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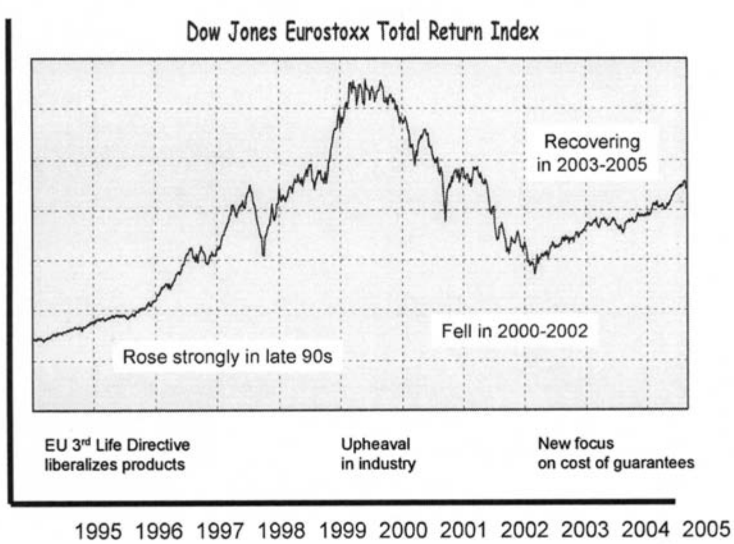
Retirement Savings Product in Europe

by Tamara Burden

Europe is in a state of financial flux. The ongoing effort to develop an integrated European economic community has led to sweeping changes in accounting regulations and pension systems. These changes will have profound implications for the competitive structure of the European life insurance market.

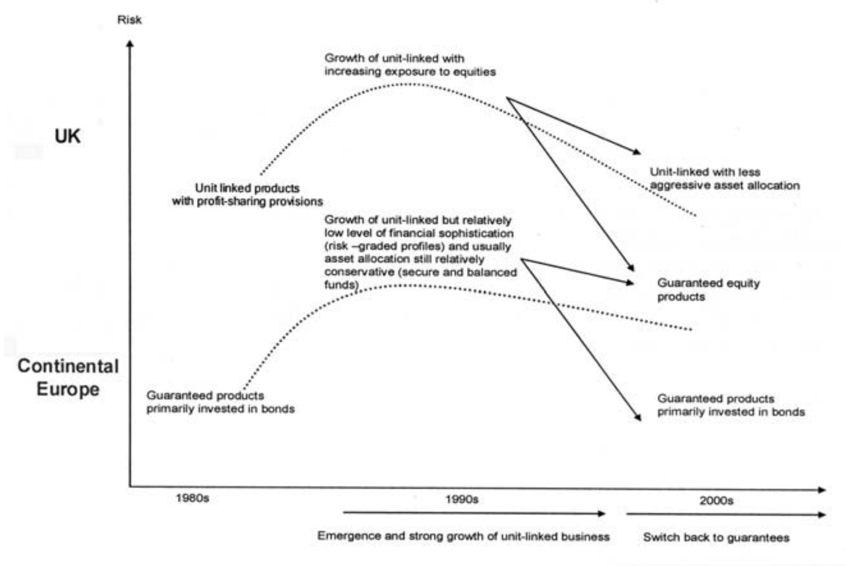
For several years, the topic of pan-European pension reform has headed the agendas of EU and World Bank meetings. In many parts of Europe the existing conventional pension schemes are failing to provide the retirement security for which they were developed (i.e., conventional pensions were originally designed for a full-time employed husband with a homemaker wife). Socio-economic changes such as two-worker families and the rise in self-employment now render these provisions obsolete. High replacement ratios—an average of 70 percent of pre-retirement income, compared to 45 percent in the US—and incentives for early retirement mean the European pension programs are the most expensive of the OECD countries. The majority of the reforms outlined or implemented revolve around defined contribution style plans, with incentives provided to workers to save for retirement on their own. This has opened the doors for insurance companies to offer individual retirement savings plans targeted to those workers trying to independently supplement employer and government sponsored pensions.



Increased political discourse and media attention have raised the awareness of the public. In most European countries, government pensions are little supplemented by private plans, and many who have been relying on social security systems to pay for their retirement now do not believe they will receive the full amount of pension promised to them. As the challenge to provide sufficient retirement funds becomes a more personal responsibility, people have begun searching for alternative retirement savings options. In several countries the insurance market has responded to this need offering **unit-linked products with guaranteed living benefits**. It's a different take on the variable annuity products that are sold in the United States. These unit-linked products support flexible recurring premium deposits during the employment years and have payouts linked to retirement, often with provisions for early election of the guarantee in the case of disability or death of a spouse.

The concept of offering minimum guarantees on equity-based savings products is very appealing in Europe. The market fall of 2000-2001 had a strong impact on the psyche of European investors. Unit-linked products had just begun to increase in popularity in the late 1990s, and for many policyholders it was their first foray into equity investments.

The untimely drop of the equity markets world-wide increased the risk-aversion of the typical European investor. However, the low interest rate environment means that fixed-income investments are not attractive either. Unit-linked products come with a menu of professionally managed investment options with a wide spectrum of investment choices. Policyholders who don't want to expose themselves to the downside risk associated with equities can cushion their unit-linked account with one or more guarantees that protect their investment in case markets perform poorly.



Starting in 2006, providers in Germany, Italy, Spain, Belgium and the UK are offering a palette of unit-linked products with guaranteed benefit riders, each adapted to the specific needs of their retirement savings population. These products are based on the variable annuity products sold in the U.S., but emphasize recurring deposits and benefit election at retirement. Additionally, they are structured to take advantage of country-specific tax incentives for retirement savings that can have conditions for minimum investment horizon or minimum strength of guarantee. The average expected equity exposure is generally lower than the equity exposure in U.S. variable annuities, and the guarantees are stronger (and more expensive), reflecting the greater risk-averseness of European investors.

For the insurance carrier, these guarantees appear as liabilities in financial statements, and the risks associated with these liabilities can be substantial. Guarantees can expose companies to equity level risk, interest rate risk, volatility risk, and exchange rate risk. In order to avoid excessive losses these risks must be constantly monitored and actively managed. Experience shows that they can be substantially reduced using an appropriate hedging strategy.

Until recently, accounting regulations in Europe made the hedging of embedded guarantees a potentially unattractive process. Even a perfect hedge of the economic value of the liability can lead to substantial income statement volatility if the accounting standards do not allow companies to reflect the pure economic value of the liability on the balance sheet. However, in addition to reforming the retirement system, Europe is simultaneously revising its methods of financial accountability. Companies are beginning to be required to report assets and liabilities at fair-market value that have for years been reported at book value or following best-estimate actuarial models. Although this adjustment will be a struggle for business currently on the books, the change to a fair-value accounting basis provides companies greater incentives to understand and manage risk.

Changes in pension legislation have opened the doors for insurance companies to take a leading role in revitalizing the European retirement savings market. Flexible, transparent, equity-based investment products with valuable guarantees are already beginning to transform the marketplace. Simultaneously, financial reporting standards in Europe are fundamentally changing in ways that provide companies greater incentives to understand and manage risks. This provides both a challenge and an opportunity for companies to differentiate themselves in the market and improve their competitive standing with new products that showcase their risk management capabilities. ☐

Tamara Burden, ASA, MAAA, is a consulting actuary with Milliman, Inc. in Chicago, IL. She can be reached at tamara.burden@milliman.com.