Retirement Income
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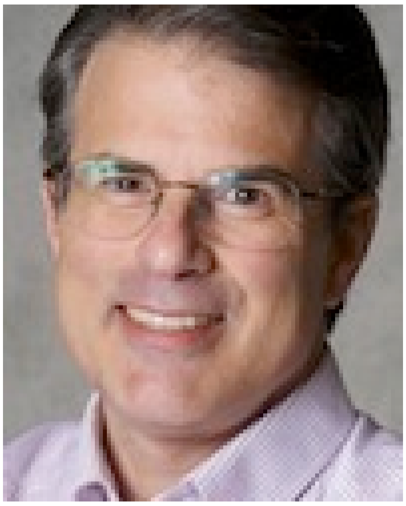
The Incredible Shrinking Income Rider

By Kerry Pechter *Thu, Mar 7, 2019*

Several variable annuity issuers offer optional income riders that allow a 7% or 8% withdrawal rate at age 70 unless or until the account value falls to zero, at which point the withdrawal rate drops to 4% or 3%. It seems like a risk-shift back to the client.



The variable annuity (VA) with a lifetime income rider is a versatile product category that suits our times. It deals with several major risks—market risk, longevity risk, and perhaps even inflation risk—in ways that seem to satisfy the needs of many retirees, distributors and issuers.

With the help of dynamic hedging programs and risk management strategies, it also appears to deliver profit margins that can meet the requirements of life insurers. Certain regulators and Wall Street analysts with memories of the 2008 equity market crash—and its immense cost to many VA issuers—remain wary, however.

One relatively minor but interesting rider design pushes the limits of the flexibility of the VA. These are guaranteed lifetime withdrawal benefits (GLWBs) where the annual payout rate (the maximum income the contract owner may withdraw each year without reducing the guarantee) falls if the account value falls to zero during the owner's lifetime. Any combination of withdrawals, fees or market depreciation can zero out the account.

Both Pacific Life and Lincoln Financial announced updated versions of these riders in February. *RIJ* reported on Lincoln's product two weeks ago. This week we're looking at the Pacific Life version, a slightly more generous version of a contract that the insurer introduced in 2016.

The idea of reducing the size of the income stream could make sense for retirees who plan to spend more during their initial "go-go" years than during their more advanced "slow-go" and "no go" years. But it also seems somewhat counter-intuitive.

Annuities, in the purest sense, transfer longevity risk from individuals or couples onto life insurance companies. Pooling and the law of large numbers equip insurers to handle that risk. The rider featured here appears to throw a chunk of longevity risk back at the retiree and even suggests a potential conflict of interest for the issuer.

Enhanced Income Select

The Pacific Life rider, **Enhanced Income Select**, allows contract owners to withdraw up to 8% a year of their contract value (which locks in as the minimum basis for future payouts, barring positive market adjustments or excess withdrawals later on) if they start taking income at age 70 or later. But if the account value drops to zero, the annual withdrawal rate falls back to 3% for the remainder of the contract.

"We have sold this product since May 2016, but we just raised the withdrawal percentages," Steve Goldberg, associate vice president for annuity product management at Pacific Life, told *RIJ* this week. "There are three age bands. We raised the withdrawal percentages by 50 basis points each."

For individuals ages 59½ to 64 the withdrawal rate is now 5.6%. It's 7.6% for those ages 65 to 69 and 8% for those age 70 or older. "We were able to do that partly because Treasury rates are going up, and it's cheaper to hedge [the risks]," Goldberg told *RIJ* in an interview.

Pacific Life designed this product for people age 70 or over who want immediate income at a high initial rate and who may have other sources of income to rely on in case the balance drops to zero and the payout rate drops to 3%. There's no annual deferral bonus, so clients have no incentive to postpone the income stream. [I'm assuming here that readers know how the benefit base differs the account value, and how the guaranteed payout rate differs from the growth rate of the underlying assets.]

"It's a rider that's designed for those looking for higher income earlier," Goldberg said. "Many people are afraid of running out of money, but it can be more fulfilling for them to have higher income while they are young and active. If the account does run out of money, we assume that the contract owners and their advisors have a plan for that. Also, clients don't have to take 8%. They can take 6%. There are a lot of options."

Fees are an important factor here, and Goldberg said that Pacific Life has tried to keep them low. The current rider fee is 1.05% per year for single lives and 1.40% for joint contracts. The so-called mortality and expense risk fee depends on the length of the surrender period: 0.95% for a five-year period, 1.25% for a three-year period and 1.35% for no surrender period.

There's also a 0.25% annual administration fee. The contract comes with a standard return of premium (adjusted for fees and withdrawals) death benefit. Investment options are restricted [see box] but Goldberg said there are several that cost 59 basis points per year. If a contract owner selects those investments, the all-in annual costs for a three-year joint life version of the rider would be 3.49% of the benefit base per year.

Potential conflict?

But there's the rub. If a healthy couple's income stream starts when the younger spouse is 70 years old, and 11.49% of initial account value is coming out every year via withdrawals and fees, the potential for the account balance to drop to 3% before the surviving spouse dies seems fairly large.

By that time, the surviving spouse would also have lost the lesser of the pair's two Social Security benefits. In addition, late-life medical expenses might have started to mount. The pinch seems even sharper if you consider the fact that the fees, which helps reduce the issuer's risk, help trigger the markdown to 3%, which also reduces the issuer's risk.

The Pacific Life rider also shares interest rate risk with the contract owner. The minimum rider fee is 70 basis points a year for a single life and 90 basis points for a joint life contract. If 10-year Treasury rates reach 4% a year, the rider fee will be capped at 1.50% per year. If rates fall below 2%, the fee for single life contracts will be capped at 2.25%. If rates are 2% to 3.99%, the rider fee will be capped at 2%. Joint life rider fees are 50 basis points higher in all three cases.

If retirees looking to annuities for income certainty, peace of mind in retirement, and fewer potential surprises as they get older, then this product appears not to fit the bill. On the other hand, Goldberg told *RIJ* that Pacific Life's market research shows a demand for it.

For the target market for this product—retired clients of advisors who take commissions—a single-premium immediate annuity (SPIA) would probably not be proposed. At age 70, this type of VA rider would produce more initial income than a SPIA purchased with an identical premium, but the SPIA would provide much more longevity insurance.

If retirees look to annuities for income certainty, peace of mind, and protection from unpleasant surprises as they age, then this product may not fit the bill. Historically, advisors, unlike issuers, welcomed the idea of zeroing out the account value on a living benefit rider. It meant that their clients had "won" the longevity bet. With this type of rider, only issuers will feel good about the reduction in income (or not as bad as if they were still paying out 8%). Clients, however, may complain to their advisors about it.

(I could be wrong about rate-reduction riders. I've been wrong before. When index-linked variable annuities came out in 2011, I doubted that investors would want to absorb unlimited downside risk beyond the buffer zone. But those products have been successful.)

Pacific Life's market research evidently shows a demand for Enhanced Income Select, however. "Our research is partly advisor-based, and partly based on our experience with selling a SPIA that offers an adjustment option that allows the payment to go up or down in the future. Depending on the situation, many advisors liked that feature. Every situation is different of course," Goldberg said, adding that product-line extension is now the name of the game in annuities for both mutual and publicly held life insurers. "Everybody is changing. All of the carriers are trying to diversify their product mixes."

An advisor who follows VA riders closely gave us a reality-check about this design. Its value "depends on the client's situation," he told *RIJ*. "If the clients have outsized expenses for a finite period and then expect relief from the sale of a vacation house, for instance, they might not need the higher income at age 80. But it has limited use. It would be very important to remind the client about the feature and provide detailed disclosure up front. This is just one more complexity that can be misrepresented or misunderstood."