Act V of the VA Drama

By Kerry Pechter *Wed, Mar 28, 2012*

In an effort to de-risk its book of GMIB business, Transamerica Life is offering to buy back the benefit. And one firm, Achaean Financial, wants to help insurers convert some of their living benefits to immediate variable annuities. Is this the start of a trend?

With the departure of Hartford and others from the variable annuity business, the curtain has come down on the fourth act of the VA drama. Innovation was the first act, followed by the Arms Race, De-Risking and then Exiting.

Now the curtain may be rising on Act V: the Buyback of Living Benefits.

In February, Transamerica Life filed a new VA prospectus with the SEC that offers to buy back, with a cash bonus, certain in-force but non-annuitized GMIBs (guaranteed minimum income benefits) that the insurer sold until 2003.

Separately, Achaean Financial, a Chicago-based firm founded by former Lincoln Financial executive Lorry Stensrud and joined recently by former Ibbotson Associates president Mike Henkel, has adapted its immediate variable annuity, IncomePlus+, as a new option that insurers can offer to certain owners of GMIB benefits.

For insurers with in-the-money GMIBs, buy-backs could help reduce the long-term risks and ongoing accounting issues associated with living benefits. For certain owners of in-the-money GMIBs, a cash bonus (in the Transamerica Life plan) or the mortality credits of an IVA (in the Achaean plan) might offer bigger payouts than their GMIB is likely to deliver.

While such deals may make sense on paper, they could carry “optics” risk. Like the re-introduction of “Classic Coke” or the famous Tylenol recall, they imply that mistakes were made. So the communication of these offers, both to advisors and to contract owners, will need to be done carefully—and in compliance with FINRA’s suitability requirements for VA transactions.

An IVA chassis

Of the two buy-back innovations, the Achaean product may have broader significance, since it is being actively marketed to a number of insurers. And, according to Henkel, an institutional investment manager, it may eventually be offered to issuers of GLWBs as well.

“There are some innovations embedded in it—that’s where our patent-pending resides—but it’s based on an IVA chassis,” Henkel told RIJ. “The problem with a standard IVA, compared to a VA guarantee on an account high water mark, is income variability. Even with the AIR (assumed interest rate) calculation, a string of bad years could drag the payment down. Lorry [Stensrud] said, We’ll have an IVA with a guarantee that payments can’t go down.”

The Achaean product differs from a standard IVA in a couple of important ways. First, it will be offered as a new rider, added retroactively, to existing GMIB VAs. Second, it involves a method for determining whether a GMIB owner is likely to be better off with an IVA or not.

The account value of the existing VA would be used to buy the new IVA, which would offer a higher annuitization factor than the insurer was contracted to pay on the guaranteed benefit base (presumably higher than the account value) under the GMIB.

For the first five years of the IVA, payments would be flat, and would be "within 10% or 15%" of the payments from a conventional SPIA, Henkel said. During that initial period, excess earnings from the managed assets would go into a side fund from which, subsequently, income bonuses would be paid or shortfalls amended.

"A risk-sharing mechanism, which acts as a collar, is embedded in the construct of the IVA," Henkel said. "For instance, a 65-year-old investor who put 100,000 into an Achaean policy might get a 6% payout, of which 3% would be return of principal and the rest investment return.

"If the $100,000 earns more than 3%, the excess goes into a risk-sharing pool. That money can be used to true up a payment or to enhance income. Any excess at the end of the policyholder's life would be paid out as a death benefit," he said.

If this sounds like Lincoln Financial's popular i4Life variable income annuity VA rider, there's a reason. Stensrud was part of the i4Life product team when he was at Lincoln. But what's new is the formula that determines whether IncomePlus+ would be better for the contract owner than the exisiting GMIB.

That test relies on Monte Carlo simulations of future market performance, but its outcome appears to depend primarily on the age of the owner, and whether the IVA's mortality credits would produce higher payouts than the GMIB—which offers no mortality pooling effect—could deliver.

The insurer benefits too, Henkel said. The IVA isn't as expensive to hedge as the GMIB. And, unlike VAs, the IVA can be reinsured, which frees up insurer capital. "We call it remediation," he said. "We're going to insurers with problematic books of business and saying, 'Would you like to do something about it?'"

Taking your lumps

As the filed prospectus explains, Transamerica Life is making a one-time Alternative Lump Sum Offer ("ALSO") to eligible owners of in-force riders that it offered until 2003 on 26 variable annuities. As of January 31, 2012, 9,994 contract owners could be affected. Policies that have already been annuitized aren't eligible for the ALSO.

If the account value is less than a certain percentage—as yet unspecified—of the benefit base, Transamerica will add a bonus—unspecified in the prospectus—to the surrender value. No surrender charges will be assessed if the contract is still in the CDSC (contingent deferred sales charge) period.

To accept the offer, the contract owner can either surrender the existing contract, trade it in for a new Transamerica Life policy, or exchange it for another insurer's life or annuity policy, the ALSO prospectus said.

"It's only for the older benefits," said Tamiko Toland, Strategic Insight's variable annuity watcher. "AEGON talked about this in its last earnings call, though not specifically. They spoke more generally about the issues with the legacy block and measures to mitigate that risk. It goes back to the GMIB. They sold GMIBs until 2003 and then switched to GLWBs. This doesn't affect any of the newer business. It's a risk management strategy. That older business is covered by macro hedges, not dynamic hedges. Paying off a long-dated obligation with a lump sum reduces the risk management onus."

Jeffrey Dellinger, an actuary formerly with Lincoln Financial who owns Longevity Risk Management Corp. in Fort Wayne, Ind., told *RIJ* in an e-mail:

"Given that these programs take time to put together, Transamerica likely started working on this ALSO program well before the December 2011-March 2012 stock market run-up. It may have appeared that the GMIB benefit base would provide an amount of income superior to the actual account value benefit base more frequently or by a greater order of magnitude than originally envisioned.

"If that were coupled with longer anticipated payouts due to greater-than-previously-assumed annuitant longevity, then that combination of events could have inspired Transamerica to take this action.

"The rider charge might have been insufficient to cover the difference between the GMIB benefit base—upon which the annuity payouts will be premised—and the VA account value—upon which the annuity payouts would be otherwise premised. And with interest rates being so low, Transamerica may be unable to make up the shortfall via the margin between earned rate on investments and credited rate on the underlying immediate annuity reserve during the payout phase.

"Without studying the specifics of the riders, that would be one educated guess motivating Transamerica to offer the ALSO program. In short, it might be buying back the GMIB option— essentially an equity put option—and conceivably doing so at less cost than if the option were actually exercised, depending on what it offers customers in the way of an 'Enhancement Amount' to do so."