



RETIREMENT INCOME UNIVERSITY

[A MONTHLY COURSE ON RETIREMENT ECONOMICS BY MOSHE A. MILEVSKY, Ph.D.]

LESSON 10:

Questions to Ask Annuity Wholesalers

GUARANTEED LIVING BENEFITS (GLiBs) within variable annuities have evolved from being an ancillary benefit offered on a rather boring investment product, and have now grown to become the *raison d'être* of the VA industry. Marketing, sales and promotional material for VAs are almost entirely focused on the unique insurance guarantee or downside protection that is embedded within their income vehicle, whether it be a living benefit, withdrawal benefit or something in between.

In my opinion, the greatest proof that the broader financial services industry is finally taking notice is the number of traditional asset management companies that are now in the process of trying to develop their own GLiBs — yet without the insurance classification and hence the unique tax treatment. A mere 10 years ago the idea of someone developing an annuity that wasn't an annuity would have been ridiculous. Today it's a business plan.

The story is quite compelling and the evidence suggests that many boomers — both current and future retirees — are now considering these products to help manage the unique risks they face during retirement. In fact, even 401(k), 403(b) and other qualified-plan sponsors are allowing for the addition

of GLiB-enhanced variable annuities in their plan's lineup. This is yet another strategy that 10 years ago was considered imprudent.

Yet one of the issues I have not seen as much emphasis on as I would like is the topic of how exactly the insurance companies themselves are managing the risks that millions of Americans are outsourcing and transferring to these carriers. Sometimes the sales pitches for GLiBs sound like they are too good to be true, which awakens the “no free lunch” economist in me.

Thus — as I mentioned in my inaugural article for *Research* (“Confessions of a VA Critic,” January 2007) — given the increased level of volatility in global equity markets, I believe it is now more important than ever for financial advisors themselves to probe the risk-management practices of the insurance companies promising to stand behind these guarantees.

From a purely financial perspective, GLiBs are complex derivative securities that are closely related to exchange-traded put options. I call them put options because they protect the holder against a decline or fall in equity markets, mortality rates and interest rates. If stock markets decline over the first few years of withdrawals, the policyholder is protected and will

at least get his money back, if not more. Also, if either individual or aggregate mortality rates decline — i.e., longevity increases and we live longer than anticipated — the annuitant will receive greater lifetime payments. Finally, if interest rates decline and immediate annuity prices become even more expensive, the policyholder is assured the ability to annuitize at a cheaper price. Hence, in describing these guarantees, I use the phrase *three-dimensional put* — or to you quants out there, three “state variables” to worry about.

More importantly, if the insurance company is granting complex put options, advisors should be entitled — and perhaps even compelled — to learn more about how the manufacturer is baking this rather complex derivative security. This is not solely the responsibility of the firm's gatekeepers. After all, what will the FA answer when the client asks: OK, how do they do it?

Yet, in today's complex economic environment of opaque financial engineering, how much can a typical advisor dig when the language of risk management is steeped in the Greek of deltas and gammas? Is using a PowerPoint deck with endless slides of equations the only way to address this topic? I think not.

Thus, to help raise the level of discussion, here are some qualitative



questions I personally would ask VA wholesalers — once I understood the basic features of the product — if they were trying to convince me to order a side of GLiBs on their VA menus.

1. Describe to me your company's overall risk-management strategy for variable annuity GLiBs. What is the educational background, size and financial resources of the group dedicated to managing this unique risk?

The proper answer to these questions need not involve rocket-science terminology. And, while having a team of Ph.D.s in mathematical finance with million-dollar budgets and Cray supercomputers on staff might not be insurance against catastrophe, it does signal a commitment and gives some level of re-assurance that the issue is being taken seriously. Personally, I would like to hear that these firms are also employing risk specialists with deep experience in derivative capital markets, as opposed to employing only traditional insurance actuaries.

2. Is your firm hedging (i.e., protecting itself) through the use of futures, options and derivative securities? Is it re-insuring these risks or is it simply reserving against this risk using traditional actuarial methods? For every billion dollars that is going into VAs with GLiBs, how much money is being set aside in reserves for these guarantees?

There is no right or wrong answer to this question. Confidence is not achieved with a deck of PowerPoint slides filled with equations. It might be the truth, but what good is it if your audience doesn't understand?

3. What are the baseline lapse and surrender assumptions built into your hedging, reserving or re-insurance? In other words, what fraction of VA poli-

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cyholders who purchase this particular variable annuity today is expected to still be holding the product in five, 10 and 15 years? How much policyholder irrationality are you assuming in your models? Are 80 percent, 50 percent or only 20 percent of investors expected to rationally utilize the guarantee? What if a secondary market develops for these GLiBs?

4. Does your company have natural business hedges in place to offset some of the unquantifiable exposures associated with longevity risk? Do you sell equal and opposite amounts of life insurance, perhaps for estate-planning purposes, that could help hedge your exposure in the event of a (positive) shock to mortality? Do you have other lines of insurance business that are completely uncorrelated to the GLiB exposure and could help buffer the risk in the event of a prolonged downturn? Do you have any capacity constraints on this particular GLiB?

5. When and how exactly can the currently imposed level of mortality and expense (M&E) insurance fees be increased on the GLiB riders? And when and how exactly might the lineup of currently available investment sub-

accounts be changed or re-arranged in the future?

These are some of the possible entry points to a more detailed discussion about risk management and hedging. In many cases it is very hard to disentangle the exposure and hence fully account for all the risks they face, but I think the questions are still worth asking.

On a slightly more philosophical level, I suspect that when the first GLiBs were created and then fused into VAs, the founding actuaries took more of a statistical rather than financial approach to the pricing and valuation. They likely assumed that the probability of utilization would be quite low given the long-term positive drift in equity markets and the rather low persistency of these contracts over time. It might have been the equivalent of Hewlett Packard offering a \$25 mail-in rebate on a printer to help increase sales, knowing full well that over half the buyers never come around to mailing in the coupon.

Then as the community of financial engineers trained in the techniques and molded by the hyperactivity of capital markets came in contact with the statistically driven actuarial models, the insurance industry started to realize these weren't just ancillary benefits. Wall Street analysts and credit rating agencies soon followed with probing questions, both groups having been previously burned by poorly understood and hidden risks.

In sum, if these living-benefit riders are truly valuable — and I believe that when properly utilized they are — then wholesalers, marketing departments and sales managers must explain how these insurance companies will manage their corporate balance sheet and manage the risks they are so graciously taking off our own personal balance sheet. **■**