GMWB features are changing

Although guaranteed minimum withdrawal benefit products have mostly cut back on payouts, these funds are still attractive to clients who value security

BY DWARKA LAKHAN

UNPREDICTABLE STOCK MARKETS, impending regulatory and accounting changes, higher costs and increasing competition have forced insurance companies to make sweeping changes to their guaranteed minimum withdrawal benefit funds since the innovative product was first launched four years ago.

In most cases, that means making these products more resistant to market upheavals. Notes Moshe Milevsky, associate professor of finance at the Schulich School of Business at York University in Toronto and executive director of the Individual Finance and Insurance Decisions Centre: "GMWBs are evolving; their building codes are changing or, more specifically, their codes are being strengthened — just like what happens to building codes after an unprecedented storm or earthquake."

The changes carry a mixed message for clients. Some changes — such as reduced exposure to the upside of equities, potentially higher fees and reduced guarantees — have made GMWBs less attractive to some investors. But other changes — such as different classes of GMWBs and spousal income streams — have enhanced these products' flexibility as a risk-management option for retirees that provides protection against longevity, inflation and market risks.

First introduced in 2006 by Toronto-based **Manulife Financial Corp.**, which remains the largest provider of GMWBs, these products are currently being offered by several insurance companies, including Toronto-based **Sun Life Financial Inc.**, **Desjardins Financial Security** of Lévis, Que., **Industrial Alliance Insurance and Financial Services Inc.** of Quebec City and Toronto-based **Transamerica Life Canada.** The first companies to offer GMWBs, including Manulife, Sun Life and Desjardins, have re-engineered their products to help deal with capital-adequacy concerns caused by changing market and regulatory conditions. Newcomers to the space, meanwhile, have created products to meet the demands of an increasingly competitive marketplace.

The historic drop in the stock market in late 2008 was the trigger for the most significant change in the investments held in GMWBs: a reduction in the equities component of some funds, from as much as 100% to as low as 70%. As a result, some GMWB funds now have fixed-income exposure of up to 30%. Notes Paul Lorentz, president of Manulife Investments in Toronto. "We've now come to the realization that markets could decline by 30% to 50% overnight and not recover for a long time."

However, not all classes of GMWBs have been altered in this way to reduce market exposure. For instance, the recently introduced SunWise Essential Series, which has been launched by Sun Life in collaboration with CI Investments Inc., owned

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Principal guarantees on some GMWBs are lower

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by **CI Financial Corp.** of Toronto, offers an investment-class GMWB invested 100% in equities. Sun Life also offers income- and estate-class GMWBs in which the equities component has been reduced to 70%. While this strategy might "reduce potential returns, it also reduces downside risk," notes Derek Green, president of CI Investments in Toronto.

Manulife also offers different classes of GMWBs with largely similar features.

As might be expected, investors are not entirely happy with the changes. Says Prem Malik, investment advisor with **Queensbury Securities Inc.** in Toronto: "Clients prefer a higher equity exposure because of the greater potential for growth, even if they are conservative."

The changes in GMWB features were required: the capital reserves of insurance companies have come under considerable strain as a result of the guarantees to investors provided by GMWBs, which must be met regardless of equities market performance. According to the **Office of the Superintendent of Financial Institutions**, the minimum capital requirements of insurance companies must take into account the "risk of loss arising from guarantees embedded in segregated funds [which include GMWBs]."

Accounting reforms are also driving change. "Global accounting standard-setters are pushing for mark-to-market valuation of liabilities, which reduces the stability of earnings," says Milevsky. "And insurance regulation — both in terms of reserves, as well as more general capital requirements — is pointing in the same direction."

Other features of GMWBs are also evolving. From a client's perspective, the most undesirable change is the reduction in principal guarantees for some classes of funds. For instance, the investment class of most GMWBs now provides a principal guarantee at death of only 75%: previous versions guaranteed 100% of principal at death. (Estate-class GMWBs, however, have maintained their 100% guarantees.) The reality is that the higher the equities exposure, the lower the principal guarantee.

Another key change is the annual payout. For example, Manulife GMWBs now offer a 5% guaranteed annual payout until death, regardless of how the stock market performs. Prior to recent changes to Manulife's product lineup, the guarantee was for only 20 years, based on a 5% annual withdrawal rate.

On the other hand, Desjardins' Helios product, which previously offered a 7% annual payout for 14 years, now has a 5% payout to age 75, with an option to extend it for life.

GMWBs also normally offer a 5% bonus for each year that the investor does not make a withdrawal. Sun Life pays this bonus for a maximum of 15 years. Manulife, which initially paid the bonus for the first 15 years, will now make a payment for any year in which withdrawals are not made.

Added flexibility to GMWBs comes in the form of spousal benefits, which allow for a "two-life income stream" option. Under this option, a surviving spouse continues to receive income at the same rate as the deceased investor for the rest of his or her life.

Clients can now benefit from a higher annual payout if they choose to commence withdrawals at a later date. "Historically, payouts commenced at age 65," says Green. "But if you start later, they will increase."

Fees for GMWBs, which average 3.5%-4%, are considered high — especially for those GMWBs that have a reduced equities component. Says Milevsky: "The cost of providing guarantees has increased because interest rates are abnormally low and markets have been quite volatile, increasing the cost of hedging."

But Lorentz believes fees are justified: "GMWBs provide peace of mind; investors know that they do not have to take any chances should the market decline." IE