

ACLI Comments on Changes in Ownership of Deferred Variable Annuities with Guaranteed Living Benefit Features (GLBs)

- GLBs always require a defined relationship between the owner and the covered person at issue (e.g. the owner must be the covered person, or the owner must be the oldest of all the covered persons, or some similar requirement.) If the owner is a company-approved non-natural person (e.g. a trust), then the covered person must be the annuitant. The contract then requires maintenance of that defined relationship with only minimal changes (e.g. transferring the ownership within a family or to a trust for estate planning purposes is OK). The establishment and maintenance of this relationship is partly for suitability reasons. For instance, if the owner is the covered person, it ensures that the death of the owner (which must end the contract under section 72(s) of the IRC) will not end the contract for a living covered person that expected benefits.
- If a transfer of ownership outside of this defined relationship to an institutional investor were allowed it would change the dynamic of the contract, which would cause GLB fees across the board to increase. For example, Guaranteed Minimum Withdrawal Benefit (GMWB) fees are based on many variables, one of which is policyholder behavior. This may involve the contract owner making personal financial decisions based on life events that require surrendering the contract or taking out more than the guaranteed amount at some point during the life of the contract because of a divorce, medical bills, home repair, accidents, etc. If a contract with a GMWB feature is sold to an institutional investor, the institutional investor will likely select against the company by always behaving totally “efficiently” (i.e., only taking withdrawals when it makes sense technically based on sophisticated financial models, never taking any excess withdrawals, never surrendering the entire contract, reallocating investment allocations based on sophisticated financial models, etc.). If the institutional investor buys GMWBs en masse, it could eliminate the policyholder behavior variable, which will cause the GMWB fees for all purchasers across the board to increase.
- Financial institutions are in the business of pricing hedges on customized cash flows based on equity market performance. If allowed to buy large quantities of GLB contracts, these institutions could use their hedge pricing skills to financially take the exact opposite position of the guarantees and use that to make a profit. Their control of the GLB contracts would allow them to utilize withdrawals in a way to maximize their investment risk for a lower price that is not designed for this type of usage. Insurers would need to raise the price of GLB riders since risk is being maximized by these institutions. There are actual cases where this sort of gaming of the products has occurred. It would drive up prices for consumers and would be outside of the true purpose of these contracts.

- The reason for the ownership restriction on these guarantees is to provide the needed protection for individuals at the lowest cost possible. The pooling of risks and the focus on how policyholders will use their annuities to meet their financial needs creates expected costs of providing the protection. If an individual's insurance needs are no longer considered, exercise of certain guarantees can be expected to be much more efficient. This is because they will be driven by capital markets opportunities and not an individual's financial needs. Products could be offered that had no restrictions. But they would need to be priced differently (more costly). It is important that companies be able to offer policies which restrict ownership assignments in order to provide purchasers with the opportunity to get a lower cost guarantee that is associated with restricted ownership assignment rights.
- There is a much greater pricing risk associated with institutional investors purchasing GLBs than with institutional investors purchasing life insurance policies. An investor could make an offer for a life insurance policy that is greater than the cash value but less than the economic value of the policy, if the person is believed to have a life expectancy that is less than average. There is some risk to the investor since the life expectancy is still an estimate and the investor may have to wait longer than anticipated. Also, if the client knew he was in poor health, he is likely to keep the insurance contract or apply for an accelerated death benefit, if available. For a GLB, the investor could make an offer that is more than the cash value and less than the economic value at the time, but then continue to make decisions that could potentially increase the value of the contract to the investor. Also, an investor is more likely to buy GMWB contracts where the guarantees are much greater than the cash value today, and where they can start optimizing the benefit immediately - no waiting for a death to occur.
- Including ownership change limitations in a contract is similar to not allowing additional premium payments or not allowing owners to terminate the rider once they have added it, i.e. to limit anti-selection.
- We are not aware of any state or federal law that limits restrictions on ownership (this will need further study to verify, but we wanted to bring it up as a possible important point).
- Restrictions on ownership of property are quite common. The government provides tax breaks for owners of low income rental properties. Even though an individual owns such a property, they are restricted in their use of the property if they want to get the tax advantage. Another example of this is an IRA. An IRA cannot be assigned because it is receiving special tax advantages with a given social purpose (to encourage saving for retirement). Easements are also very common restrictions on property rights, many of which exist for the good of society, i.e., sidewalks and utilities.
- Currently we know of no GMWB product that is offered without a provision restricting ownership and/or adjusting the benefits following an ownership/covered

person change (not sure about other GLB products, although these products have not become as popular and so have not had the exposure to this risk). If the IIPRC standards restrict ownership, two scenarios could occur:

1. Companies could choose not to file with the IIPRC and instead seek approvals in the states that continue to allow restriction or drop the product (currently we know of no state that has not approved ownership restrictions); or
 2. Companies could chose to file with the IIPRC, with the intent of offering higher fees to cover the risks of the institutional investor taking over blocks of business. This would decrease the interest in this product among individuals (especially if they could buy a state approved product for less), but some of those who did buy this product would still make some inefficient decisions, which either the institutional investor or the company would profit from. If individual clients have to pay a higher cost because of the risk that a portion of the block will be sold to investors, this could be considered a “penalty” for the individual client.
- It would appear that restricted ownership and lower rates for all would be in the best interests of the consumer.

Suggested Solutions

- Companies would be allowed to limit ownership changes to specific types of changes as specified in the contract, subject to any state law restrictions. The limit would be exercised by allowing the company to terminate a GLB rider (but not the base policy) if other types of ownership changes were made. Assignment limitations would be similar.
- An alternative solution would be to allow companies to reject assignments and ownership changes made to institutional investors.
- Companies would be required to include the following explanation in their assignment/ownership provisions:

“The purpose and intent of this Contract is to confer annuity and related benefits (including Death Benefits) to single individuals and their beneficiaries. These annuity and related benefits impose certain risks upon the company. This Contract is not intended for use by institutional investors due to an increase in those risks and the related costs, which would be reflected in higher fees to our customers.”

- Companies would be required to include the following statement on the cover page of the rider:

“This rider will terminate if the contract to which it is attached is assigned or if the owner is changed to any person (natural or non-natural) not specifically allowed in this contract.”

- If ownership restrictions are not allowed, at a minimum companies need to have the ability to adjust/reset benefits in some way.