, from which variable annuities are sold. Recommendations are made and any deficiencies are noted. If the situation is serious enough, it is referred to the SEC's enforcement division.

Regulation of Fees and Charges

Currently, the SEC does not regulate individual variable annuity fees and charges. However, the 1940 Act makes it unlawful for any registered separate account funding variable annuity contracts, or for the sponsoring insurance company, to sell any such contract unless the fees and charges deducted under the contract are, in the aggregate, reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company. The insurer must represent in the annuity contract's registration statement that the fees and charges are reasonable.

SEC and NASD Advertising Rules

SEC Rules

SEC rules govern variable annuity advertising. If past performance of a fund or variable annuity is presented, performance must be calculated according to standardized formulas. "Non-standardized" performance may also be presented, but must be presented with standardized performance. In addition, if an advertisement contains performance information, total returns current to the most recent month-end must be made available within seven business days of the end of the month at a toll-free or collect telephone number or on a website.

NASD Rules

In addition to the SEC rules governing variable annuities, NASD rules govern variable annuity advertisements. Broker/dealer firms that disseminate variable annuity advertising must file these communications with the NASD and take into account comments provided by the NASD staff.

TAXATION OF ANNUITIES

This section explains the federal income taxation of annuities. The focus is on annuities that are not part of a qualified plan, although the basic differences between qualified and non-qualified annuities are discussed. State taxes and federal estate and gift taxes are not discussed; however, these taxes may also affect annuity owners.

Premiums

If an annuity contract is part of a qualified plan, premiums are plan contributions and generally not includible in the employee's income when paid. For a non-qualified annuity, premiums are not tax deductible.

Tax Deferral

Dividends, interest, and capital gains credited to an annuity are not taxed until they are withdrawn. In other words, earnings are tax-deferred and reinvested to help accumulate assets for retirement. Because of this feature, money may be transferred from one investment option to another inside a variable annuity without incurring a tax liability. This is not true for taxable investments, where moving funds from one investment vehicle to another, such as from one portfolio of a mutual fund to another portfolio of that fund, will be treated as a sale and any gains will be taxed.

If a contract is not owned by an individual, but rather by an entity such as a corporation, the contract is not eligible for tax deferral in most cases. Rather, the entity is taxed each year on the increase in the net surrender value of the contract, minus premiums paid during the year. Congress enacted this requirement to ensure that the tax deferral granted by annuities is used primarily as a vehicle for individuals' retirement savings.

Withdrawals

When a contract owner begins to receive distributions from an annuity, amounts received in excess of amounts invested are subject to taxation at the owner's ordinary income tax rate. Just as with IRAs, 401(k) plans and other qualified plans, when money is finally withdrawn, it does not receive favorable capital gains treatment. However, as discussed below, annuity payments receive more favorable tax treatment than lump sum or systematic withdrawals, and the flow of income from an annuity can be controlled so that assets continue to grow tax deferred over an extended period of time.

Because Congress set the rules on tax deferral to encourage long-term retirement savings, withdrawals made before age 59½ are generally subject to a 10% federal tax penalty on the taxable amount of earnings withdrawn, in addition to any income taxes due on that amount. (There are exceptions to the 10% penalty.) This is similar to the 10% penalty tax on IRAs and underscores the fact that annuities are designed to be long-term retirement vehicles, unlike other assets that are earmarked for near-term expenses or for unforeseen emergencies. (There also may be surrender charges, as discussed in Chapter 1, if the withdrawal exceeds any annual free withdrawal amount and the surrender charge period has not run out. Surrender charges should not be confused with the 10% federal tax penalty.)

For most contracts, the tax rule on withdrawals is "interest and earnings first." Under this rule, interest and earnings are considered withdrawn first for federal income tax purposes. For example, if someone invested $25,000 in a fixed or variable annuity and the contract is now worth $45,000, the first $20,000 withdrawn is taxable. The remaining $25,000 would not be taxed because it is considered a return of principal. Withdrawals are taxed until all interest and earnings are withdrawn; the principal then can be withdrawn without tax.

The "interest and earnings first" rule is intended to encourage annuities to be used for long-term savings and retirement plans. Congress decided that the advantage of tax deferral should not be accompanied by the ability to withdrawal principal first, with no tax payable until all principal is withdrawn.

Complete Surrenders

When an owner surrenders an annuity contract rather than elects to take annuity payments, the difference between the amount received and the cost basis in the contract is taxable. Generally, the cost basis is the amount of premiums paid (less any principal that has been previously returned to the contract owner without tax) at the time of distribution.

Gifts of Annuity Contracts

If a contract owner gives an annuity contract as a gift, the contract owner may have to pay income tax at the time of the transfer. The contract owner must include in income the difference between the cash surrender value of the contract and the owner's basis in the contract at the time of the transfer. This rule does not apply if the transfer is made between spouses, or former spouses as part of a divorce. Gift taxes also may apply.

In addition, any assignment or pledge of (or agreement to assign or pledge) any portion of an annuity contract's cash surrender value is treated as a withdrawal of such amount from the contract. Hence, the tax treatment that normally applies to withdrawals also applies to assignments or pledges of annuity contracts.

Premature Distributions

For non-qualified annuities, a 10% federal tax penalty may apply to the taxable portion of a withdrawal or complete surrender made before age 59½. There are exceptions to the 10% penalty, for example if the payment is made upon the death or disability of the owner. As noted above, this penalty is intended to encourage the use of annuities for retirement savings purposes. For that reason, similar penalties generally apply to withdrawals from IRAs and qualified plans, which are also intended for retirement savings.

Taxation of Annuity Payouts

Annuity owners can elect a number of payout options, as discussed in Chapter 4. The basic rule for annuity payouts is that the money a contract owner invests in the contract is returned in equal tax-free installments over the payment period. The remainder of the amount received each year is treated as the earnings on the owner's premiums and is includible in income. The income portion is taxed at ordinary income tax rates, not capital gains rates. The total amount that is received tax-free can never exceed the premiums the owner paid for the contract.

The taxable portion of each payment is equal to the excess of the payment over the "exclusion amount." With a fixed annuity, the exclusion amount generally is computed by (1) dividing the premiums paid for the annuity by the expected return, as determined by IRS tables, and (2) multiplying the payment by such ratio. With a variable annuity, because the expected return cannot be predicted, the exclusion amount is computed generally by dividing the premiums paid for the contract by the number of years that payments are expected to be made. For a life annuity, this would be the annuitant's life expectancy as determined using IRS tables.

To illustrate, assume that a male age 65 elects a life annuity and his investment in the contract is $100,000. Assume further that he has elected to receive annual variable annuity payments and the payment for the first year is $8,000 (since the payments are variable, they will vary each year thereafter). (For simplicity, this illustration assumes annual annuity payments, although monthly or quarterly payments are more common.) Applicable IRS tables indicate that such a person is expected to live 20 years. One hundred thousand dollars divided by 20 is $5,000, which is the portion of each annuity payment that is excluded from income. During the first year, $5,000 of the $8,000 will be excluded from income and $3,000 will be included. The $5,000 is excluded each year until the total investment in the contract has been received.

Death of an Owner

When an owner of an annuity dies, the general rule is that certain distributions must be made. (Similar rules apply to qualified plans.) The tax policy is to prevent deferral of income on the gains in an annuity contract by passing ownership from person to person without taxation occurring.

If an owner dies on or after the annuity commencement date, but before the entire interest in the contract has been distributed (for example, if the owner dies five years into a ten-year guaranteed payout term), the remaining portion must be distributed at least as rapidly as under the method of distribution in effect at the time of death.

If an owner dies before the annuity commencement date, the general rule is that the entire interest in the contract must be distributed within five years after the date of the owner's death. However, there are exceptions to this rule. If an individual is the owner under a contract and the spouse is the beneficiary, following the death of the owner, the surviving spouse has the option of continuing the contract by becoming the new owner.

Upon the death of the owner before the annuity commencement date (or the death of the surviving spouse before that date if the spouse has elected to continue the contract following the owner's death) beneficiaries other than a spouse have five choices. They can:

- Take the amount due under the contract and pay tax at that time;
- Make withdrawals over the course of the next five years and pay taxes on each withdrawal, with the remainder of the contract value growing tax-deferred;
- Wait up to five years with the contract value growing tax-deferred, then take the entire amount due and pay taxes;
- Annuitize over their life or life expectancy within 12 months of the owner's death and receive the favorable tax treatment accompanying annuity payments; or
- Begin withdrawals within 12 months of the owner's death over a period equal to the beneficiary's life expectancy calculated in a manner specified in IRS rules.

Replacement Contracts/1035 Exchanges

When a contract owner purchases a new annuity contract to replace an existing one, the new contract is referred to as a replacement contract. Replacement contracts usually occur in connection with a tax-free exchange of non-qualified contracts under Section 1035 of the Internal Revenue Code, or because of a rollover or direct transfer of a qualified plan contract (for example, an individual retirement annuity) from one life insurance company to another. Annuity owners generally can exchange their annuity contract for a new one, tax-free. The reason for an exchange may be:

- The owner has a fixed annuity that has a substantially lower interest rate than other contracts currently available.
- The company that issued the current contract is not as financially strong as it once was.
- The new contract may have substantially better features, such as an enhanced death benefit, guaranteed minimum income benefit, portfolio rebalancing or dollar cost averaging.
- The new contract may have more or better-performing investment options available.
- The new contract may have lower fees and charges.

Many states have passed replacement regulations requiring certain procedures to be followed before an annuity contract is replaced. The contract purchaser and the agent must sign a statement as to whether the contract being purchased will replace an existing one. If so, the new insurance company must promptly notify the old insurance company. The new insurance company must provide the purchaser with a prescribed statement about important factors to consider before buying the replacement contract.

In some cases, a surrender charge may be incurred by surrendering the old contract and a new surrender charge period may start on the new contract. For this reason, an individual and his or her financial adviser should carefully evaluate a proposed exchange to ensure that it is in the contract owner's best interest. States have adopted replacement regulations ensuring full disclosure in these situations and affording other protections.

States may provide longer free-look periods for replacement contracts than for other annuity contracts.

Demographics of a Typical Owner

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Background of Gallup Organization Survey

Who owns non-qualified annuity contracts, i.e., annuity contracts purchased with after-tax dollars outside of tax-qualified retirement plans? Why did they buy their annuities? And how do these individuals intend to use their annuity savings? In an effort to find the answers to these questions, the Committee of Annuity Insurers has commissioned Gallup surveys eight times since 1992. These surveys, developed by the Committee of Annuity Insurers, The Gallup Organization, and Mathew Greenwald & Associates, ask owners of non-qualified annuities for demographic data and their opinions on issues such as saving for retirement and purchasing annuities. As demonstrated in previous years and again in 2001 (the most recent survey available), owners of non-qualified annuities are middle-class individuals who feel confident about their retirement planning. (2004 survey results will be released later this year.)

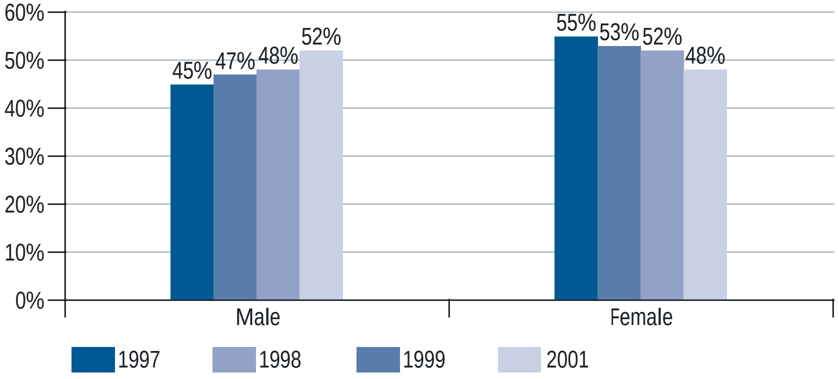
According to the survey, the typical owner is at least a high school graduate, has an annual income under $75,000, and purchased his or her first non-qualified annuity contract before age 65. Approximately four in ten owners of non-qualified annuity contracts reported that the current value of all of the non-qualified contracts that they or their spouse own is between $25,000 and $100,000. Thirteen percent of owners reported values of under $25,000, while 33% reported values of over $100,000.

Who Owns Non-qualified Annuities?

Gender

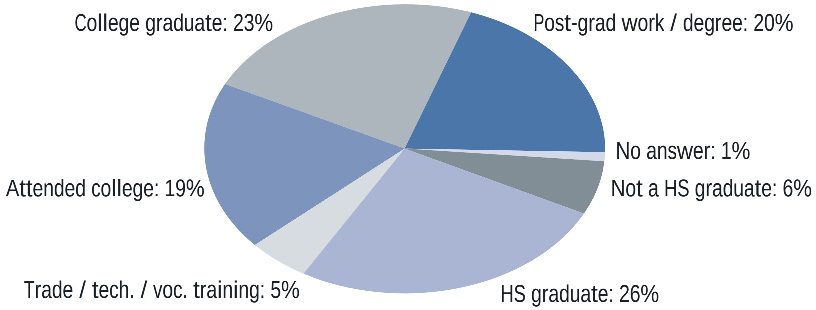
Owners of non-qualified annuity contracts are slightly more likely to be male than female—52% of owners of non-qualified annuity contracts are male, 48% are female. (See Chart 1.) Males are more likely than females to own *variable* non-qualified annuity contracts (70% vs. 60%).

Chart 1: *Gender*



As shown in Chart 2, owners of non-qualified annuities have diverse educational backgrounds. More than half of owners of non-qualified annuity contracts (56%) are not college graduates. One in five has a college diploma and another one in five has done post-graduate work or has a post-graduate degree. Overall, 88% of owners of non-qualified annuity contracts have at least a high school education.

Chart 2: *Level of Education*

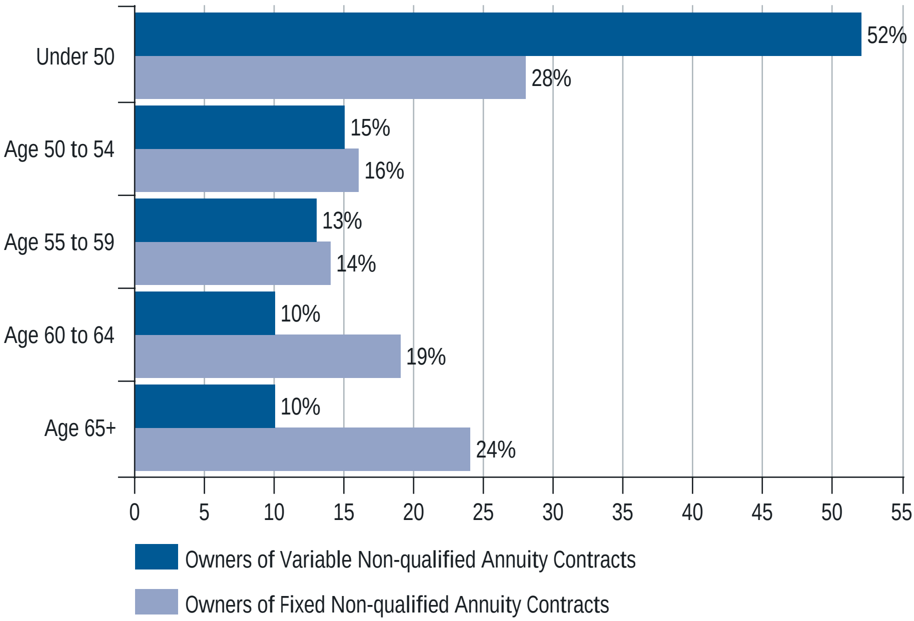


Age

The average age of owners of non-qualified annuity contracts is 65. One third of owners of non-qualified annuity contracts (35%) are age 72 and older. This represents an increase of nine percentage points from 1992. Twenty percent of owners are under age 54.

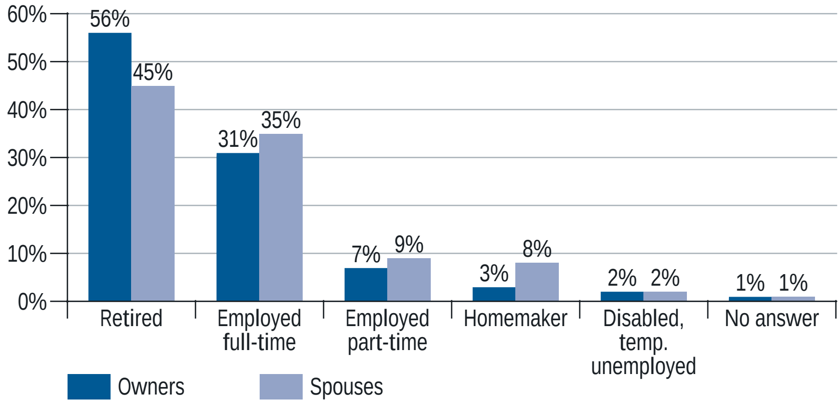
Evidencing the nature of annuities as retirement savings vehicles, 85% of owners of non-qualified annuity contracts purchased their first annuity when they were under 65 years of age. Forty-four percent were under 50 years of age, while only 15% were age 65 and older. The average age at which owners purchased their first annuity is 50. Almost all (91%) still own the first annuity that they purchased. As shown in Chart 3, owners of *variable* annuity contracts tended to purchase their first annuity contracts at a younger age than owners of *fixed* annuity contracts. Fifty-two percent of owners of *variable* annuity contracts were under age 50 when they purchased their first annuity contract.

Chart 3: *Age at Which First Annuity was Purchased by Type of Annuity*



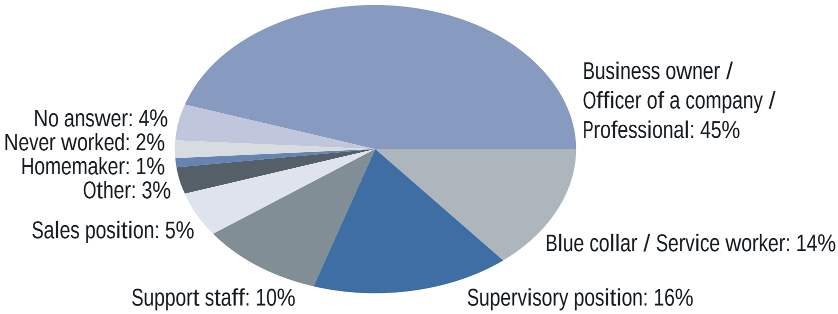
Many owners of non-qualified annuity contracts and their spouses are retired (nearly six in ten owners and nearly half their spouses). Approximately 40% of owners and spouses are still employed either full-time or part-time. (See Chart 4.)

Chart 4: *Employment Status of Owners and Their Spouses*



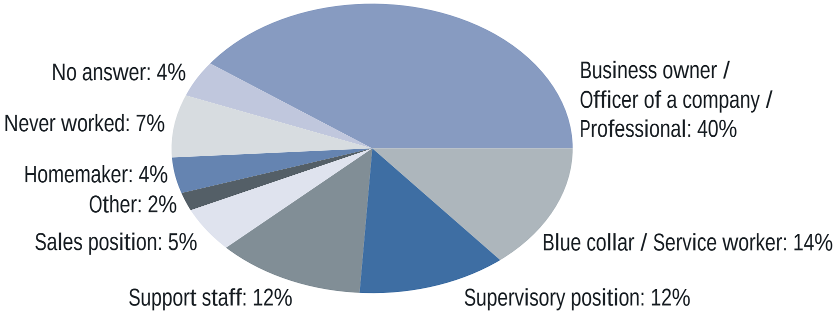
Charts 5 and 6 show the occupations (or former occupations, for those who are retired) of owners of non-qualified annuities and their spouses.

Chart 5: *Occupation of Owners*



Annuity contract owners come from a variety of professions. More than two in five owners of non-qualified annuities (45%) identify their occupation (or former occupation, if retired) as being a business owner, officer of a company, or other type of professional, such as a doctor, lawyer or teacher. One in seven (14%) is (or was) a blue collar or service worker and one in six (16%) work (or worked) in a supervisory position. The occupations of the spouses of annuity owners follow similar patterns.

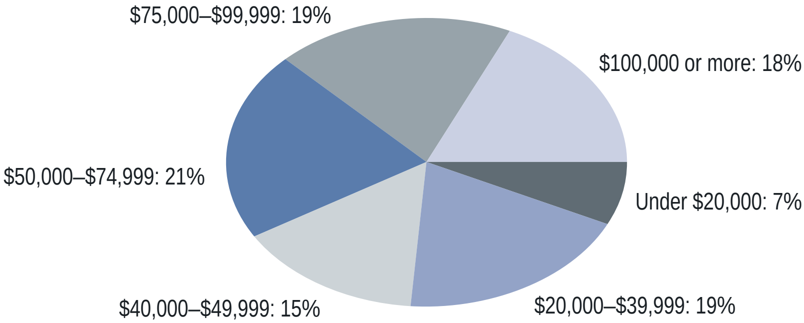
Chart 6: *Occupation of Spouses*



Income

Owners of non-qualified annuity contracts are predominantly middle-class. In the 2001 survey, and in each of the previous surveys, substantial majorities of owners of non-qualified annuity contracts have had total annual household incomes between $20,000 and $74,999. Six in ten owners in the 2001 survey have annual household incomes under $75,000. (See Chart 7.) Annuity owners with household annual incomes greater than $75,000 are more likely to own variable annuity contracts.

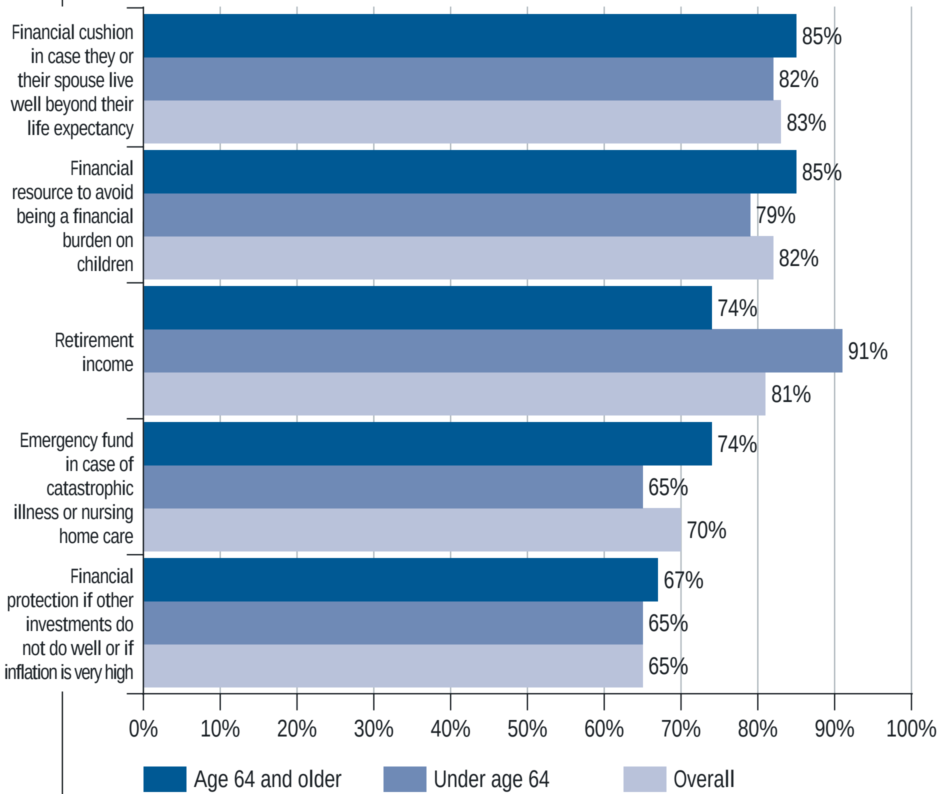
Chart 7: *Annual Household Income*



What Do Owners of Non-qualified Annuities Think About Savings?

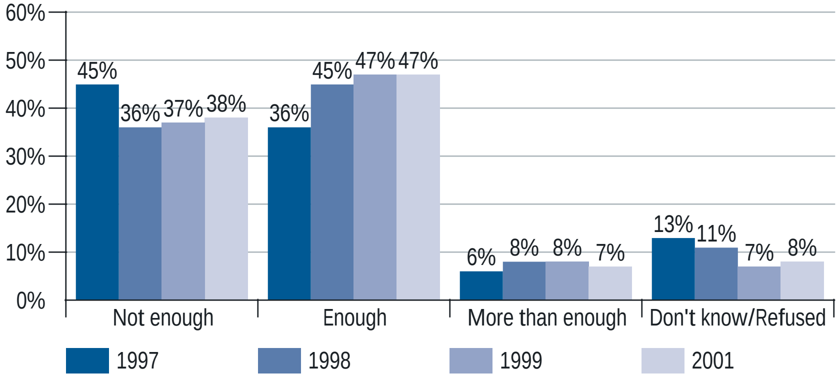
Clearly, Americans are getting the message that they are responsible for their own retirement, and annuities are an ideal means of guaranteeing that they will not outlive their resources in retirement. Owners of non-qualified annuities generally feel that they have done a very good job in saving for their own retirement (88% feel this way). Highlighting the inherent uncertainty of retirement, however, a significant number of them are concerned that the costs of a catastrophic illness or nursing home care might bankrupt them or that they will run out of money in retirement. (See Chart 8.)

Chart 8: *Intended Uses of Annuity Savings by Age*



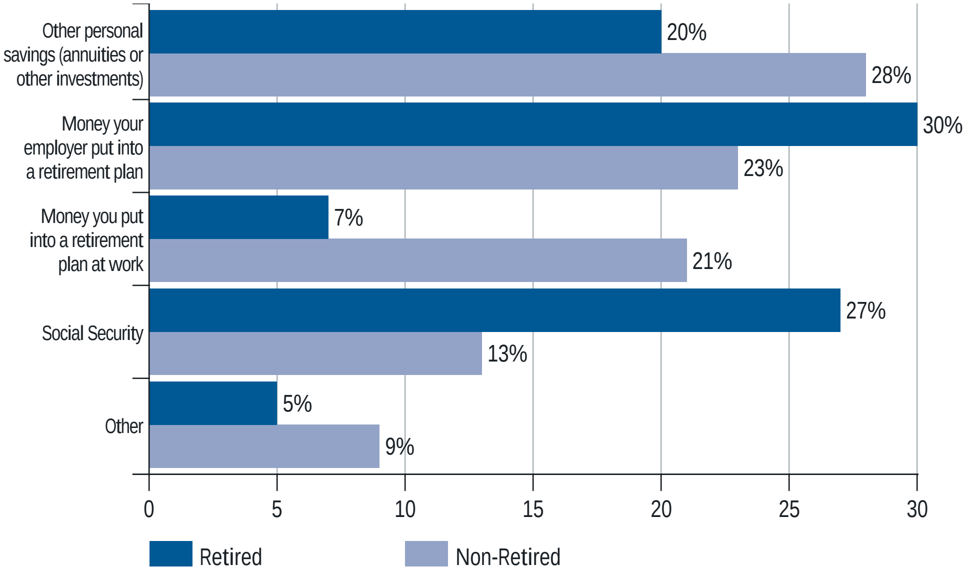
Although many owners of non-qualified annuity contracts believe that the money they will receive from their pensions and other employment-related retirement programs (including Social Security) will be enough to meet their financial needs in retirement (see Chart 9), they also recognize the need to save additional amounts for retirement.

Chart 9: *Whether Money From Pension and Retirement Plans Will Cover Retirement Expenses*



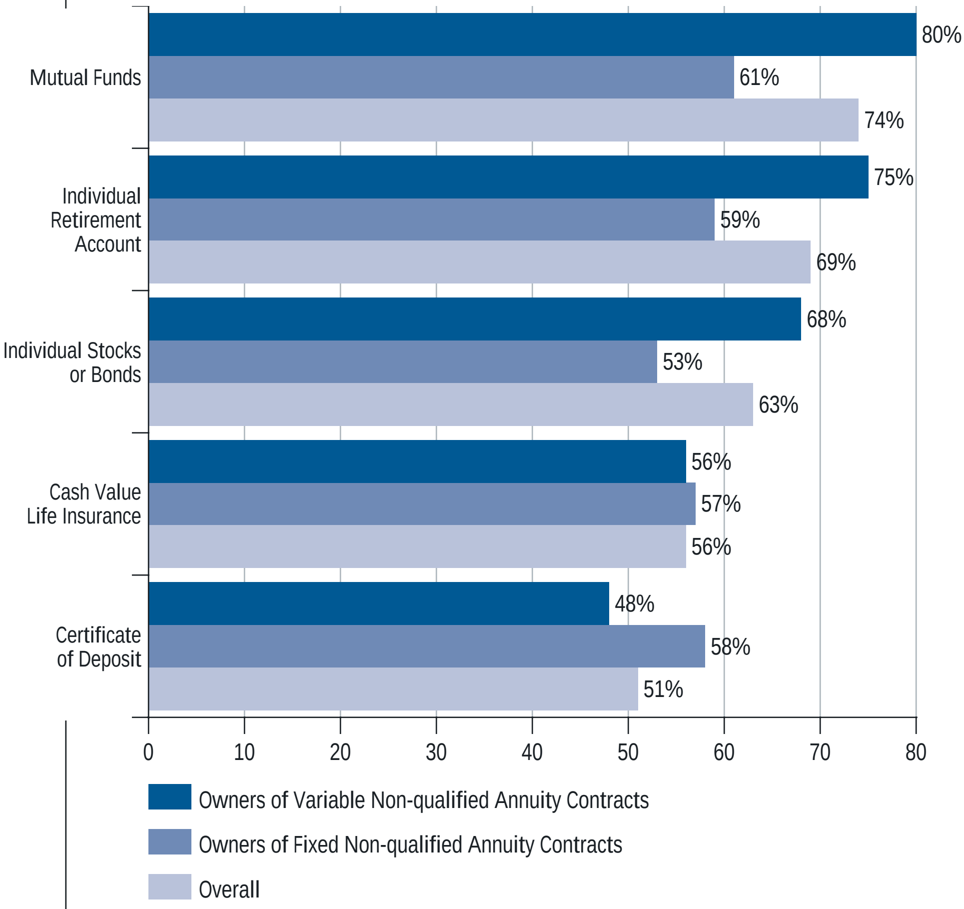
Of those owners who are not yet retired, 72% expect that their personal savings or pensions (i.e., sources of retirement money other than Social Security) will be the largest source of their retirement income. Even those owners who are already retired recognize the role that personal savings play in their financial security in retirement. Over half (57%) cite personal savings or pensions as the largest source of their retirement income. (See Chart 10.)

Chart 10: *Largest Source of Retirement Income*



Aside from their non-qualified annuities, owners save in a number of other financial products. (See Chart 11.)

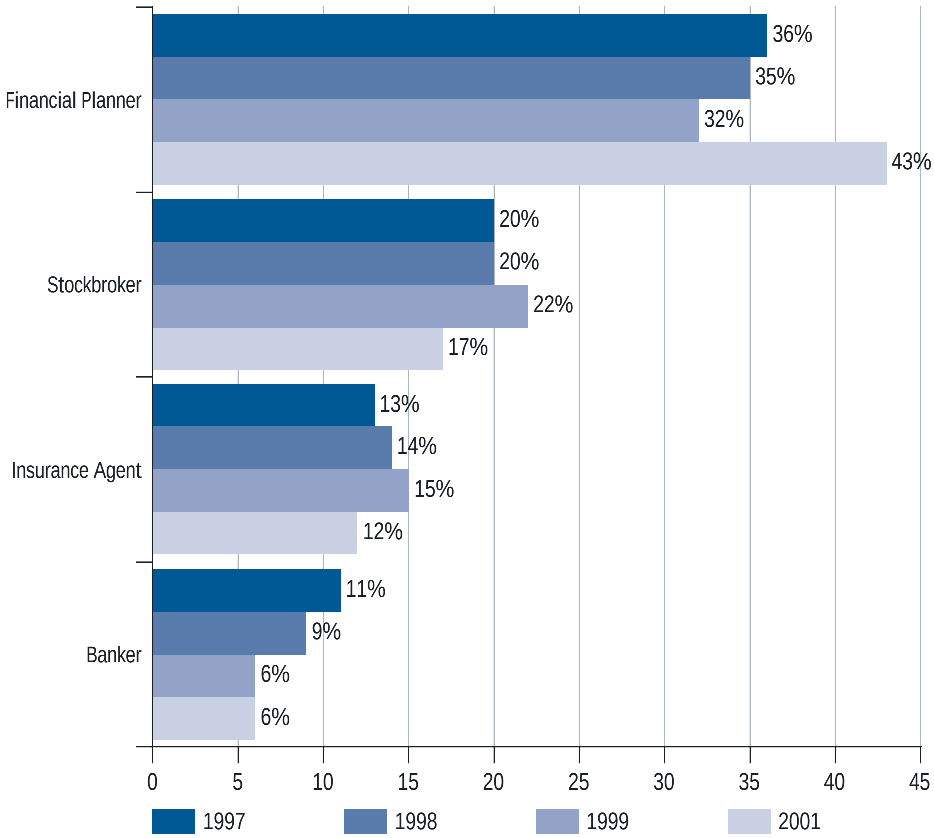
Chart 11: *Savings in Other Financial Products by Type of Annuity*



Where Do People Learn About Annuities, and How Do They Buy Them?

Owners of non-qualified annuities reported talking to a variety of different people when making the decision to purchase an annuity contract. This included financial planners (43%), stockbrokers (17%), insurance agents (12%), and bankers (6%). (See Chart 12.)

Chart 12: *Sources of Information About Non-qualified Annuities*



The 2001 survey found that the typical owner of a non-qualified annuity uses more than one source of funds for the purchase of his or her annuity. Overall, about half (48%) used money from at least one of the following one-time events to purchase an annuity contract: an inheritance (21%), the sale of a home, farm or business (13%), a death benefit from a life insurance policy (13%), a gift from a relative (11%), or a bonus (10%). Many owners also indicated that some of their annuity premiums came from regular savings (55%), their or their spouse's current income (53%), and proceeds from an investment (35%).

Why Do People Purchase Annuities?

In an open-ended question regarding their reasons for purchasing their last annuity contract, a plurality of owners of non-qualified annuity contracts (20%) reported that they purchased their annuity contracts to provide retirement income. Only 11% reported that tax savings had been their motivation. Nevertheless, the fact that earnings on annuity savings are not taxed until the savings are used, is a strong motivation for purchasing a non-qualified annuity. When asked whether any of a list of specific reasons for purchasing an annuity contract were true for them, 89% of owners of non-qualified annuity contracts say that the tax treatment of annuity contracts was a "very" or "somewhat" important reason that they purchased a non-qualified annuity. Of note, younger owners of non-qualified annuity contracts (those under age 64) are more likely than those who are older to say that the tax treatment of annuity contracts was a "completely" or "somewhat" important reason that they purchased a non-qualified annuity (94% of those under age 64 compared to 88% of those age 64 and older). Large numbers also indicate that "very" or "somewhat" important reasons for purchasing an annuity were that it is a safe purchase (88%), it has a good rate of return (87%), and they wanted a long-term savings plan (79%).

About three-quarters of owners of non-qualified annuity contracts report the following as "very" or "somewhat" important reasons for purchasing a non-qualified annuity: they can get income guaranteed for life (75%), it is an easy way to save (72%), they want a source of funds for emergencies (71%), and they have a choice of methods of receiving payments from their annuity savings (68%). Slightly fewer report that it provides money in case they or their spouse need to enter a nursing home (66%).

What Do Annuity Owners Think About Annuities?

Nearly all owners of non-qualified annuity contracts agree "completely" or "somewhat" that "keeping the tax advantage of annuities is a good way of encouraging long-term savings" (90%), "annuities are an effective way to save for retirement" (91%), "annuities are a good way to ensure your [surviving] spouse has a continuing income" (91%), and "annuities are secure and safe" (89%).

Very large proportions of owners of non-qualified annuity contracts agree "completely" or "somewhat" that annuities "have attractive tax treatment" (84%), "are an effective way of assuring money is available to pay for a catastrophic illness or nursing home care" (83%), "are a good source of emergency funds in old age" (85%), "offer a good return" (83%), "will prevent them from being a financial burden on their children in their later years" (81%), and "are an important source of retirement security" (79%).

Conclusions and Trends

As advancing age, market fluctuations, and proposals to "fix" Social Security continue to focus baby boomers on retirement, more and more of them will become concerned about outliving their savings as they age.

Only annuities offer guaranteed lifetime income that can protect them against outliving their assets. The Gallup surveys underscore the importance of the use of non-qualified annuities by middle-class Americans as a means of financing a comfortable retirement.

Methodology

For each survey, at least 1,000 owners of non-qualified annuities were interviewed. In November 2000, The Gallup Organization interviewed 1,005 owners of non-qualified annuity contracts, a representative sample of people who currently own non-qualified annuity contracts. The companies that issued the contracts owned by these 1,005 individuals are geographically diverse and represent a mix of large and small companies and various distribution systems. It is Gallup's view (based on the sampling procedures used and other research that Gallup has conducted in this area) that the results of the 2001 survey represent the characteristics of owners of non-qualified annuity contracts, with a sampling error of plus or minus three percentage points, at the 95% confidence level.

Data Section

TOTAL ANNUITY MARKET:

Total Industry Annuity Net Assets

(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Variable	$307.5	$399.9	$502.4	$640.0	$771.3	$973.5	$956.5	$885.8	$795.6	$993.9
Fixed	356.0	388.0	432.0	429.0	432.0	443.0	398.0	417.0	466.0	513.0
Total Annuity Market	**$663.5**	**$787.9**	**$934.4**	**$1,069.0**	**$1,203.3**	**$1,416.5**	**$1,354.5**	**$1,302.8**	**$1,261.6**	**$1,506.9**

Source: NAVA, Finetre/VARDS and LIMRA Int'l

Total Industry Annuity Sales

(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Variable	$50.2	$51.3	$74.3	$88.2	$99.8	$123.0	$137.3	$113.3	$115.0	$126.4
Fixed	47.2	49.0	38.0	38.2	32.0	41.7	52.7	74.3	103.3	87.6
Total Annuity Market	**$97.4**	**$100.3**	**$112.3**	**$126.4**	**$131.8**	**$164.7**	**$190.0**	**$187.6**	**$218.3**	**$214.0**

Source: NAVA, Finetre/VARDS and LIMRA Int'l

Total Industry Annuity Net Assets: Qualified vs. Non-qualified

(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Qualified:										
Variable	$168.5	$296.9	$355.4	$434.0	$510.3	$630.5	$604.5	$550.8	$494.6	$598.5
Fixed	160.0	191.0	190.0	180.0	210.0	210.0	189.0	170.0	186.0	200.0
Total Qualified	$328.5	$487.9	$545.4	$614.0	$720.3	$840.5	$793.5	$720.8	$680.6	$798.5
Non-qualified:										
Variable	$139.0	$103.0	$147.0	$206.0	$261.0	$343.0	$352.0	$335.0	$301.0	$395.4
Fixed	196.0	197.0	242.0	249.0	222.0	233.0	209.0	247.0	280.0	313.0
Total Non-qualified	$335.0	$300.0	$389.0	$455.0	$483.0	$576.0	$561.0	$582.0	$581.0	$708.4
Total Annuity Market	**$663.5**	**$787.9**	**$934.4**	**$1,069.0**	**$1,203.3**	**$1,416.5**	**$1,354.5**	**$1,302.8**	**$1,261.6**	**$1,506.9**

Source: NAVA, Finetre/VARDS and LIMRA Int'l

Total Industry Annuity Sales: Qualified vs. Non-qualified

(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Qualified:										
Variable	$27.5	$28.1	$40.7	$48.4	$49.2	$62.9	$70.8	$60.4	$66.0	$74.1
Fixed	17.5	18.7	13.5	12.1	11.8	15.6	15.4	19.0	31.1	25.1
Total Qualified	$45.0	$46.8	$54.2	$60.5	$61.0	$78.5	$86.2	$79.4	$97.1	$99.2
Non-qualified:										
Variable	$22.7	$23.2	$33.6	$39.8	$50.6	$60.1	$66.5	$52.9	$49.0	$52.3
Fixed	29.7	30.3	24.5	26.1	20.2	26.1	37.3	55.3	72.2	62.5
Total Non-qualified	$52.4	$53.5	$58.1	$65.9	$70.8	$86.2	$103.8	$108.2	$121.2	$114.8
Total Annuity Market	**$97.4**	**$100.3**	**$112.3**	**$126.4**	**$131.8**	**$164.7**	**$190.0**	**$187.6**	**$218.3**	**$214.0**

Source: NAVA, Finetre/VARDS and LIMRA Int'l

Total Industry Annuity Sales: Deferred vs. Immediate

(dollars in billions)

	1996	1997	1998	1999	2000	2001	2002	2003
Deferred	$107.0	$120.8	$126.2	$158.0	$181.4	$177.4	$207.1	$202.5
Immediate	5.3	5.6	5.6	6.7	8.6	10.2	11.2	11.5
Annual Total	**$112.3**	**$126.4**	**$131.8**	**$164.7**	**$190.0**	**$187.6**	**$218.3**	**$214.0**

Source: NAVA, Finetre/VARDS and LIMRA Int'l

Total Industry Annuity Net Assets by Investment Objective

(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Variable Annuity Accounts:										
Equity	$125.2	$185.1	$257.5	$360.5	$464.2	$634.9	$621.7	$518.8	$381.5	$537.0
Fixed Accounts	122.0	139.3	152.6	165.1	162.9	175.7	179.8	196.5	234.8	256.9
Balanced	31.1	40.2	49.7	63.7	77.7	86.5	80.4	69.2	64.7	84.1
Bonds	18.0	24.0	28.4	35.2	44.7	45.0	44.0	61.9	75.7	87.1
Money Market	11.2	11.3	14.2	15.5	21.8	31.4	30.6	39.4	38.9	28.8
Fixed Annuity Accounts	356.0	388.0	432.0	429.0	432.0	443.0	398.0	417.0	466.0	513.0
Total	**$663.5**	**$787.9**	**$934.4**	**$1,069.0**	**$1,203.3**	**$1,416.5**	**$1,354.5**	**$1,302.8**	**$1,261.6**	**$1,506.9**

Source: NAVA, Finetre/VARDS and LIMRA Int'l

Total Industry Annuity Sales by Distribution Channel

(dollars in billions)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Captive Agents	$41.5	$40.7	$42.1	$44.2	$45.4	$52.9	$48.9	$53.0	$54.1
Independent Agents	27.5	24.5	31.9	33.5	48.2	61.7	57.8	68.1	63.1
Stockbrokers	15.7	24.9	29.2	31.6	37.9	36.7	34.7	37.6	37.6
Banks	12.2	17.0	19.4	17.6	26.8	32.3	38.6	49.4	50.2
Direct Response	2.1	3.8	2.4	3.6	4.3	4.1	3.2	2.8	2.3
Other	1.3	1.4	1.4	1.3	2.1	2.3	4.4	7.4	6.7
Total	**$100.3**	**$112.3**	**$126.4**	**$131.8**	**$164.7**	**$190.0**	**$187.6**	**$218.3**	**$214.0**

Source: NAVA, Finetre/VARDS and LIMRA Int'l

*Total Industry Annuity Sales: Qualified Retirement Income Programs**

(dollars in billions)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	Percent change '02/'03
IRA	$25.4	$29.0	$33.6	$38.8	$50.7	$53.8	$50.1	$68.7	$71.6	4%
403(b)	18.0	19.4	21.0	21.4	24.8	27.3	25.0	27.0	27.5	2%
401(k)	2.0	2.3	2.9	3.2	4.3	6.5	2.4	2.3	1.9	-17%
Keogh	0.5	0.5	0.5	0.4	0.4	0.3	0.3	0.5	0.6	20%
Pension Trust	1.1	1.2	1.2	1.0	1.0	0.4	0.4	1.2	0.8	-33%
Deferred Comp.	1.0	1.0	1.1	1.4	2.4	1.8	2.1	2.5	2.5	0%
Total	**$48.0**	**$53.4**	**$60.3**	**$66.2**	**$83.6**	**$90.1**	**$80.3**	**$102.2**	**$104.9**	**3%**

*Based on data from 50 companies

Source: LIMRA Int'l

VARIABLE ANNUITY MARKET:

Variable Annuity Net Assets

(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Net assets	**$307.5**	**$399.9**	**$502.4**	**$640.0**	**$771.3**	**$973.5**	**$956.5**	**$885.8**	**$795.6**	**$993.9**

Source: NAVA and Finetre/VARDS

Variable Annuity Total Sales

(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Sales	**$50.2**	**$51.3**	**$74.3**	**$88.2**	**$99.8**	**$123.0**	**$137.3**	**$113.3**	**$115.0**	**$126.4**

Source: NAVA and Finetre/VARDS

Variable Annuity Quarterly Sales and Assets

(dollars in billions)

	2002					2003				
	Q1	Q2	Q3	Q4	**Total**	Q1	Q2	Q3	Q4	**Total**
Total Sales	$26.8	$29.4	$28.8	$30.0	**$115.0**	$29.9	$32.8	$31.9	$31.8	**$126.4**
Net Sales	$8.0	$6.4	$8.1	$8.2	**$30.7**	$7.6	$12.0	$13.1	$13.3	**$46.0**
Net Assets	$891.5	$830.7	$756.9	$795.6		$800.6	$886.3	$924.8	$993.9	

Source: NAVA and Finetre/VARDS

Number of Unique Variable Annuity Contracts Offered

(units)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Contracts	**129**	**170**	**201**	**240**	**295**	**359**	**437**	**523**	**667**	**818**

Source: NAVA and Finetre/VARDS

Variable Annuity Total Sales: Immediate vs. Deferred

(dollars in billions)

	1996	1997	1998	1999	2000	2001	2002	2003
Deferred	$74.2	$88.1	$99.6	$122.7	$136.7	$112.7	$114.5	$125.9
Immediate	0.1	0.1	0.2	0.3	0.6	0.6	0.5	0.5
Annual Total	**$74.3**	**$88.2**	**$99.8**	**$123.0**	**$137.3**	**$113.3**	**$115.0**	**$126.4**

Source: NAVA and Finetre/VARDS

Variable Annuity Net Assets: Immediate vs. Deferred

(dollars in billions)

	1996	1997	1998	1999	2000	2001	2002	2003
Deferred	$502.0	$639.3	$770.3	$972.1	$954.8	$883.9	$793.7	$991.6
Immediate	0.4	0.7	1.0	1.4	1.7	1.9	1.9	2.3
Annual Total	**$502.4**	**$640.0**	**$771.3**	**$973.5**	**$956.5**	**$885.8**	**$795.6**	**$993.9**

Source: NAVA and Finetre/VARDS

Variable Annuity Total Sales: Qualified vs. Non-qualified

(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Qualified	$27.5	$28.1	$40.7	$48.4	$49.2	$62.9	$70.8	$60.4	$66.0	$74.1
Non-qualified	22.7	23.2	33.6	39.8	50.6	60.1	66.5	52.9	49.0	52.3
Total	**$50.2**	**$51.3**	**$74.3**	**$88.2**	**$99.8**	**$123.0**	**$137.3**	**$113.3**	**$115.0**	**$126.4**

Source: NAVA and VARDS

Variable Annuity Net Assets: Qualified vs. Non-qualified

(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Qualified	$168.5	$296.9	$355.4	$434.0	$510.3	$630.5	$604.5	$550.8	$494.6	$598.5
Non-qualified	139.0	103.0	147.0	206.0	261.0	343.0	352.0	335.0	301.0	395.4
Total	**$307.5**	**$399.9**	**$502.4**	**$640.0**	**$771.3**	**$973.5**	**$956.5**	**$885.8**	**$795.6**	**$993.9**

Source: NAVA and VARDS

Variable Annuity Net Assets by Investment Objective

(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Equity	$125.2	$185.1	$257.5	$360.5	$464.2	$634.9	$621.7	$518.8	$381.5	$537.0
Fixed Accounts	122.0	139.3	152.6	165.1	162.9	175.7	179.8	196.5	234.8	256.9
Balanced	31.1	40.2	49.7	63.7	77.7	86.5	80.4	69.2	64.7	84.1
Bonds	18.0	24.0	28.4	35.2	44.7	45.0	44.0	61.9	75.7	87.1
Money Market	11.2	11.3	14.2	15.5	21.8	31.4	30.6	39.4	38.9	28.8
Total	**$307.5**	**$399.9**	**$502.4**	**$640.0**	**$771.3**	**$973.5**	**$956.5**	**$885.8**	**$795.6**	**$993.9**

Source: NAVA and Finetre/VARDS

Variable Annuity Net Assets by Subaccount Investment Objective

(dollars in billions)

Subaccounts	**1999**	**2000**	**2001**	**2002**	**2003**
EQUITY FUNDS:					
Aggressive Growth	$51.7	$53.3	$38.8	$15.6	$15.0
Growth	199.8	202.6	165.1	129.1	190.0
Small Company	19.0	22.3	21.6	17.9	30.5
Specialty	14.2	17.5	15.6	13.3	20.2
International Stock	64.7	61.5	45.8	35.0	50.8
Growth and Income	266.0	245.7	213.9	156.3	210.3
Equity-Income	19.5	18.8	18.0	14.3	20.2
FIXED ACCOUNTS:					
Fixed	175.7	179.8	196.5	234.8	256.9
BALANCED:					
Balanced/Asset Allocation	79.9	74.4	63.7	59.4	77.6
Balanced/Income	2.2	2.1	2.3	2.3	3.3
Balanced/International	4.4	3.9	3.2	2.8	2.8
Balanced/Convertable	–	–	–	0.2	0.4
BONDS:					
Corporate Bond General	14.0	14.8	25.2	26.5	29.0
Corporate Bond High Quality	9.0	9.6	13.8	17.4	18.0
Corporate Bond High Yield	13.7	11.1	11.4	11.6	18.5
International Bond	1.8	1.6	1.5	2.2	2.8
Government Bond General	5.3	5.4	7.5	13.1	16.3
Government Bond Mtge-Backed	0.6	0.6	0.9	1.7	1.9
Government Bond Treasury	0.6	0.9	1.6	3.2	0.6
MONEY MARKET:					
Money Market	31.4	30.6	39.4	38.9	28.8
	$ 973.5	**$ 956.5**	**$ 885.8**	**$ 795.6**	**$993.9**

Source: NAVA and Finetre/VARDS

Variable Annuity Sales by Distribution Channel

(dollars in billions)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Captive Agents	$28.2	$31.9	$34.3	$37.9	$39.7	$45.9	$40.8	$40.9	$42.7
Independent Agents	8.8	8.9	15.9	19.0	32.0	37.8	27.8	29.1	33.5
Stockbrokers	10.8	22.3	26.5	28.9	33.2	33.4	30.3	30.5	31.6
Banks	2.0	8.2	9.7	11.0	14.7	16.7	11.8	12.5	17.3
Direct Response	1.5	3.0	1.8	3.0	3.4	3.5	2.6	2.0	1.3
Total	**$51.3**	**$74.3**	**$88.2**	**$99.8**	**$123.0**	**$137.3**	**$113.3**	**$115.0**	**$126.4**

Source: NAVA and Finetre/VARDS

Variable Annuity Sales by State – 2002

(dollars in billions)

Rank	State	2002 Total	% of Total
1	California	$10.2	10.3%
2	New York	7.4	7.4%
3	Florida	7.0	7.0%
4	Texas	5.7	5.8%
5	Illinois	4.7	4.7%
6	New Jersey	4.3	4.3%
7	Pennsylvania	4.3	4.3%
8	Ohio	3.6	3.7%
9	Michigan	3.6	3.6%
10	North Carolina	2.9	2.9%
11	Massachusetts	2.7	2.7%
12	Minnesota	2.5	2.5%
13	Virginia	2.4	2.4%
14	Georgia	2.3	2.3%
15	Wisconsin	2.3	2.3%
16	Indiana	2.2	2.2%
17	Connecticut	1.9	1.9%
18	Washington	1.9	1.9%
19	Maryland	1.8	1.9%
20	Colorado	1.8	1.9%
21	Arizona	1.8	1.8%
22	Tennessee	1.7	1.7%
23	Missouri	1.7	1.7%
24	Iowa	1.3	1.3%
25	Louisiana	1.1	1.1%
26	South Carolina	1.1	1.1%
27	Utah	1.0	1.0%
28	Oklahoma	$1.0	1.0%
29	Alabama	1.0	1.0%
30	Kansas	1.0	1.0%
31	Arkansas	1.0	1.0%
32	Kentucky	0.9	0.9%
33	Oregon	0.8	0.8%
34	Rhode Island	0.8	0.8%
35	Nebraska	0.6	0.6%
36	Montana	0.6	0.6%
37	New Mexico	0.6	0.6%
38	Nevada	0.6	0.6%
39	New Hampshire	0.5	0.5%
40	Maine	0.5	0.5%
41	Hawaii	0.5	0.5%
42	Mississippi	0.5	0.5%
43	West Virginia	0.4	0.4%
44	Idaho	0.4	0.4%
45	North Dakota	0.4	0.4%
46	Delaware	0.3	0.3%
47	District of Columbia	0.3	0.3%
48	South Dakota	0.3	0.3%
49	Vermont	0.3	0.3%
50	Wyoming	0.2	0.2%
51	Other	0.2	0.2%
52	Alaska	0.1	0.1%
53	Puerto Rico	0.1	0.1%
54	Virgin Islands	0.0	0.0%
	Total	**$99.2***	**100.0%**

*$99.2 represents 86.3% of 2002 total sales of $115.0

Source: NAVA and Finetre/VARDS

FIXED ANNUITY MARKET:
(Includes Structured Settlements)

Fixed Annuity Net Assets
(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Net Assets	**$356.0**	**$388.0**	**$432.0**	**$429.0**	**$432.0**	**$443.0**	**$398.0**	**$417.0**	**$466.0**	**$513.0**

Source: LIMRA Int'l

Fixed Annuity Sales
(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Sales	**$47.2**	**$49.0**	**$38.0**	**$38.2**	**$32.0**	**$41.7**	**$52.7**	**$74.3**	**$103.3**	**$87.6**

Source: LIMRA Int'l

Fixed Annuity Net Assets: Qualified vs. Non-qualified
(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Qualified	$160.0	$191.0	$190.0	$180.0	$210.0	$210.0	$189.0	$170.0	$186.0	$200.0
Non-qualified	196.0	197.0	242.0	249.0	222.0	233.0	209.0	247.0	280.0	313.0
Total	**$356.0**	**$388.0**	**$432.0**	**$429.0**	**$432.0**	**$443.0**	**$398.0**	**$417.0**	**$466.0**	**$513.0**

Source: LIMRA Int'l

Fixed Annuity Sales: Qualified vs. Non-qualified
(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Qualified	$17.5	$18.7	$13.5	$12.1	$11.8	$15.6	$15.4	$19.0	$31.1	$25.1
Non-qualified	29.7	30.3	24.5	26.1	20.2	26.1	37.3	55.3	72.2	62.5
Total	**$47.2**	**$49.0**	**$38.0**	**$38.2**	**$32.0**	**$41.7**	**$52.7**	**$74.3**	**$103.3**	**$87.6**

Source: LIMRA Int'l

Fixed Annuity Sales: Immediate vs. Deferred

(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Deferred	$41.6	$42.8	$32.8	$32.7	$26.6	$35.3	$44.7	$64.7	$92.6	$76.6
Immediate	5.6	6.2	5.2	5.5	5.4	6.4	8.0	9.6	10.7	11.0
Annual Total	**$47.2**	**$49.0**	**$38.0**	**$38.2**	**$32.0**	**$41.7**	**$52.7**	**$74.3**	**$103.3**	**$87.6**

Source: LIMRA Int'l

Fixed Annuity Sales by Distribution Channel

(dollars in billions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Captive Agents	$12.5	$13.3	$8.8	$7.8	$6.3	$5.7	$7.0	$8.1	$12.1	$11.4
Independent Agents	16.5	18.7	15.6	16.0	14.5	16.2	23.9	30.0	39.0	29.6
Stockbrokers	4.2	4.9	2.6	2.7	2.7	4.7	3.3	4.4	7.1	6.0
Banks	12.1	10.2	8.8	9.7	6.6	12.1	15.6	26.8	36.9	32.9
Direct Response	0.7	0.6	0.8	0.6	0.6	0.9	0.6	0.6	0.8	1.0
Other	1.2	1.3	1.4	1.4	1.3	2.1	2.3	4.4	7.4	6.7
Total	**$47.2**	**$49.0**	**$38.0**	**$38.2**	**$32.0**	**$41.7**	**$52.7**	**$74.3**	**$103.3**	**$87.6**

Source: LIMRA Int'l

Glossary of Terms

Accumulation phase or accumulation period: The time when the owner of a deferred annuity makes payments into the contract and accumulates assets.

Accumulation units: A contract holder's evidence of ownership in a variable annuity investment portfolio during the savings period. As additional premiums are paid, additional units are purchased.

Accumulation value: The sum of premiums and earnings in an annuity contract, minus contract charges and withdrawals. Also known as the contract value.

Administrative charges: Expenses that cover all of the services involved with maintaining a variable annuity contract, such as transfers among sub-accounts, preparation of contract statements and mailings, and other customer services.

Annual contract fee: An annual fee, typically $30 or $40, paid to the insurance company for administering the contract. The fee is often waived for contracts with high account values.

Annuitant: The person(s) upon whose life annuity payments are based. Often, but not always, the annuitant and the owner are the same person.

Annuitization: The conversion of the accumulated value of an annuity into a stream of income, either for one or more lifetimes or a specific period of time.

Annuity: A series of periodic payments.

Annuity commencement date: The date income payments begin. Also known as the annuity starting date.

Annuity contract: A legal agreement between the contract owner and the insurance company.

Annuity income payments or payouts: A series of payments made over a specified period of time with the duration guaranteed by the life insurance company at the beginning of the period.

Annuity purchase rate: The cost of an annuity based on insurance company tables, which take into account various factors such as age and gender.

Annuity starting date: See definition of "annuity commencement date."

Annuity unit value: The measurement used to determine the amount of variable annuity payments. The amount of the payment is determined by the number of annuity units times the annuity unit value at the time of the payment.

A-share variable annuities: Variable annuity contracts that have up-front sales charges instead of surrender charges. Sales charges are calculated as a percentage of each purchase payment. Often accompanied by lower M&E charges.

Assumed interest rate (AIR): The rate of interest an annuity provider uses to determine the amount of each variable annuity income payment. (Also known as the benchmark rate.) If the actual performance of the contract holder's underlying investment portfolio is higher than the AIR, payments will go up; if it is lower, payments will go down.

Asset allocation programs: A system of allocating variable annuity purchase payments to subaccounts based on a contract owner's financial goals and risk tolerance. Portfolio rebalancing programs "rebalance" the amount of money allocated to each subaccount when the target percentages move out of alignment over time as the value of some subaccounts changes faster than others.

Beneficiary: The person designated under the contract to receive any payments that may be due upon the death of the owner or the annuitant.

B-share variable annuities: Variable annuity contracts characterized by deferred sales charges which typically range from 5%–7% in the first year, and subsequently decline to zero after 5–7 years. The most common form of annuity contract sold.

Cash-refund annuity: An annuity which guarantees that if the annuitant dies before the total of annuity payments received equals the premiums paid for the annuity, a lump sum equal to the difference between the premiums and the sum of the annuity payments already made is paid to the beneficiary.

Cash surrender value: The amount that can be withdrawn from the contract after the deduction of any surrender charge. It is equal to the contract value (the sum of premiums and earnings minus contract charges and withdrawals) minus the surrender charge. Also known as cash value.

Commutation: A process provided under some annuities that allows annuity payments to be terminated and the remaining value to be withdrawn from the contract.

Contract date: The date an annuity contract becomes effective.

Contract owner: The person(s) who pays the premiums and has certain rights under the contract, such as making withdrawals, determining investment decisions, surrendering the contract, and changing the beneficiary or other terms of the contract.

Contract value: See definition of "accumulation value."

C-share variable annuities: Variable annuity contracts with no up-front or contingent deferred sales charge which offer full liquidity to contract holders at any time. Also called no-surrender charge annuities.

Death benefit: The payment made to the beneficiary upon the death of the contract owner or annuitant.

Deferred annuity: An annuity contract that is purchased either with a single premium or with periodic payments to help save for retirement. The contract owner determines the point at which accumulated principal and earnings are converted into a stream of income.

Dollar cost averaging: A program for investing a fixed amount of money at set intervals with the goal of purchasing more shares at low values and fewer shares at high values. Variable annuity dollar cost averaging programs involve allocating a certain amount of money to one investment subaccount, such as the money market fund, and then having portions of that payment periodically transferred to other subaccounts.

Enhanced death benefit: A death benefit that goes beyond the guaranteed minimum death benefit by locking in investment gains every few years or every year, or paying a minimum stated interest rate on purchase payments.

Enhanced earnings benefit: A feature of some variable annuity contracts which provides beneficiaries with an additional death benefit amount, usually equal to a percentage of earnings.

Equity indexed annuity: An annuity that allows limited participation in gains tied to an index, usually the S&P 500, and that also provides a floor guarantee against downside market risk.

Expense ratio: The amount, as a percentage of the total variable annuity account value, that is paid annually for administrative, investment, management, and insurance expenses.

Fixed account: Part of the insurance company's general account to which a variable annuity contract owner may allocate all or part of premium payments. A minimum rate of interest is guaranteed, usually for a period of one year. Also known as a fixed investment option.

Fixed annuity: An annuity contract that guarantees that the contract owner will earn a stated rate of interest during the accumulation phase of a deferred annuity, and receive a fixed amount of income on a regular schedule when the contract is annuitized.

Fixed investment option: See definition of "fixed account."

Flexible premium contract: A contract that allows payments to be made at any time after the initial purchase payment.

Free-look period: A specified number of days (e.g. 10 days) during which an annuity contract owner may revoke the purchase of the contract.

General account: All the assets of the insurance company not allocated to separate accounts.

Guaranteed death benefit: The basic death benefit offered under variable annuity contracts. If the owner or, in some contracts, the annuitant dies before annuity income payments begin, the beneficiary will receive a payment equal to the greater of the contract value or purchase payments less withdrawals. Many variable annuity contracts now offer enhanced death benefits.

Guaranteed living benefit: A benefit that protects against investment risks by guaranteeing the level of account values or annuity payments. There are three types—guaranteed minimum income benefits, guaranteed minimum accumulation benefits, and guaranteed minimum withdrawal benefits.

Guaranteed minimum accumulation benefit: A guarantee that the contract value will be at least equal to a certain minimum amount after a specified number of years.

Guaranteed minimum income benefit: A guarantee that ensures, under certain conditions, that the owner may annuitize the contract based on the greater of (1) the actual account value or (2) a "payout base" equal to premiums credited with some interest rate, or the maximum anniversary value of the account prior to annuitization.

Guaranteed minimum withdrawal benefit: A guarantee that promises that the owner may make annual withdrawals of a stated percentage of total premiums (e.g., 7%) until the premiums are completely recovered, regardless of market performance or the actual account balance.

Guarantee period: The period during which the level of interest credited under a fixed annuity is guaranteed.

Immediate annuity: An annuity that is purchased with a single lump sum. Income payments begin within a short period—less than 13 months. Immediate annuities can be either fixed or variable.

Indexed annuity: See definition of "equity indexed annuity."

Income or payout options: Different ways by which a contract owner can receive income from an annuity. These include a lump sum payment, systematic withdrawals, and annuitization.

Installment-refund annuity: An annuity that guarantees that if the annuitant dies before the total of the annuity payments received equals the premiums paid for the annuity, the annuity payments will continue to the beneficiary until the total of the annuity payments equals the premiums.

Insurance charges: Charges that cover administrative expenses and the cost of the mortality and expense (M&E) risk.

Investment management fee: The fee paid in connection with the professional management of the assets of the investment funds underlying variable annuities.

Issuer: The insurance company that issues the annuity contract.

Joint and survivor annuity: A life annuity in which there are two annuitants, usually spouses, known as joint annuitants. Annuity payments continue as long as either annuitant is alive.

Levelized annuity payments: Annuity payments under a variable annuity contract that remain the same for a period of time, such as 12 months, and then change to reflect investment performance. Once changed, the payments remain the same for the next twelve months.

Life annuity: Annuity payments that are guaranteed to continue for the life of the annuitant.

Life annuity with installments certain: An annuity that provides that if the annuitant dies before a certain number of payments have been made, the remaining number of payments will be made to the beneficiary.

Life annuity with period certain: A type of refund annuity that guarantees that if the annuitant dies before payments have been made for some minimum number of years, payments to the beneficiary will continue until the end of the guarantee period.

L-share variable annuities: Variable annuity contracts that typically have shorter surrender periods, such as three or four years, but may have higher M&E charges.

Market value adjustment: A feature included in some annuity contracts that imposes an adjustment or fee upon the surrender of a fixed annuity or the fixed account of a variable annuity. The adjustment is based on the relationship of market interest rates at the time of surrender and the interest rate guaranteed in the annuity.

Mortality and expense (M&E) risk charge: A fee that pays for the insurance guarantees, including the death benefit and the ability to choose a payout option that can provide lifetime income at rates set in the contract at the time of purchase.

Non-qualified annuities: Any annuity that is not purchased as part of a retirement program that receives special tax treatment.

Partial surrender: The withdrawal of an amount less than the entire cash surrender value of the contract.

Payout phase or payout period: The period during which the money accumulated in a deferred annuity contract, or the purchase payment for an immediate annuity, is paid out as income payments.

Portfolio rebalancing: A type of asset allocation program that periodically reallocates contract assets, in specified proportion, among fixed and variable investment options under a variable annuity contract.

Premiums: The amounts of money paid into an annuity contract. Also known as purchase payments.

Purchase payments: See definition of “premiums.”

Pure life annuity: An annuity with payments that stop when the annuitant dies. Also known as a straight life annuity.

Qualified annuity: An annuity purchased with pre-tax dollars as part of a retirement program such as a 401(k) plan that receives special tax treatment.

Ratchet guaranteed minimum death benefit: A type of enhanced death benefit that is equal to the greater of (1) the contract value, (2) premium payments less prior withdrawals, or (3) the contract value on a specified prior date.

Refund annuity: A type of annuity that guarantees that if the annuitant dies before a specified amount of premiums paid for the annuity are received as annuity income, some or all of the premiums will be refunded to the beneficiary.

Retirement income period: The period during which the money accumulated in a deferred annuity contract, or the purchase payment for an immediate annuity, is paid out as income payments.

Rising floor guaranteed minimum death benefit: A type of enhanced death benefit that is equal to the greater of (a) contract value or (b) premium payments less prior withdrawals increased annually at a specified rate of interest.

Savings period: The period in which the owner of a deferred annuity makes payments and accumulates assets.

Separate account: An account that is set apart from an insurer's general account and is legally insulated from the insurer's general creditors. Variable annuities are issued through separate accounts.

Single premium annuity: An annuity contract that is purchased with a single payment. All immediate annuities and some deferred non-qualified annuities are in this category.

Stepped-up death benefit: A death benefit that is increased regularly to protect investment gains.

Straight life annuity: See definition of a "pure life annuity."

Subaccount: The investment funds offered in variable annuity contracts are often referred to as subaccounts. The term refers to their position as accounts held within the separate account of the insurance company offering the variable annuity.

Surrender charge: The cost to a contract owner for withdrawals from the contract before the end of the surrender charge period. The surrender charge period typically is five to seven years.

Systematic withdrawal plan: A plan that allows a variable annuity contract owner or other designated person to periodically receive a specified amount as a partial withdrawal from the annuity contract value prior to the annuity starting date. Unlike lifetime annuity payments, systematic withdrawals can continue only until the contract cash value is exhausted. The tax treatment of systematic withdrawals differs from that of annuity payments.

Term certain annuity: An annuity that provides income payments over a fixed number of years.

Transfer: The movement of assets from one subaccount to another.

Transfer fee: The charge for transferring assets from one subaccount to another.

Unbundled contracts: Annuity contracts that permit purchasers to choose and pay for certain optional features they want in their contract.

Variable annuity: An annuity whose contract value or income payments vary in dollar amount according to the investment performance of selected subaccounts.

Variable annuitization: Retirement income payments that vary based on the performance of underlying subaccounts.

Variable annuity payment floors: A guaranteed minimum amount or “floor” for each annuity payment.

Withdrawals: Distributions from an annuity other than scheduled annuity payments.

Withdrawal fee: An administrative fee charged on withdrawals.

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1982: Tax Equity and Fiscal Responsibility Act of 1982 allows annuities to keep their valuable tax-deferred status, retains the exclusion ratio which treats annuitization payments as part return of principal and part return of taxable earnings, and changes the taxation of withdrawals from principle first to income first.

1984: Tax Reform Act of 1984 eliminates the double taxation of realized capital gains of separate accounts at the insurance company level.

1986: Tax Reform Act of 1986 disallows non-natural owners of annuities unless they are held by a trust acting as agent for an individual. Capital gain preference tax is eliminated and tax shelter investments are greatly curtailed.

1991: The National Association for Variable Annuities (NAVA) is formed.

1994: Variable annuity sales figures published on a regular basis in the *National Underwriter*.

1995: Equity Indexed Annuities and maximum anniversary value death benefit introduced.

1995: Total annuity sales top $100 billion.

1997: Total annuity assets top $1 trillion

1998: Bonus variable annuities and guaranteed minimum income benefit (GMIB) introduced.

1999: Variable annuity sales top $100 billion.

2000: Variable annuity assets top $1 trillion in the first quarter.

2000: Enhanced earnings benefits (EEBs) and L-share variable annuities introduced.

2002: Industry standardizes net flow reporting.

2002: Fixed annuity sales top $100 billion.

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