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Variable Annuities #2: Guaranteed Minimum Death Benefits Are Not Much Benefit

Introduction

There has been much litigation and regulatory action surrounding annuity abuses involving unsuitably risky sub accounts and excessive annuity contract switches. Annuity abuses also arise if investors are misled into believing that the insurance feature of an annuity is worth anything more than a de minimis amount.

Guaranteed Minimum Death Benefit

Annuities have an insurance-like feature, the *guaranteed minimum death benefit*, typically guaranteeing to pay at least the amount an investor has put into the contract to a beneficiary in the event that the investor dies before regular scheduled withdrawals begin. Thus, if the investor dies at a time when the aggregate value of the sub accounts is less than net investment in the contract, the insurance company pays out the amount of any shortfall.

The GDMB is an amalgam of a life insurance policy and a put option. The implicit insurance policy pays out a put option on the aggregate value of the sub accounts as a death benefit. In the simplest case, the GMDB delivers an immediately expiring put option with a strike price equal to the net investment in the account. If the investor dies, the beneficiary either receives the value of the sub accounts or - if the contract is worth less than the net investment – she *puts* the sub-accounts back to the insurance company for a return of the net investment.

How Valuable Is The GMDB?

A simple GMDB is typically worth almost nothing since it is unlikely that a well diversified set of sub accounts will be worth less than the investor's net investment at the time of the investor's death.

There is extensive scientific literature which values GMDB based on the expected returns and variances of alternative sub accounts and on actuarial estimates of remaining life expectancy. This literature establishes the value of GMDB at only five or ten basis points per year.

Complex GMDBs

Some annuities have more complicated GMDBs. Instead of guaranteeing to pay out the net investment if the investor dies, the contract might guarantee to pay the highest contract value on specified dates during the life of the contract. In other contracts, the GMDB guarantees to pay the net investment increased by a fixed percent per year with the guarantee capped at twice the value of the net investment.[1]

Mortality & Expense Risk Charge

The insurance company assesses a fee referred to as the Mortality and Expense Risk charge. This substantial fee is inaptly named since, contrary to the implication of its name, only a miniscule portion of it goes to funding the death benefit. While the GMDB is worth less than ten basis points, the M&E charge is usually greater than one hundred basis points and is invariant to factors which affect mortality risk.

The M&E charge is equivalent to the 12b-1 fees assessed by load mutual fund companies to fund substantial upfront commissions paid to brokers who sell the investments.

Conclusions

Brokers sell annuities in part based on a claimed death benefit. This benefit is miniscule and so any such sales claims which are not tempered with realistic assessments of the true value of the death benefit are materially misleading.

April 15, 2005

[1] GMDBs with guarantees that ratchet up on anniversary dates or that increase at a fixed percent per year can also be thought of as traditional insurance contracts that deliver immediately expiring put options with strike prices contingent on interim aggregate sub account values or on the time between the contract purchase and the investor's death.

 SLCG Practice Notes are intended to deal briefly with narrow topics. A companion note addresses the equally misunderstood tax deferral feature of annuities that often ends up causing investors to pay more taxes and have less after-tax wealth than they would have had in a taxable account. More substantial working papers are available at www.slcg.com. Craig McCann, PhD, CFA craigmccann@slcg.com, 703-246-9381; Dengpan Luo, PhD, dengpanluo@slcg.com, 703-246-9382.