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An Integrated Product Approach for the **Retirement Planning Market**

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Insurance companies have always been key players in the retirement planning marketplace, however they have had to compete with banks and other financial institutions for a share of retirement assets. Over the past decade, insurers have more aggressively entered the marketplace through the introduction of variable annuity products with guaranteed living benefit options. This has proved an effective way for insurers to grab a larger share of retirement assets, but the industry has failed to achieve market dominance utilizing its unique core competency, the management of mortality, longevity and morbidity risk.

The current financial crisis is forcing insurance companies to re-evaluate their variable annuity strategies in both the pre- and post-retirement arenas as they struggle with negative balance sheet impacts resulting from deferred acquisition cost write-downs and increased capital and reserving requirements now that guarantees are largely in the money.

Smart insurers have recognized that these turbulent economic times present a huge opportunity for carriers to reposition themselves, and product innovation should be at the heart of their strategy. In line with this thinking, we recently researched, designed and developed a new retirement planning product concept of our own. And, applying our minimal marketing skill to the task of naming this product, we decided on Integrated Retirement Planning Insurance.

The Integrated Retirement Planning Insurance Product

It is important to note that this is not a substitute for current investment-based retirement products such as variable annuities, but instead would provide for a base level of guaranteed retirement benefits to meet primary needs.

This product utilizes a fund-based approach similar to fixed universal life, where charges are deducted from the fund to cover benefit levels elected. The base product provides for all of the following:

- Monthly income for life.
- An estate upon death.
- Morbidity coverage provided as a multiple of the monthly income for a healthy life.

At the time of purchase, the buyer has the choice of electing a greater guaranteed income (and therefore greater morbidity coverage) in exchange for less guaranteed estate coverage or vice versa. Income payments can be purchased on an immediate or deferred basis depending on the individual's retirement timeframe.

Under this approach, after the deduction of benefit charges, funds continue to grow at a current interest rate. If the current interest rate exceeds the guaranteed level used to determine the initial coverage guarantees, then an excess interest credit accrues to the retiree. The retiree can then apply the excess interest credit in any of the following ways:

- Take the excess interest as cash.
- Purchase additional paid-up estate coverage.
- Purchase additional income and morbidity coverage.

Gains and losses from mortality and morbidity experience accrue to the insurance company and are incorporated in the modeling of the product profitability. While the annual excess interest credits are not guaranteed, if a new layer of estate or income/morbidity coverage is purchased, the amounts are guaranteed for all future years.

Besides offering potential inherent inflation protection, the excess interest credit provides a source of liquidity (it can be taken in cash) as well as the flexibility to balance guaranteed coverage levels between income, estate and morbidity to meet changing retirement needs in the future. An additional indirect source of liquidity is provided through the nonforfeiture value of the estate protection.

Here's why this product makes sense.

First, the actuarial soundness of the design should make it attractive to insurers, producers and customers, especially in today's economic environment. All guarantees are based on conservative assumptions for mortality, morbidity and interest and the underlying benefits are well tested and understood.

Second, natural hedging exists between the underlying risks—longevity, morbidity and mortality—thus provid-

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ing superior risk management and asset/liability management opportunities for the insurer. And unlike variable annuities with guaranteed options, this product would not require the purchase of hedges at a non-guaranteed future price, daily portfolio rebalancing, and complex hedge fund accounting to manage the contractual guarantees.

In addition, since coverage is purchased on a paid-up, single premium basis, the financial risk presented by potential anti-selection is minimized, particularly for the estate coverage component.

Table 1A
Integrated Retirement Planning Product Benefit Levels
Male 65, Excess Interest Applied to Buy Additional Income

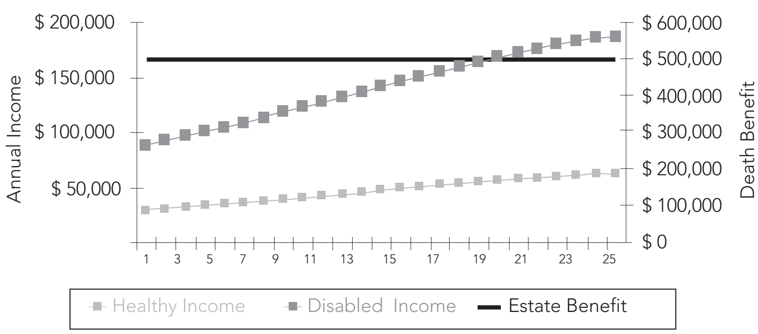
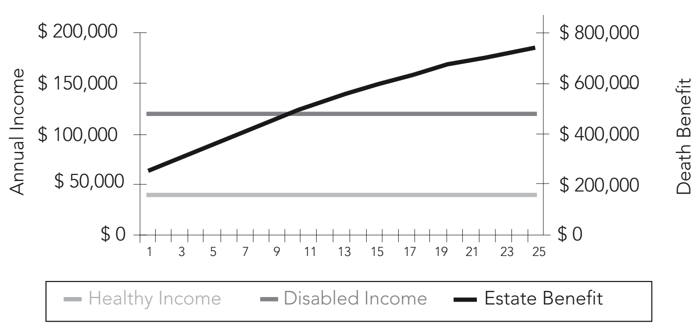


Table 1B
Integrated Retirement Planning Product Benefit Levels
Male 65, Excess Interest Applied to Buy Additional Estate



Finally, this product does not require SEC registration and broker-dealer licensing so it can be marketed and sold through traditional distribution channels.

With a focus on customer needs, this product provides the buyer with substantial coverage through a single purchase. As we have conceived it, from the buyer's perspective, this product should offer nothing to distract from the primary purpose of the policy—income/morbidity coverage and death benefit. It should be simple—simple for the producer to explain, simple for the carrier to illustrate, and simple for the customer to understand. No riders, no additional options, no superfluous benefits to complicate the sales process.

A Simple Illustration

The graphs on the left illustrate the integrated benefits provided on both a guaranteed and current basis under the current Integrated Retirement Planning Insurance product design. The illustrations are based on the life of a healthy male, non-smoker, 65 years old with an initial investment of $1,000,000.

Table 1A shows projected coverage assuming the policyholder elects an estate benefit of $500,000 with the remainder allocated to purchase income/morbidity. All future excess interest credits are applied to purchase additional income/morbidity coverage.

Table 1B shows projected coverage assuming the policyholder elects a set level of income/morbidity with the remainder allocated to purchase estate coverage. All future excess interest credits are applied to purchase additional paid-up estate coverage.

The assumed guaranteed interest rate is 1.5 percent and guaranteed mortality and morbidity rates are based on current reserve assumptions for annuity, life and long-term care insurance coverages.

The current interest rate is illustrated at 4 percent and for illustration purposes there is an initial front end load of 10 percent assumed to cover commissions and other upfront costs.

While benefit levels would vary with an individual company's pricing and product design decisions, these illustrations demonstrate the transparency and potential simplicity of this product strategy. There is no need for the retiree or the financial planner to optimize retirement benefits by choosing between various non-guaranteed investment alternatives. At the same time, on a current assumption basis, the illustration is relatively competitive with similar benefits offered individually in the marketplace.

Implementation Considerations

All new and innovative product strategies require careful thought with respect to pricing, administration, marketing and distribution issues. A few of the issues that would need to be considered are:

- Choice of assumptions for pricing the guaranteed coverage levels and the impact on pricing and marketability.
- Choice of compensation structure and training approach for various distribution channels.
- Development of actuarial formulas based on multiple decrement probabilities.
- Understanding natural hedging impact—Insurers may be able to incorporate the natural hedging that occurs between estate protection and annuity/morbidity benefits. This natural hedging could reduce capital and reserving requirements for the integrated product as compared to the sum of the capital and reserves that would be held for the same individual coverages determined on a non-integrated basis. However, modeling is required to understand the appropriate degree of reduction and secure the necessary regulatory approvals.
- Asset/liability management for the integrated strategy—This may be challenging since the liability cashflows for the integrated strategy will not be the sum of the liability cashflows for the individual coverages on a non-integrated basis. However, appropriate analysis of the integrated liability cashflows may lead to the development of an investment strategy which significantly improves product performance.
- Operational issues such as the administrative structure required to manage the determination of excess interest credits, financial reporting requirements, etc., would need to be reviewed, and the approach could vary from company to company depending on the existing administrative infrastructure available.
- Tax considerations always arise when insurance products with different tax treatments are integrated. It is important to point out that this product was not conceived as a tax planning strategy, but instead as an integrated financial planning coverage to meet all the needs of retirees.

There is an old Chinese saying which states, "where there is chaos, there is opportunity." The financial services industry is in crisis today and clearly the survivors of this crisis will be those companies with sufficient capital and surplus to ride out the storm. But the beneficiaries of this crisis will be those companies that create new opportunities for themselves through research and introduction of innovative new products and services.

We believe an integrated product that provides for the primary needs of the retirement market on a guaranteed basis is a good example of the significant potential that exists for insurance companies to take a leadership position in the retirement marketplace. ◻