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A Primer on Living Benefits

Baby boomers, as they move toward retirement, are beginning to question how they will maintain their standard of living during their golden years. For many, the need to create lifetime income will require the use and integration of many investment products, perhaps including variable annuities.

For those of whom variable annuities are a suitable solution, the big question to answer is "which one?" Variable annuities today come with a variety of riders, all of which are designed to address specific investment objectives and risk profiles, but especially principal risk and longevity risk. Most of those features come in the form of guarantees, chief among them the guaranteed death benefit and the guaranteed living benefit. What are some of those guarantees and what are the risks and benefits associated with those guarantees?

Variable annuities with a guaranteed death benefit are suitable for individuals who would like to be heavily invested in the market, yet would like to have guarantees about the amount of money that their heirs will receive even if the market declines, and who want at least some access to the cash value in the meantime. In other words, they do not plan to or need to "annuitize" their variable annuity. Often, the basic death benefit is equal to the greater of (1) the contract value, and (2) purchase payments less withdrawals (or what is also called a "return of premiums" guarantee) and is made to the beneficiary upon the death of the owner and/or annuitant, according to RetireOnYourTerms. Nearly all contracts sold these days have additional death benefit features, including guaranteed accruals on premiums and/or so-called "high water marks" that pay the highest value on any previous contract anniversary date, according to "The Annuity Advisor" by John Olsen and Michael Kitces, MSFS, CFP®, CLU, ChFC.

Some variable annuities also have guaranteed living benefits, which are designed for investors who desire current protection of principal, income, or the ability to take withdrawals, while they are still alive. In some cases, obtaining the protection features may require them to "annuitize" their investment. In other cases, principal may be recovered through guaranteed withdrawals over a specified period, and annuitization is not required. Other forms of living benefits guarantee a floor of principal that will be restored if the annuity has experienced losses over a set time period. With a guaranteed living benefit, the owner or annuitant is purchasing protection against investment risk or the risk of not being able to generate an adequate amount of income, and the variable annuity contract will either guarantee the level of account values which may be accessed through current withdrawals or the amount of annuitized payments that can be received in the future.

Typically, these guarantees come with some restrictions of one form or another depending on the guarantee. What's more, variable annuities with guarantees may be confusing. Contracts, for
instance, may make a distinction between the payout base of a variable annuity that can be used to generate guaranteed income (but not available for withdrawal) and the actual contract cash value that can be surrendered at any time.

The most popular forms of guaranteed living benefits features are guaranteed minimum income benefit (GMIB) riders, guaranteed minimum accumulation (or account) benefit (GMAB) riders,

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and guaranteed minimum withdrawal benefit (GMWB) riders. Immediate annuities with for-life guarantees can be nice retirement income tools, but may not always be the best fit for your client.

The variable annuity with a GMIB rider ensures that under certain conditions the owner may annuitize the contract based on the greater of (1) actual account value or (2) an adjusted 'payout base' equal to premiums credited with a specified minimum interest rate or a step-up in value based upon the maximum annual anniversary value of the account value prior to annuitization. In essence, these products are designed to provide a steadily growing base for generating annuitized income, even in the face of a large or extended bear market. Most GMIBs provide an annuitization value based on the greater of premiums accumulated at a 5 or 6 percent return, or an annual step-up of the contract value. Some contracts require a waiting period of as much as 10 years prior to the implementation of the guaranteed payments.

These annuities have several restrictions. An annuity owner must annuitize in order to exercise the guarantee; there may be a minimum exercise age; and the guaranteed annuity payout rates are typically much lower than current rates on new immediate annuity contracts. What's more, the annuity owner, after annuitizing their investment under the guarantee, may not participate in any stock market gains (if a fixed annuitization is required or selected). And, the annuity owner who dies after annuitizing the contract may not be able to pass any money to beneficiaries, depending on the form of benefit selected or required under the guarantee Also of note, the contract for these products should always be read carefully since it contains language that defines exactly how the GMIB payout base is determined, as well as disclosure of additional fees resulting from the GMIB benefit. These fees directly reduce the performance of the contract and may range from 25 to 65 basis points.

The variable annuity with a GMAB rider promises that, at specified periods, the account value will not be less than purchase payments, sometimes with an additional minimum rate of interest. After a specified waiting period the annuity owner's losses are immediately restored to the guaranteed minimum account value, without any annuitization requirements. Thus, even if investment losses are otherwise incurred, the annuity owner will at least get back their original investment. A drawback is that investors who purchase a GMAB cannot take current income from the product during the waiting period without a potential reduction in the guarantee. Companies offering GMABs typically reserve the right to reallocate unilaterally the annuity owner's investments. As with the other benefits, the fees incurred in exchange for the GMAB should be carefully considered.

The variable annuity with the GMWB rider allows contract holders to take a set percentage of the original investment, usually from 5 to 7 percent, as distributions per year, regardless of investment performance. Thus, even in a period of declining stock prices where the account value goes to $0, an annuity owner will eventually get back their entire principal a bit at a time. In addition, in a bull market, some riders allow the annuity owner to step up their guaranteed amount to the highest contract value, usually every three to five years, but sometimes annually. As with the other benefits outlined, the cost of the benefit may be "wasted" if the guarantee isn't actually utilized. On the other hand, the psychic support provided by the guarantee may allow a particular investor to subject long-term assets to market risk (and the prospect of higher returns) when otherwise she would not do so. Withdrawals in excess of the guaranteed amount reduce the amount of principal protected or may forfeit the guarantee. Of note, the annuity owner doesn't have to annuitize as they do with the GMIB and they may have to wait to withdraw money as they do with the GMAB.

With a GMWB, there are specific restrictions. This form of guaranteed benefit does not provide permanent income and it will take a specified time period, usually 14 or more years (at 7 percent withdrawals per year), to get the initial investment back. In some cases, there may be a waiting period of up to five years before withdrawals can be exercised. Typically, taking out any withdrawal in excess of the GMWB allowable amount can substantially reduce or completely lose the underlying guarantee.

Regardless of the rider, an investor must understand what costs are incurred in order to manage the risk negated. Generally, the insurance companies who provide these benefits do so in order to support investors that want to take on market risk when they otherwise might not do so, and expect few contract holders to exercise the benefit. And since some companies were hurt by mistakenly priced products during the last bear market, few benefits are now likely to be offered without corresponding, fully priced costs. Fully informed investors will select benefits carefully based upon their priorities and after a full consideration of the cost and associated risks.

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