BMO Offers Non-Insured Lifetime Income Product

By Editor Test *Wed, Jan 19, 2011*

The Bank of Montreal's Lifetime Cash Flow product pays out 6% of principal per year for life after a 10-year deferral period. After-tax principal is paid out tax-free for 15 years, followed by taxable payments.

The Bank of Montreal (BMO) has launched a non-insured lifetime income product that, after a 10-year deferral period, promises lifetime payouts of 6% per year. If the contract is funded with after-tax money, the income is tax-free for the first 15 years and taxable thereafter.

The product is called BMO Lifetime Cash Flow, and it is backed by the Toronto-based bank, which has an AA rating from DBRS Limited, an A+ rating from Standard & Poor's and an Aa1 rating from Moody's. The minimum investment is $5,000, and the money is invested in mutual funds that grow more conservative over time. The all-in 2.75% annual fee is based on the account value.

A BMO spokesperson told RIJ that, while the first 15 years of income consists of returned principal, the subsequent lifetime payouts (6% of principal) do not come out of the account value, which by then presumably contains 25 years of gains. "Payments after year 25 do not draw down on any portfolio gains or deposit value," said Amanda Robinson. At the owner's death, the remaining account value goes to beneficiaries.

Here are two illustrations of the just-announced Lifetime Cash Flow product (using Canadian dollars):

Jim, a 55-year-old single man, has no private pension and intends to retire in 10 years. He has $250,000 in taxable accounts and $300,000 in guaranteed investments in his Registered Retirement Savings Plan (RRSP), a tax-deferred account.

He needs $3,000 a month in retirement, half of which will come from his Canada Pension Plan (a payroll-based Social Security-like program) and his Old Age Security (a government pension based on years of residency in Canada).

To provide the other $1,500, he invests $100,000 of his after-tax savings in the BMO Lifetime Cash Flow program ($500 per month for life) and rolls his RRSP money into a Registered Retirement Income Fund (RRIF), from which he begins taking minimum required distributions ($1,000 per month).

At his death, Jim's beneficiaries will receive the balance in his account, if any, net of fees and withdrawals.

In the second scenario:

Ray plans to retire in 10 years, at age 70, with a defined benefit pension of $2,100 a month and $1,000 from the Canada Pension Plan and Old Age Security. His wife Abby, five years younger, never worked and so doesn't qualify for the CPP. But she'll get $400 a month as her Old Age Security. They have $400,000 in taxable accounts.

Their pensions will provide $3,500 a month–$700 a month shy of what they will need. To fill the gap, they invest $140,000 in Abby's name in the BMO Lifetime Cash Flow program. They invest their remaining $260,000 elsewhere for income and growth. If Ray dies before her, Abby's income from his pension will be reduced and his income under CPP and OAS will cease.

A BMO spokesperson said the payouts are not adjusted for inflation, and the payouts apparently remain fixed at 6% of the initial investment even if the account value grows during the deferral period and after payments begin.

Since 2009, BMO has offered LifeStage Retirement Income Portfolios, which are notes that pay an inflation-adjusted 6% of the initial investment for 15 years, starting immediately, or after a five-year wait, or after a 10-year wait. That product offered inflation-adjusted, but not lifetime, income. The new product offers lifetime, but not inflation-adjusted, income.

The minimum deposit for the LifeStage Retirement Income Portfolios is $5,000. Each note costs about $100. Assets are invested in BMO's Lifestage target-date funds. Investors can buy the notes with registered or non-registered (pre-tax or after-tax) savings, but after-tax money is recommended.

At the end of the deferral period—during which the assets are largely illiquid and the investments grow tax-deferred—the notes provide a tax-free, inflation-adjusted income of about 6% of principal per year for 15 years. The all-in annual fee is 2.75% per year.

When all principal has been paid out—i.e., the maturity date—the owner of the notes (or the beneficiary) receives the original deposit back, net of fees and payouts.

In a typical scenario, a 55-year-old might put $100,000 in one of the notes. At age 65, he or she would receive an inflation-adjusted income starting at $6,000 per year for 15 years, tax-free, followed by reimbursement of any money left in the account.

If the market value of the underlying investments drops too much, BMO retains the right to convert the account to a term-certain annuity. "On each business day, we will compare the Deposit Value of a version and series of LifeStage Retirement Income Notes to the annuity value of a LifeStage Retirement Income Note of the same version and series. If on any business day that Deposit Value is equal to or less than the annuity value, a "capital preservation event" will have occurred.

"This indicates that the value of the LifeStage Retirement Income Portfolio is not enough, if invested at the relevant government bond rates (or other higher rate as may be chosen by us), to pay the scheduled capital distributions during the remainder of the term and the Deposit Balance at maturity," the information statement reads.

The BMO notes appear to resemble Barclays Bank's Inflation-Indexed Level-Pay Notes, which were introduced last summer in the U.S., and which provide 10 years or 20 years of income backed by the bank. Like the Barclays product, the BMO notes aren't intended to provide liquidity, although owners can try to sell them on the secondary market or back to BMO. As the product information statement says:

“A LifeStage Retirement Income Note is not designed to be repaid in full on demand at any time. Other than the regularly scheduled capital distributions that we make to you, you will not be able to withdraw the amount invested in a LifeStage Retirement Income Note until it matures. However, you may be able to sell your LifeStage Retirement Income Notes prior to maturity to BMO Nesbitt Burns Inc.,” a capital markets unit of BMO.

Most Canadians receive the Old Age Security (maximum C$524 per month) that’s proportional to the number of years (up to 40) that a person has lived in Canada since age 18. Most also receive the Canada Pension Plan, an earnings-based benefit of up to C$934 a month. The poor are also eligible for a means-tested Guaranteed Income Supplement, and there’s an “Allowance” for spouses or partners of GIS recipients.

The BMO notes are expected to compete in Canada alongside variable annuities with living benefits, Sun Life Elite Plus, and the Desjardins Helios, the *Financial Post* reported.