A Liquidity Option for DIAs?

By Kerry Pechter *Thu, Jan 2, 2014*

The desirability and feasibility of allowing owners of deferred income annuities to convert income streams to lump sums was discussed at the American Law Institute's Continuing Legal Education Conference on Life Insurance Company Products in November.

Deferred income annuities (DIAs) have been one of the surprise success stories of the post-crisis, low-interest era. The potential market might be larger, some life insurers say, if contract owners had more flexibility to cancel the policy and withdraw a lump sum.

But a number of regulatory hurdles, as well as some potential hurdles in product pricing and design, apparently stand in the way of such a change. Some of those legal hurdles were the topic of a presentation by New York Life attorney Judy Bartlett at the annual American Law Institute's Continuing Legal Education Conference on Life Insurance Products, held last November at a hotel in Washington, D.C.'s Foggy Bottom section.

The conference attracted enough insurance industry attorneys from all over the U.S. to fill a large Marriott ballroom. Attorneys from Allstate, Ameriprise Financial, Midland National, Pacific Life, Prudential, TIAA-CREF and Transamerica, in addition to New York Life, served as panelists or presenters.

In addition, lawyers from the big Washington law firms that specialize in securities and insurance law, as well as regulators from FINRA, the Securities and Exchange Commission, the Department of Labor, walked, took the Metro or drove over from their nearby offices. State insurance commissioners from Pennsylvania and Missouri flew in.

For a day and a half, a series of discussions touched on two dozen or so major and minor legal controversies that currently vex the retirement industry, either directly or indirectly. Lawyers from two prominent Washington firms, Steve Roth of Sutherland Asbill & Brennan and Richard Choi of Jorden Burt, chaired the meeting.

The meeting gave visiting lawyers a chance to earn educational credits by learning more about issues both familiar and new. Familiar issues included, for instance, the summary prospectus for variable annuities, federal regulation of insurance products and preservation of tax-preferences for retirement and insurance products.

New issues included potential conflicts of interest in the design of managed-volatility funds, the transparency of fees for mutual fund sub-advisors, principles-based reserve requirements, and the recent flurry of decisions in "excessive fee" class action lawsuits. In short, the meeting was a cram course in the state of securities and insurance regulation. (The study materials were published by the ALI in a 1,000-page, phone book sized document.)

DIAs and the law

Of the topics covered at the conference, the regulatory status of deferred income annuities was of particular interest, given the sudden popularity of these products in the past two years. Eight or nine life insurers now offer DIAs, whose sales were expected to reach about $2 billion in 2013. The product's lack of liquidity can be a deal-breaker for many potential buyers, however.

The latest DIA designs do offer some liquidity. There are death benefits during the deferral period, optional cash refunds or installment refunds of remaining principal if the annuitant dies, and the option to take several months' payments as a lump sum. Some contracts allow owners to move their chosen income start date forward (i.e., shorten the pre-selected deferral period), if they decide they need income sooner than they thought they would.

But DIA owners can't as a rule cancel their contracts and commute their future payments into a lump sum. Such a possibility wasn't even considered by state regulators when they looked at DIAs in 2010. At the time, DIAs were understood to be marketed as "longevity insurance"—a heavily discounted, long-dated, no-cash-value, life-only product that would provide lifetime income only if and when a person reached age 85 or so.

Only about a year after those standards were developed, however, that product (which had so far been a non-starter, sales-wise) changed dramatically. Starting in mid-2011, New York Life tweaked the product and repositioned it as a personal pension, to be purchased at age 55 to 60 for retirement income starting as early as age 65 or 70.

To the surprise of many, sales quickly leapt to $100 million a month. They could be higher if there were a cancellation option for a period certain DIA, as there may be for a single-premium immediate annuity with a period certain. But this would require new proposals to the states or the state consortium, the IIPRC, which currently doesn't allow the payment of a commuted value for a period certain DIA. It's not clear whether proposals to change that have been made, will be made, or even considered.

(Adding a cancellation option in a life-contingent annuity doesn't work, because the insurer would be vulnerable to the very real risk that sick people might disproportionately cash out, thus corrupting the mortality assumptions on which the prices and payout rates were based.)

If cashing-out were allowed during the deferral period of a DIA, it's been suggested, taking income might become a secondary rather than primary characteristic of the product, and it wouldn't be much different from an ordinary deferred annuity.

Another complication might arise, related to the regulatory status of a DIA. If the calculation of the commuted cash value was affected by interest rates, then the annuity owner might in effect be exposed to investment risk, which might prevent a DIA from being exempt from registration with the SEC.

As it stands, Bartlett pointed out in her presentation, DIAs aren't as clearly exempt from SEC regulation as fixed indexed annuities (FIAs) are. Both SEC Rule 151 Safe Harbor and the Harkin Amendment to the Dodd-Frank law in 2010 specifically protected FIAs from SEC regulation but said nothing about the current designs of DIAs. FIAs with guaranteed lifetime income benefits compete with DIAs.

In sum, there are a variety of reasons why DIAs probably won't be allowed to offer cash-out cancellation options and why life insurers won't even try to change the regulations to make cash-outs easier. That might mean a smaller potential market for DIAs; it might also mean that the product will retain its integrity.