Retirement Income
JOURNAL

BMO 'Lifetime Cash Flow' Product Critiqued

By Editor Test *Wed, Jan 26, 2011*

Garth Bernard responds to last week's RIJ article on the Bank of Montreal's Lifetime Cash Flow product, saying the product has 'room for improvement.'

In response to RIJ's article last week on the Lifetime Cash Flow product from the Bank of Montreal, we received a letter from RIJ reader and guest columnist Garth Bernard, CEO of Sharper Financial Group, and former resident of Toronto.

Saying that the product "is a fair value with room for improvement," Bernard observed that the guaranteed lifetime withdrawal riders on U.S. indexed and variable annuities offer more income than Lifetime Cash Flow (LCF) and that differences between U.S. and Canadian tax law would prevent a U.S. bank or insurer from offering an identical product. "Essentially, BMO has introduced a Canadian version of the GLWB to Canadian retirees," he wrote.

After reviewing LCF's data sheet and disclosures, Bernard found:

- Lifetime Cash Flow's 10-year deferral with a payout of 6% of the original deposit for life is substantially less than a U.S. variable annuity with a GLWB would pay. LCF also provides no inflation protection.
- The initial principal deposit for LCF is invested in an illiquid structured note for the 10-year deferral period. The note's underlying investments are mutual funds. As with a GMAB (guaranteed minimum accumulation benefit) on a U.S. variable annuity, the value of the note at the maturity date is the greater of the mutual fund value or the initial principal deposit.
- After the 10-year period, the client can receive a distribution of 6% of the original principal per year for 15 years (or take a lump sum equal to the fee-adjusted value of the underlying mutual fund account). In the 25th year, after the 10-year deferral and 15 years of distributions, the client can continue the 6% distributions regardless of the value of the underlying funds. In that sense, it is no different from a GLWB after the 10th year).
- Tax-free principal is distributed first from the LCF, followed by taxable distributions of gains. This is exactly the opposite of the tax treatment of deferred annuity distributions in the U.S., where taxable gains come out first and non-taxable distributions later.
- BMO recommends funding an LCF with after-tax savings, allows the use of pre-tax savings. Funding with pre-tax dollars wouldn't work in the U.S., where the illiquidity of the product during the first 10 years would prevent purchasers over age 61 from making their required minimum distributions starting at age 70½.
- The article says that the income is not insured. That's incorrect. If the funds are depleted to 10% of the original principal, BMO makes the payments for life. Therefore, the income is effectively insured—by the claims-paying ability of the bank. Insurance, income tax and securities laws are different in Canada. A Canadian bank can insure a product like LCF, but a non-insurance company in the U.S. could not.
- The fees on this BMO product appear quite high in relation to the guaranteed benefits provided.

Under Series 1 of the notes, the explicit fees are 275 basis points. But there is an implicit additional fee because the *participation rate* of the principal-protected note in the performance of the underlying fund portfolio is 75%. In other words, there is an additional fee equal to 25% of the underlying fund performance. For example, if the funds were to return a steady 6% every year, the total annual fee would be 275 bps + 150 bps (0.25 x 6%) for a total of 425 bps. The net return to the client would be only 1.75%.

- The product does provide a benefit for beneficiaries that the article doesn't mention. The article says that payouts after year 25 do not come out of the account value. BMO's product disclosures state however that interest distributions *are* paid from the account value after year 25, *but 10% of the capital is preserved*. Remember that only 90% of the original principal (15 x 6%) was distributed by year 25. So, instead of tapping into its own reserves when the account value goes to zero, BMO taps in when the account value reaches 10% of principal. As a result they leave 10% of the original principal for beneficiaries.

"In conclusion," Bernard wrote, "this product resembles a VA with two riders. The first rider is a 10-year GMAB with no guaranteed increase ("rollup") in the benefit base; the second is a 6% GLWB with a 10-year waiting period, no rollup, and no step-ups (mark-ups of the benefit base to the account value).

"The Canadian version differs in that there is no liquidity for the first 10 years (not possible under U.S.-regulated deferred variable annuities), and the fees would be comparable to those of a relatively rich U.S. benefit. I would speculate that the profits on LCF would have to be high relative to variable annuity profits because reserve requirements are higher in Canada than in the U.S.

"As a result, makers of U.S. annuities—variable annuities with GLWBs, fixed indexed annuities with GLWBs, and 10-year deferred income annuities (which currently yield 11% of principal for life at age 65 when purchased by a 55-year-old male from Symetra)—probably wouldn't want to issue a product identical to LCF even if they could."