

Liability Risk

Failure to mention GMWBs may lead to lawsuits

BY MARK NOBLE

Advisors who fail to mention guaranteed minimum withdrawal benefit products (GMWBs) to clients could leave themselves open to legal liability, says a U.S. lawyer and variable annuities expert.

John Huggard, a retired law professor who now consults on variable annuities, believes GMWBs are the most important personal financial innovation since the introduction of the mutual fund in the 1940s. Huggard says advisors have a fiduciary responsibility to mention GMWBs just as they need to discuss other major asset classes like mutual funds, stocks, bonds and insurance.

Huggard believes GMWBs are the only product that addresses two important problems faced by investors in the drawdown phase of investing – longevity risk and sequence of returns.

Longevity risk is straightforward; it's the risk that retirees will outlive their money. Sequence of returns relates to the devastating impact drawing down a portfolio during a bear market can have on a retirement portfolio – particularly during the early stages of retirement if it's a bear market. Sequence of returns interacts considerably to longevity risk, since a market downturn in the early stages of drawdown could take a decade off the retirement portfolio's lifespan, leaving an investor financially ruined before they die.

Defined benefit pension plans solve this problem but most people don't have them and those that do may see it phased out in the future. For those without a guaranteed pension income, GMWBs could be a worthwhile alternative.

This isn't just Huggard's opinion. U.S. regulators, such as the Financial Industry Regulatory Authority, are also taking notice. Huggard says he was asked by a financial entity to help on the case of an accredited advisor who didn't mention the existence of GMWBs to a group of early retirees who had received lump-sum pension buyouts from an oil company.

"He sat down and decided to tell these people they needed to put their money in stocks, mutual funds, bonds and a little bit into managed money," Huggard says. "These are blue-collar oil workers who have just left work at age 55, they are never going to work again and the cheque in their hand has

got to last them the rest of their lives."

Huggard noted that the advisor should have mentioned to the clients the existence of these products, which would replicate the protections of a pension, providing an income for life and protect a spouse if the retiree happened to die prematurely.

"These people put their money in other products, the market went against them and all of a sudden longevity risk was a big issue for these clients. Not only that, they got caught in the sequence of returns. Around age 63, with no education, they realized they would lose everything they owned: their house, their car and most importantly their dignity," he explains. "The one that really bothered the regulators was the idea that this advisor did not even bother to present variable annuities to these folks."

That advisor's firm was fined for \$3.5 million and the rep was personally fined for \$19.5 million – \$10 million of which was for punitive damages. The company had to pay it and the advisor doesn't get his licence back until he pays the company, which is virtually impossible. Other cases surrounding the same advisor have been subsequently filed that have cost his company close to \$40 million.

"The lawyer for the clients asked every one of them on the stand, 'Had you been told that there was such thing as a living benefit that would have replicated your pension?' Every one of them came back and said not only would they have considered it, they probably would have bought it," he says.

Advisors have a fiduciary responsibility to mention GMWBs just like they need to discuss other major asset classes.

Huggard offers the following rule of thumb for advisors: "If someone comes into your office, and they are 45 years or older, and they have money that both you and they recognize has got to last into their retirement – it could be an IRA, RRSP, a pension buyout, sale of the family farm, it doesn't matter – you've got to help them understand a suitable way for them to invest. That would certainly in-

clude a variable annuity with living benefit," he says. "You've got to make them available to the clients. The minute they come in and say I don't want them, you're off the hook."

Huggard adamantly believes few clients nearing retirement who don't have a guaranteed source of income will turn them down. Rather, he says it's advisors who are stalling their sale. For instance, a lot of advisors are concerned about the solvency or credit risk of insurers to meet the guarantees, something he finds incredible, because the same advisors have no problem selling life insurance.

"Look at insurance. If somebody sells me a million-dollar life insurance policy and I pay \$100,000 premium on it and die. Where is the guarantee that insurance company is going to be able to pay my wife?" he asks. "The insurance company is taking the risk to pay \$1 million to my wife in a lump sum if I die. With a variable annuity, if I put \$100,000 dollars in and a couple years from now start pulling money out of it while the markets go against it, the insurance company may have to pay \$200,000. However, they will have a 20-year window to do it."

Huggard says risk in GMWB contracts is simply mitigated the same way as a life policy. Insurers find the break-even point, and then reinsure all of the excess liability. In turn, the reinsurer will go out and insure their risk, so multiple levels of risk are spread across the industry.

This level of reinsurance means all the variable annuities contracts in the U.S. have been honoured, Huggard says, despite the fact that some of the providers of the early versions of variable annuities (like guaranteed minimum income benefit products (GMIB) or guaranteed minimum accumulation benefits (GMABs)) have stopped selling them or gone out of business.

He chalks this up to the fact that older versions of variable annuities had serious flaws. For example, with a GMIB a client has to opt to annuitize their investment, otherwise it's subject to market conditions.

He thinks the Canadian GMWB products, which offer automatic guaranteed income for life, represent the best in class features. However, in the U.S., the

market is moving forward another step to include inflation protection and long-term care policy conversion.

According to Huggard, GMWBs are worth the price for the right investor profile: an investor over 45 with a substantial nest egg who intends to draw upon it soon, as his or her primary source of retirement income.

Few clients nearing retirement who don't have a guaranteed source of income will turn GMWBs down.

"If you have money sitting in stocks and mutual funds and the stock market drops dramatically – 50% in value over a three-year period – who comes in to insure those stocks and mutual funds against loss? No one," he says. "There is no insurance for those things. People who had their money in Bear Stearns have lost 90% of their money in less than six months. I would rather have my money sitting in an insured product with Manulife, Sun Life, Hartford or ING. Stocks are not insured, IRAs are not insured and RRSPs are not insured."

If there is a risk with GMWBs, Huggard believes it is with their misuse. He stresses investors should hold the GMWB for the requisite period of time to get the benefit and be wary of withdrawing more than the minimum guaranteed amount, as set out in the contract. "Depending on the policy, pulling out more than allowed may significantly reduce their income for the rest of the time they hold the policy," he says.

Indeed, companies such as Manulife warn investors about pulling out more than their allotted yearly amount. For example, if a client over age 65 deposited \$200,000 using Manulife's IncomePlus they would be eligible for lifetime annual guaranteed withdrawals of \$10,000 (5% of \$200k). As long as they didn't exceed the \$10,000 a year withdrawal, they would be able to receive at least this amount for life. If they took out more than \$10,000 in a year – \$20,000 for example – and the market value after their withdrawal was \$160,000, the new lifetime annual guaranteed withdrawal amount would be reset to \$8,000 per year (5% of \$160,000).

Manulife says it does not encourage people to invest only in a GMWB for this reason. The company stresses clients should have funds available in other investments should they need money

over and above the withdrawal amount.

A GMWB's appeal is that the client can construct a portfolio of equities. If the time horizon is long enough, the historical returns of the market would suggest the portfolio should outperform the rate of inflation and fixed-income investments. The big question is whether the extra fees on a GMWB will eat up that difference. Industry analyst Dan Hallett, president of Dan Hallett and Associates, says the total cost of a Canadian GMWB product could be 4% to 5%. He is concerned this could substantially stunt the upside potential of the investment.

Hallett says cheaper alternative guaranteed investments can be constructed. For example, an advisor can construct a portfolio using a traditional annuity and then use fixed income investments with conservative growth rates, such as GICs.

"For a client that has no pension plan, who is relying on their savings for retirement income, looking at some sort of guaranteed product is a good thing to do – it just doesn't have to be this kind of product," he says.

A cost-benefit analysis will become even more difficult as GMWBs offer additional risk management features, such as inflation protection and long-term care conversion. These are features that have just arrived in the U.S. market and make the products much more appealing for protection planning.

Inflation protection is particularly compelling. One of the major criticisms of GMWBs was that if markets are flat or decline, inflation erodes the value of the withdrawal. Huggard says some companies in the U.S. will charge an additional fee to add inflation protection of about 2.5% to 3% on top of the GMWB rider.

Also, three carriers in the U.S. are offering an LTC conversion option, allowing investors to turn their GMWB into a long-term care policy if they need to enter a nursing home. The underwriting is automatic, although the LTC conversion potential only kicks in after the client has held the product for a set number of years.

"The insurer will immediately double the payout so that the 6% payout goes to 12%. If you've got a million dollars in there and you were withdrawing \$60,000 before you went into a nursing home, that will ratchet up to \$120,000. The insurer will pay that as long as you're in the nursing home."