RECORD, Volume 30, No. 2*

Spring Meeting, San Antonio, TX
June 14–15, 2004

Session 30 PD
Retirement Income Solutions: Payout Annuities

Track: Product Development

Moderator: Susan J. Sell

Panelists: Steve P. Cooperstein
Joel Jessen†
Susan J. Sell

Summary: Increasing life spans and fluctuations in the equity markets have raised awareness of the potential of outliving one's income. Industry leaders discuss single premium immediate annuities (SPIAs) as one solution to this growing issue.

MS. SUSAN J. SELL: I'm a consulting actuary with Milliman in its Chicago-Lake Forest office. I've been with the firm for about four years, and my focus is on annuity product development.

Our second presenter is Joel Jessen. Joel's a guest speaker. He's the annuity product manager and assistant vice president at Wachovia Securities. Joel's been with Wachovia six and a half years. We look forward to his comments from the distribution perspective.

Our third panelist is Steve Cooperstein. He is the president of Steve Cooperstein & Affiliates. He's going to focus on the impaired annuity market. His company was launched in 1982 with a focus on entrepreneurial market development. Since the '90s, it's also focused on senior markets. More recently, Steve established Income Solutions for Life, which, among other things, is testing its products in the marketplace.

I'm going to start talking mostly about general market trends; in fact, the focus of my talk is going to be on the results of a recent survey that was conducted by Milliman. We sent surveys to about 30 companies that were the leaders, based on

*Copyright © 2004, Society of Actuaries

†Joel Jessen, not a member of the sponsoring organizations, is an annuity product manager with Wachovia in Charlotte, N.C.

Note: The chart(s) referred to in the text can be found at the end of the manuscript.

sales recorded by the Life Insurance Marketing and Research Association (LIMRA) last year. It was a rather extensive survey, and we were pleasantly surprised that we got about 24 companies that provided 25 responses. We felt that this must be an important topic if we got that much participation. That was on the SPIA side, on the fixed side of the business.

Unfortunately, we only had about four responses on the variable income annuity (VIA) side. In our experience, there isn't as much going on on the variable side as there is on the fixed side, so that was consistent with our expectations. My comments will mostly focus on the fixed side of the business. Any time I talk about statistics where I haven't noted a source, that information has come from our survey.

Chart 1 demonstrates what has been going on in the market as far as sales have been concerned. As you can see, sales have grown consistently on the fixed side, year over year, until about 2003, when they were fairly flat. They were about $5 billion. Also it shows how VIA sales have been dropping year over year. This is consistent with what's going on in the equity market, although we don't expect to see the sales come back that much, even in '04.

Sales have been dominated by the independent producer and career agent channels. They made up about 76 percent of the sales in the past year. In spite of all the growth in the fixed immediate annuity market, SPIAs still make up a small percentage of total fixed annuity sales. They were about 6 percent of fixed annuity sales in '03.

Consistent with what's been happening in the past, nonqualified sales continue to outpace qualified sales. They ran about 75 percent. Our survey also showed that in the past year, the average issue age was about 71, and the gender mix was about 46 percent males and 54 percent females. Average premiums have grown, especially on the nonqualified side. There was a big leap from '02 to '03 that may have been a result of the use of SPIAs to fund life insurance premiums.

Which are the successful companies? You still see the familiar names out there, although there have been some new carriers whose sales jumped up quite a bit in the past year or two. Those tend to be the ones that, again, have used SPIAs to fund life insurance or have focused on SPIAs a little more and have some product packaging or are incorporating it more in various retirement planning tools.

Competitive assessment has the same qualities. Nothing has changed. It's the same factors as far as what qualities are needed to be successful, although I'll be interested to see whether Joel has any comments regarding this information.

Next are SPIA variations. The same options are out there; you might see some customized options for the larger premium sizes. The participants in our survey reported that, on average, 50 percent of the sales were in the period-certain option

and half of those were in the five-to-nine-year period. Twenty-three percent were single life with period certain, there were about 10 percent life-only, and 9 percent took joint life options.

What's been going on recently? There is certainly an increased level of interest in payout annuities. Product development activity has picked up. Carriers are dusting off their products; they're reviewing their pricing assumptions. It's a little more than just talking about it—we're seeing a lot more activity. Again, it's on the fixed side, and you might hear some companies talking about doing a VIA, but they're in the early stages. It seems that every year there are about six to eight carriers that say they're going to do a VIA, and it always seems to get back-burnered.

The conditions have been good for selling SPIAs, as far as little reserve strain. The maximum valuation interest rate in '03 was 6 percent; it's probably going to go down 25 to 50 basis points for '04. That brought up the question (and I don't know if many carriers considered it): Should you really be using the maximum valuation interest rate when you're not earning that rate?

I've mentioned a couple of times the use of SPIAs to fund life insurance, both on a standard and substandard basis. On average, about 13 percent of the sales reported by our survey participants were used to fund life insurance premiums. However, there were some carriers where as much as 80 percent of their sales were used to fund life insurance premiums.

Similarly, an average of about 1 percent of the survey participant sales were used to fund long-term-care premiums, but there was a carrier that had as much as 10 percent of its sales used to fund long-term-care premiums.

Companies have been discussing impaired risk products. I'm not going to talk anymore about that because that's the topic that Steve is going to cover. There's been a lot of competition in the large case market. We're seeing some agents accepting a cut in compensation in this market.

Next I'll discuss emerging product features. They haven't emerged in the past, and based on our survey results, few of these features are out there in products that are being sold, other than the cost-of-living adjustments. Thirteen out of the 24 carriers did have the cost-of-living adjustment in their immediate annuity products. The majority of them were a specified percent rather than based on the consumer price index.

Optional death benefits were rare on life-contingent options. A couple of carriers included that in their product features, and similarly, increasing the benefit because of the occurrence of a specified event. I think there were only four carriers that had that in their products.

There is one idea out there on the impaired variable annuity (IVA) side that's a little

different: introduce a side fund. The intent is to stabilize the payment, so maybe the payment amount will go up only a specified percentage—possibly the inflation rate—and anything in excess of that is set aside in a side fund to stabilize any payments that may have dropped otherwise.

Liquidity has always been a perceived barrier to sales of immediate annuities. Out of our survey participants, 11 of them did not offer commutability. Ten offered it on a period-certain option; six offered it on a life with period-certain option, on the period-certain portion; and none offered it on a life-only option. Four of them applied surrender charges; five carriers applied a market-value adjustment; and two of them had a waiting period before you could exercise the commutability option.

There's been little flexibility, at least in the past, offered on the products. Three carriers allowed changes to payment modes, the length of the period certain or the payout options after issue.

Compensation has been stable in the immediate annuity market. You don't see the reductions that you've been seeing on the deferred side of the business. On average, for the longer payout options, the compensation is about 3 percent to 5 percent. For the shorter payout options, it's 1.5 percent to 3 percent, and there still does tend to be some reduction at the older ages. Few carriers are offering tail compensation, and chargebacks aren't typical unless you allow the commutation of benefits in the early years. This is one area that we understand a lot of carriers are taking a look at. They're focusing on their sales compensation and on their immediate annuity products and at the same time looking at their compensation on annuitization. They're trying to align those.

Our survey results showed little variation by channel. The lowest average was in the wirehouse channel at 3.3 percent, and the highest was in the independent producer channel at 4.3 percent. That might explain why you see a few more sales in the independent producer channel.

I'm going to talk about pricing assumptions that carriers have been using in the past, and not necessarily what they're realizing when they get to profitability. Again, these were reported in our immediate annuity study. For experience mortality, pretty much everybody is going to the Annuity 2000 and the Annuity 2000 Basic tables. Many of them do not reflect any future mortality improvement. If they do, it's based on Projection Scale G, and some adjust those female factors 50 percent to 80 percent. Valuation is basically on the Annuity 2000 table with no improvement.

Expenses are all over the place. There are a lot of different bases and a lot of combinations of bases. More commonly on the issue-expense side, you see per-policy expense assumptions in pricing and percent of premium. On average this is about 80 basis points on the premium side and $235 per contract. Similarly, on the

maintenance-expense side, we typically see a per-policy and basis points of assets. Averages were $55 per contract there and 12 basis points.

For common target surplus assumptions, by far the majority of them hold a percent of statutory reserves that's about 4.3 percent. Some incorporate a premium component, and that averages 3.8 percent of statutory reserves, plus 4.84 percent of premium. On average, these levels represent about 250 percent of NAIC risk-based capital (RBC).

For pricing targets, we did not ask them what actual profitability they were realizing, but by far again, the majority use statutory internal rate of return (IRR) as the pricing measure. It averages about 12 percent. The second most common measure is GAAP return on equity (ROE), and it has similar ranges and averages as the statutory IRR. Other measures that were reported were return on assets and profit margin, and those are often used as a secondary measure.

We asked our survey participants to report what their average asset mix was for their immediate annuities, and about 70 percent of the assets were in investment-grade corporates and commercial mortgages. These are similar asset types to what you would see on the deferred side. The assets would maybe be a little longer and less liquid on the immediate annuity side than on the deferred side, especially on the life-contingent options. Many carriers don't distinguish between immediate annuities and deferred annuities. They maybe have one portfolio and they lump everything in there because their immediate annuity business is still relatively small.

We asked the carriers if they do any duration matching, and 18 of the 25 responses said that they do. Of those 18, 15 mentioned that they do it on an aggregate basis, rather than a payout-specific basis. Again, that might be due to the size of that block of business.

As far as what kind of earned rate is assumed in pricing, it was common in the past to assume that your earned rate dropped after 20 or 30 years. Today we've seen carriers assume a level earned rate throughout the pricing horizon, and we see some carriers that are assuming that the rate is going to increase in the future.

Similar to expenses, the required interest spreads are all over the place. Because you have so many different product designs, some contracts don't have any loads; some have policy fees, annual loads and upfront percent of premium loads, so it's difficult to generalize spreads. They ranged in our survey from 50 basis points to 320 basis points. It's common to see the spreads vary by payout option, although there are some carriers that assume a level spread across all options. They probably have to be a little concerned about distribution risk. Some of the cells may be more profitable and others less profitable. On average we saw a spread of about 118 basis points for a five-year period certain and 89 basis points for a single life option.

I mentioned policy loads. It's not uncommon to see a policy fee, either on an explicit basis or implicitly. It's fairly common to see implicit percent of premium loads, which are used to cover your commissions. Some carriers incorporate an annual per-policy load, which is intended to cover the maintenance expenses.

What's going to happen in the future? We did ask our survey participants what they saw for the future, and many of them said that they were going to focus on immediate annuities in '04 or '05. They're going to make it more of a retirement planning process. They also indicated that they were going to take a closer look at their mortality assumptions, especially those that were more involved in mortality arbitrage with premium financing. Another area that I've mentioned is they were going to look at their compensation structures. It seems that there may be more possibilities with the tail commissions with these products. Equity-indexed products have been popular on the deferred side, and we know that there are some discussions going on with equity-indexed immediate annuities, as well.

I mentioned that there's been talk also about the impaired risk market, which Steve is going to cover. I'm going to hand it over to Joel, and he's going to give us a distributor's perspective.

MR. JOEL JESSEN: There are a couple of things that I'd like to go through. First of all, I think we've all heard at various times and we've read in numerous articles about all the things that are going on in our society right now that play into this whole theme. Baby boomers are retiring. There are 401(k) rollovers getting ready to roll over, and they're going to be big. People are living longer, so there's a lot of risk for them. We have pension plans disappearing. We have systematic withdrawal risks. I've seen lots of good charts where they tail off at the end there. We have Social Security, and everyone is rather uncertain as to how it's going to turn out. I decided to do a little scientific research. I snuck into the office late one night and did some Tillinghast models on all these factors. Here's the answer: immediate annuities.

At Wachovia, we're excited about using immediate annuities. They are something that we see as definitely a wave of the future. There are three things I'd like to talk to you about today. First of all, what's our strategy? How do we go about selling annuities et al. at Wachovia? Next is our bank retirement initiative, which plays right into this. How do we position immediate annuities in particular?

At Wachovia we first have what we call an objective wholesaling model. We have our own set of annuity wholesalers, about 17 altogether out in the field, working with our people in the branches. Basically their main purpose in life is to get our platform representatives and our brokers to sell annuities. We're not concerned which ones, necessarily. Whatever one is the right one. If your company has a good one, that's fine. If it has a place, we can sell it.

We have 17 externals and 17 internals, as well, calling them on the phone, following up with them and giving them sales ideas. We use the conceptual method of selling. We want the brokers to understand what the concept behind an annuity is. What's the benefit of an annuity? And then we'll fit the right product in. We're not just going to push a product; we're going to push a concept. We're going to take the right product and plug in at the right time.

Because of that, we don't have a huge number of products. We have the number of products that we think is right. We have about eight carriers that we work with, and we believe that we have a full lineup of products to meet about every need. There are some niches out there that we think we can still go after. I'm always interested in capturing business from the mutual funds or from CDs or some other financial product.

Also, when we bring out a product, we want to bring out something that's going to grow the market for us. We don't want something that's going to shift the pie around. We want something that's going to grow the market and give us a lift. Maybe it goes after 35-year-old customers. That's something that we don't currently have with annuities. Maybe it's something that goes after 95-year-old customers. Whatever it is that's going to grow our business is the type of products that we're interested in. We want to stay ahead of the curve. We don't want to be lagging behind everyone else when we come out with products. We want to be a leader in the industry. We want to be the ones who set the pace.

We feel that we have been successful in that. We have a long way to go and a lot of things we can do, but we have had some success. Last year we did $4.2 billion in annuity sales in just the bank channel of distribution at Wachovia. We've done about $30 million in immediate annuity sales, which, relative to our overall number is not huge. But we do feel that, relative to the industry, we are holding our own in the immediate annuity market. We hope that's going to increase.

That's our wholesaling strategy. Another thing that's playing into our hands is that Wachovia, as a bank, has decided to position itself as a leader in the retirement market. It wants to be known as a provider of retirement services. We sat back and we said, "This is great for us in the annuity department because we fit that market so well."

Wachovia is focused on retirement. Basically it has said it wants to look at the three main strategies in terms of focusing on retirement. These have been categorized in different ways, but here's one way of doing it. First you focus on the accumulation side—building up wealth. We've seen a lot of that; everyone's been doing that. There is nothing too original there. What about distribution? We want to focus on that as well. The third aspect is transfer. We look at the retirement base, the accumulation, distribution or retirement and then transfer—passing that wealth along.

We look at that and say, "What product better fits that marketplace right there? That looks like it has annuity written all over it." We can do accumulation. Distribution, that's what we're talking about today, isn't it? We have immediate annuities. We can do transfer, as well. We also offer life insurance, so we can cover that even better. We were all excited about those. What the bank is doing for us, which we didn't ask for but were thankful for, is that it is developing this training plan for our platform representatives to teach them how to sell retirement solutions to customers. An integral part of that is showing them where the immediate annuity fits in the customer's overall retirement planning.

We have about 3,100 platform representatives who are selling both bank products and investments. They have great relationships with the clients, so we think that this is going to be a great opportunity for us to capitalize on those relationships.

Finally, I want to take a look at sales positioning and what we are doing in terms of positioning the immediate annuity in particular at Wachovia. The first thing we want to do is educate our sales force. Again, we feel like we can do this effectively because of the type of wholesaling that we do. We want to challenge them to consider the differences between accumulation strategies and distribution strategies. If you think about some of the strategies that you have when you're accumulating, you'll realize that those are different.

We have to take a different approach in the distribution phase. We have dollar-cost averaging. Dollar-cost averaging has been advertised as being great for accumulation. You put your money in every month, buy at different prices and get better deals (so the marketing material goes). If that works so well going in, my guess is that the opposite is going to be true going out. It's going to work badly going out. Dollar-cost averaging, which is essentially what a systematic withdrawal plan can do for you, going outward is going to be negative for the client. We have to have a different strategy there.

You have to consider customers' time horizons. Typically, when you're accumulating, you have some date in mind. "I'm going to retire when I'm 55. I'm going to be optimistic here. When I'm 55, I'm going to retire. At 60, I have some particular time in mind that I'm driving toward." When you hit retirement, you wonder, "Now I'm going to retire until when?" You know there's no definite date. It will be whenever it happens to be—whenever you die. Hopefully it's a long time, but I don't know. How long is it going to be? Our strategy is going to be different there. The time horizon is different.
Risk tolerance is a different strategy. During accumulation, you start off aggressive and gradually get more conservative. Again, when you hit the distribution cycle, you have to continue to become more conservative as you grow older. That's more of a gradual change, not a sharp one. You have tax strategies that are going to change. You have to think about your taxes a little bit differently. Perhaps when you retire, you'll be in a different tax bracket. You have things like provisional income to worry about that you didn't have to worry about before. Those are some things that you

have to be concerned about.

We want to basically teach our brokers to be wealth distribution specialists and to teach them how they can distinguish themselves from other brokers who are just accumulation specialists. We want them to be wealth distribution specialists and to be able to be prepared so when all those baby boomers that we're hearing about hit that retirement phase and that distribution phase, our guys are going to be ready, and they're going to be able to distinguish themselves from everyone else who's out there.

We have to overcome some of the traditional objections, and it's encouraging to hear some of the different ideas and new products out there because, as these distribution products begin to evolve, I think we'll be able to overcome a lot of these even more than we have been already. You can think about loss of control as one of them, and of course we can look at products with some sort of commutation in there. There's no growth potential here. We can look at products with variable payouts. Obviously, there's opportunity there. There's limited response as Sue was saying from carriers out there, and I think part of it trying to crack the simplicity egg on these variable payouts.

Variable payouts are risky. Someone might object then if we use something variable. We can do combinations and use some fixed and some variable. There are variables with floor payouts, so you never get less than 90 percent. There's another objection. For the broker, there is the loss of recurring income, and so we have to be creative with some of the tail options that we're able to provide, so the broker will continue to receive income on the money.

The next thing we want to do with the brokers is teach them how to position the product with the customer, so that the customer can relate this to something you know. There are two basic questions for your customers. One is: What sources of income do you have that will last the rest of your life? There's one in particular, Social Security, we hope. Maybe they have a pension plan. "Do you like_those coming in, Mr. Customer?" "Oh yes." "You like having a consistent check every month, don't you?" "Yes, sure." "What if I could provide that for you, as well, with some of your other investments?" That's where you bring them into the immediate annuity sale.

Another option is to use combinations. There are a lot of different ways in which you can bundle and package some of these together. I want to look at a couple of ways in which we have positioned immediate annuities in the past. These are rather loosely based on real life examples. I've changed some of the circumstances because what I find a lot of times with these case studies is that you get lost in all the details.

The first example is a customer, age 65, retiring, using a laddered bond approach to generating income. He has $1 million portfolio earning 5 percent. A generous 5

percent, I guess, in today's environment. This was done a couple of years ago, I'm sure, back in better rate days. He's generating $50,000 in income per year. That income is fully taxable to him unless he has a few municipal bonds in there or something like that, but basically it's fully taxable. He has some risks that are associated with investing like this. The bonds could be called; interest rates could go up; and the value of his portfolio would then decrease. Things like that are going to adversely affect the customer. Here's our customer. How can we solve his problem?

He has a situation, maybe it's not a problem; $50,000 a year may be okay, but how can we make it better for him? How can we improve life for him? Here's the first alternative. You use an immediate annuity. That sounds like a good solution to me. What can we do here? We can control taxes, reduce risk and guarantee lifetime income. I don't think we can do that with our other alternatives. We can do the lifetime annuity. This will be our first option. A straight life payout—invest $600,000 into a straight life, and we'll get $50,000. But this isn't the same $50,000 that he had before because not only have we given him $50,000 like he they had before, but we've given him an income increase because his taxes have gone down. We brought his after-tax income up by 26 percent. Now he has an additional $400,000 that he can invest.

I think there are a couple of other ways now that we can give the broker an opportunity for additional sale. We have an additional 25 percent to 26 percent that his income has increased. That sounds like something that can be used for some premium to me. Long-term-care insurance or life insurance may be a possibility. I heard something about longevity insurance in another session. Maybe there's some opportunity for a new product. We have some opportunities there. For the $400,000, I can't think of a better product than a variable annuity to put it in. That sounds like a good solution to me.

One other way we can position with this client is to take a 10-year certain instead. This is a little different spin. We take $428,000 and put it in for a 10-year certain. Again we're back at our $50,000, but here we've increased after-tax income by 36 percent. Of course, in the future he'll have to pay some of those taxes anyway, but for today we've definitely helped him out. We invest the remainder, $6,500, in a variable annuity with some sort of a guaranteed minimum income benefit (GMIB) earning 6 percent to 7 percent.
At the end of 10 years, we have several options. If the variable annuity has gone up more than 6 percent to 7 percent, we can maybe take some money out. We can do whatever we want with it. We can reevaluate the customer's needs at that time. If the market has been lousy, we can still promise the customer that we've guaranteed that you've grown back to your $1 million after this time that we can annuitize. Then you do some sort of annuitization option with them there. Basically you sit back and reevaluate there.

There are some other ways we can look at this: options three through 100. I think

the beauty of annuities is the different options, the different flexibility and the creative way. You can't do this fun stuff with a mutual fund or a CD. I haven't seen it done yet.

We can look at different options such as taking fixed and variable annuitizations, giving him some inflation hedges or things like that. We can say to him, "Instead of getting $50,000, let's get less because we've reduced your tax burden. Let's take less, so you can put more in and invest that." The options are endless. I think it's exciting. I think there are a lot of good opportunities even to use the products that we have today, position those, take time, educate the brokers and educate the clients of the benefits that are already inherent in them. I think there are a lot of opportunities to capitalize on some of these markets, improve the products that we have and give us the ability to overcome some more of those objections.

MR. STEVE P. COOPERSTEIN: I wrote an article on that in *National Underwriter* and became an industry expert on impaired annuities. I have valuable "derived" information on impaired annuities and I am an expert on highly impaired annuities. I tend to be creative, so I'll add some extra thoughts, as well.

I call impaired annuities the "undertapped under-tapped market." We've already talked about payout annuities being undertapped, and I'm saying that impaired annuities are even more undertapped. A significant percentage of those in the growing mature market are either unhealthy or feel they are. There are only a few companies in this market, and depending on what segment of the market they are in, they felt that 6 percent to 40 percent of their market might be impaired. In England, where under the compulsory retirement you have to annuitize, 25 percent of those people who convert annuitize with impaired annuities. The implication is that 25 percent of the people who are eligible for annuitization are potentially impaired.

In an earlier panel, we talked about the possibility of a deferred immediate annuity. One of the problems with deferred immediate annuities, or even a pension, is that when you get to retirement you might be impaired, and your pension is going to be the same whether you're healthy or not. It's not a good option for those impaired at that point. Think about the market-defined contribution plans that can offer impaired annuities rather than just regular annuities.
It amazes me that only a relatively few companies seek to tap this reality in trying to tap the income in the retirement market. Small companies especially aren't into it. Companies that feature fixed single premium immediate annuities (SPIAs) are more likely to offer impaired annuities than those featuring immediate variable annuities (IVAs) are. For larger companies in the SPIA market, even if they don't offer impaired annuities at the outset, their sales force will see opportunities and ask for it. For smaller companies, their smaller volume doesn't justify it partly because of the underwriting involved.

Does anyone know of a legal reason why you can't have an impaired IVA? I don't

know. It would be a little complex, there's not enough market, the annuitant is unhealthy, and there would be a shorter investment horizon, so you might say IVAs aren't appropriate, etc., but nobody seems to be offering one, which suggests a potential niche to me.

Next I'll discuss the progression over time of impaired immediate annuities. A Supreme Court decision about impaired immediate annuities in '41 was interesting. It had to do with somebody at 80 years old buying a single premium life product, as well as an immediate annuity from the same company on the same day. The Supreme Court said that there was no risk. The insurance company was getting $27,000 for a $25,000 policy. At that time, estate tax law was such that only the first $40,000 of life insurance death benefits were not estate-tax taxable. The law has changed, but that ruling has affected the way people market/sell in such situations.

Sue talked about how life sales have been pushing immediate annuity sales. Certainly in the substandard market, the same thing happens. You have a life sale that's substandard, so the broker will come back and say, "Let's fund it with an immediate annuity, and I can get you a better rate." It works into a natural fit, but if you're doing it in the same company, the Supreme Court ruling is still a concern. So brokers go to different companies with the two sales and sometimes not at the same time. This has hampered the market, but companies and brokers, as they get into this market, start to move beyond this. I think it's safe, but there are some people who feel that there is a risk of doing these types of dual sales.

Then in 1988, Actuarial Guidelines IX-A and B were established with respect to structured settlements. Structured settlements are underwritten annuities, but in the case of litigation, and they're usually geared to people at younger ages who have been in accidents and such. At that time, and even in recently issued Actuarial Guideline IX-C, it mentions that Bob Callahan of the New York Insurance Department didn't want to chance substandard reserving on regular impaired annuities because he was afraid it would affect reserving for the standard SPIAs by removing unhealthy lives from the standard class and result in deficient reserves. The issue was put on hold.

Actuarial Guideline IX-C was adopted, taking the surplus strain from impaired immediate annuities. That changed the market. Companies can now offer much higher age adjustments and have the opportunity to go much more into this product without having to put up surplus.

The other significant market development is the shift to defined contribution plans. Boomers and longevity are going to make impaired annuities a hot complement to SPIAs. In some ways, they might even push SPIAs ultimately.

Why offer impaired annuities? The market is there. Certainly there's a potential market for substandard life types of cases of payout annuities. If you're in the

payout annuity market, impaired annuities are a natural complement. When somebody declines a long-term-care policy, quite often people have been offered impaired annuities. The seriously impaired annuity, which I'll discuss later, is an even better match here, as it exactly matches that market. People focus on the senior market, so there's a lot of market there, too. In the past couple of years, distribution is starting to ask not only for the SPIAs, but it's asking for impaired SPIAs. I was talking to one company, and it said that it was interested in getting into the impaired market just because its salespeople asked about it. It was an upscale type of company, and the upscale agents seem to be interested primarily because of the substandard-life-type sales.

At some point, GMIBs are going to start to mature, and if they're not in the money at that point, people are going to have the option. They would have been educated to some extent about the retirement income. At that point, they can just go the regular option under the variable annuity they have, but somebody can say, "I can get you an impaired annuity if you're impaired at that point, …". It's the right market for agents to go in and "steal" business, so to speak, in the conversion. The impaired annuity gives the agent the natural force for competing. I think the distribution will be asking for it and will be interested in it. It gives the ability to say, "I can do something for you."

Even going out into the future in terms of strategy, at some point there could be compulsory annuitization and there impaired annuities would seem to be an important alternative. The longevity issue is not as big on the impaired side as for regular immediates because the shortened life expectancy and specific disease underwriting don't have the same exposure. .

Why not offer impaired annuities? There's underwriting involved. There's the cost of underwriting, which is folded into pricing and brings not-taken rates into play, but this isn't a big factor. Underwriting is different from life cases, so getting up to speed is a factor. Outsourcing, consultations and reinsurance can be helpful here. There's also the effort involved in bringing underwriting into the annuity process.

Not the least is extra burden on the agent to get health information as insurance companies haven't generally been willing to gather medical information in this market. This partially stems from the fact it is the prospect in these cases that wants to bring impairment information to the insurance company, just the reverse of the life case. That means the agent has to go to doctors to get reports from attending physicians. We all know on the life side how difficult, and even costly, that is. Reverse underwriting becomes a marketing issue.

There's certainly also risk in underwriting these cases. It's an art, not a science. There is competition. Just like in the substandard life side, there can be a lot of shopping of the cases, and the market is small, at least now. Maybe we'll get to the 25 percent phase, but to date we're talking 25 percent of a pretty untapped market.

As you know, though, defined contribution (DC) plans are now the "in" program. Actuaries have thought about DC plans negatively in terms of providing income in retirement. However DC plans have not encouraged people to annuitize. As they do, it will create a big opportunity for impaired annuities.

Positioning is key. What do you want to achieve within your company? Do you have an income market? Are you upscale? Are you into selling long-term-care insurance? As an example, I spoke with one company recently that has an excellent staff of substandard life underwriters who were interested in more fully exploiting this. In another instance a company want to satisfy a niche of certain distributors, akin to what Joel mentioned. There are also niche players in this market that you might attract by offering impaireds.

There are three major sectors. The first is "easy does it." Easy does it is where a company underwrites through rules. Companies might ask three or four questions about current health in their application, and if something is indicated, it automatically give prospects a rate enhancement. The enhancement would be smaller than for more individualized underwriting, but this is a simplified approach. I've seen a couple of companies in the SPIA market doing this, and others want to offer something too. In effect they are giving the brokers the ability to automatically offer their prospects something better if the person is impaired based on a yes answer.

Impairment levels in these cases are not that great—maybe 25 percent to 50 percent. By the way, in that Actuarial Guideline IX-C, you have to have 25 percent extra mortality determined by a physician to claim a substandard reserve basis, so the rules base might still require seeking reports if strain is a factor. The typical age range of easy does it cases is 60 to 70, the normal first round retirement market. If you are seeking regular SPIA retirement sales, by means of your application and perhaps other types of rules, you can market for impaired type annuities, as well. This market is large because it applies to anybody who is looking to retire, albeit the enhancement is not that big.

The broad market of up to 150 of extra mortality for impaired annuities is underwritten, though there are rules-based approaches being used by some companies, especially in the UK. It also has bit broader age range of up to 80 and even 85. These are the more typical cases where information is brought to the underwriter, so the broker really needs to have somebody who is impaired.

One of the difficulties in this market is lower interest rates. An actuary who was about to retire a couple of years ago called me and said he was interested in an annuity to provide a lifetime income to match his current outlays of $85,000 a year. He had about half of his assets in a 401(k) and the rest being invested for him in aggressive equities. On inquiry, I realized that he was impaired and determined that he might qualify for a 10-year age rate up.

An IVA would have been perfect because interest rates were low, and he could have moved his money in equities until interest rates rose, but there were no substandard IVAs on the market. We agreed that it wasn't appropriate to buy it at the low-interest-rate market, so we decided to wait. He had another heart attack and is now unfortunately disabled. His wife is in charge of his affairs and doesn't want to talk about investing in what she perceives to be risky at this point. My point is that in the higher impaired market, waiting for interest rates to rise to a reasonable level can be an extra risk in terms of making a sale.

The enhancement in the broad market could be 50 percent. An interesting observation, though, is that even with Actuarial Guideline IX-C, companies seem to still be restricting the maximum rated (or nonrated) age to no higher than age 89. In other words, for a rated 70 year old, 85 year old or healthy 90 year old, the highest age rate offered is 89. It may be 90 or 85, depending on the players in the field. Nobody (other than for the seriously impaired cases I will discuss later) goes over those ages, rated or not, because they're afraid of the risk; the payout becomes too high. I personally think they are being overly cautious, especially given experience for seriously impaired lives and because there is reinsurance available in the impaired annuity market.

The third market is seriously impaired or "care" annuities. It's for the people who are already incurring long-term-care costs: people in nursing homes and assisted living facilities or people at home, who have a shortened life expectancy. These cases involve 250 percent extra mortality. These annuities leverage that short life expectancy. Here is a brief example of the need. Somebody with $500,000 of assets can take $200,000 of those assets and maybe generate $40,000, $50,000 or $60,000 a year of monthly income—a 20 percent, 30 percent or 40 percent "return on their money" to ensure the ability to pay for care costs without risking the other $300,000. That person has taken the $200,000, and if he died the next day, he haven't lost it. He's assured the other $300,000, keeping him focused on the objective. It balances short life expectancy with a high ongoing cost of long-term care.
It's a sensitive niche market. Seventy-five percent of people in nursing homes are under Medicaid, so the market there involves only the remaining 25 percent. If you conservatively assume that perhaps only one in 10 would be for a broker that is a small niche market. Focusing on the need is also sensitive, so marketing and training are important.

It is the natural inclination of brokers in this market to go to a center of influence like a nursing home or geriatric care manager. These centers like the concept but not enough to help brokers reach these prospects and/or their families. There are confidentiality and privacy issues as well as priorities involved.

There are opportunities for using the concept for meaningful consumer-friendly innovations in long-term-care insurance products.

Underwriting is of course critical. Someone might say, "After my second heart attack, they put a pig valve into me. I've been feeling great since." You have to watch what the impairment is and look at what the potential outcomes are. For instance, for life insurance, cancer might be something that you don't want to cover. For this product, you might offer an enhancement for the first 5 years, but after that the person might have normal longevity.

Monitoring experience is critical, particularly in the early years of offering this product. Such monitoring should be not only for mortality but also for mix of business. You'll want to watch in your pricing that you are not affecting your regular annuity business.

One of the ways of pricing impaired annuities is by using mortality formulae such as $A^*a_{x+b+t} + C$. Depending on the type of impairment, you might want to do a percentage extra to the q_x. You might want to add more years to the qx, or you might want a constant addition to the mortality. The underwriter will say, "We expect this person to live five years, and the maximum we expect him to live is maybe nine years." Then you take a mortality table, apply margin additions and solve for the expected lifetime or to the 90 percent interval of how long the person is expected to live.

There aren't too many product variations. There are a couple that I have in mind beyond what's on the market. If universal life is your market, you might consider flexibility variations. For long-term care, where people are concerned about premium increases, you might want to have a shortened period so that the person might fund a 10-year . There are also some variations that might come into play with regular or impaired SPIAs.

For reserves, as I mentioned before, you can now take the rated age and grade back into a standard reserve over a certain number of years. I think it's the expectation of life.
As I said, reinsurance is available. By the way, going back to underwriting, there is outsourcing of underwriting. If your own people can't do it, there's outsourcing. Also there are rules-based companies that can help you establish rules and underwriting guides to help you get into business. The reinsurers can help, as well.

I was interested in Sue's presentation because I am thinking of doing an impaired annuity survey. Now that I hear what Sue did, I'm just going to ask her to redo her survey, and we'll work together. I want it to be participatory; I want to get the practices, the markets and the sales. One of the things I couldn't get any information on is aggregate sales of impaired annuities. Presumably with a survey we can compare SPIA sales to impaired SPIA sales. If anybody is interested in such a survey, contact me.

FROM THE FLOOR: I just wanted to bring up a point on why you offer impaired annuities. In my company, we've seen some spatial sales. Are you familiar with

that?

MR. COOPERSTEIN: What company is it?

FROM THE FLOOR: I'm with AXA Financial. You have the healthy people, who are going to the universal life, and they use the immediate annuity to fund the premium. When those people die, they get back the premium that they put in. There is a disconnect between the mortality that you use for the annuity because it's an average mortality and whether they're underwritten on the universal life. If too many of those sales go through, you'll have to look at your annuity mortality and then revise it upward.

MR. COOPERSTEIN: Because of the preferred?

FROM THE FLOOR: Yes.

MR. COOPERSTEIN: I heard you guys had that problem. I thought of mentioning that one, but it's not really an impaired annuity. It's the standard case problem, but it's in the same ball park.

MS. SELL: I have a couple of questions for Steve on impaired annuities. If you have to undergo some type of underwriting process, I would think clients would expect a certain percentage increase in the benefit payment to have it even make any sense. Why would I go through this process if my benefit payment isn't even going to increase that much?

MR. COOPERSTEIN: That's where the broad market comes in. I think it was a 50 percent enhancement for the broad market where it's underwritten, whereas for "easy does it," it was usually in a situation where you have rules-based. You just have questions in the application. I think Mutual of Omaha has a product where if you answer one of three questions yes, you'll get a 15 or 30 percent increase in your payout annuity. That's an automated thing.

Some companies have much more complex rules. There are some companies out there, in England specifically, where they've developed over the years some rules-based for more elaborate underwriting and where you don't have to go through that, so they try to get around the underwriting problems by having rules. As you get into higher ratings, you're taking that risk. It's the same thing on the life side. You have the certain level that you're going to nonmedical and stuff like that. This is the same thing.

MS. SELL: Right. My second question is that annuity representatives in general aren't used to underwriting and asking their clients health questions and things like that. I wonder how they're overcoming that issue, and would you maybe see some life insurance representatives, more likely, starting to sell some of these impaired or substandard annuities? They are used to the whole underwriting process.

MR. COOPERSTEIN: I think your report says, and I've seen that too, that people are in the life business and are seeing the combination sale as the place to go with immediate annuity, whether it's a SPIA or impaired annuity. As I said before, I think it's the companies that are in the SPIA market, where the agents have encountered people who were unhealthy, but they come back to the company and say, "We want it." There are those two types of salespeople that I see wanting the impaired annuity.

Going one step further, I'm in favor of an unbundled SPIA. In an unbundled SPIA, it becomes much more of a needs sale and an explanatory sale where you make the person understand that they're not entering a black box, but they're entering into a universal life type of product where, instead of the cost of insurance charge, you have what we call a living credit. You basically show them that their bank account is going to be credited with money. People respond positively to that. They understand that. They don't know who is going to die, but the people who die don't give it back to the insurance company.

It's part of an insurance pool that goes to the people who live and therefore have an enhanced income. I think when you start to unbundle that way, you also start to make people understand the different aspects of the annuity, like the legacy piece of what you're planning. I see that changing the market. My point is that I see it becoming more needs sales. We've done SPIAs as a commodity, but I think our mistake is we haven't been doing it as a needs sale. I think you were pointing out that you have to take all the things into account when you encounter that person who is looking at retirement and solve it with so many different options.

MR. JESSEN: Yes, and we've been moving more toward having our brokers sell life insurance. We have a number of them who are already doing that. We're looking into the impaired risk SPIA because our goal is to make it as easy as possible for the broker so that the same set of APSs that the doctors fax to the life insurance company for the underwriting gets sent to the insurance company for the SPIA. It cuts down on a lot of that extra work. There is a possibility there.

MS. SELL: I guess I have a question for Joel. At the end of my presentation I talked about what the survey participants saw as important things that were going to happen in the future. You mentioned Wachovia sells eight different carriers' products. From your perspective, what do you think is going to happen in the future, both in the short term and the long term?

MR. JESSEN: I think we definitely see a huge opportunity in the income market, but I do think there has to be some improvement in the simplicity of the products, particularly on the variable side. Obviously, a fixed immediate annuity is relatively simple, but I think on the IVA side, you start getting into assumed interest rates and things like that, and you can lose your customers fairly easily. You can lose a broker pretty quickly. The broker wants a sale that he can make without a whole lot

of additional explanation, so he doesn't have to explain to his customers what kind of return they're going to get every time they come back. I think there has to be some improvement in that, and I think that's perhaps one of the reasons why IVAs have not taken off more than they could have. We've mentioned several times that the commission is certainly a big factor for the broker. He doesn't want to lose an income in tying something up in a lifetime annuity.

MS. SELL: But would they be willing to give up front end for tail?

MR. JESSEN: I think if it was attractive enough. Wachovia is pushing the brokers to do that anyway because Wachovia sees the benefit of it as an institution to have that recurring income.

MR. COOPERSTEIN: I have a question for you, Sue. You mentioned there were a couple of companies that are using underwriting for liquidity. Do you have any more information on that?

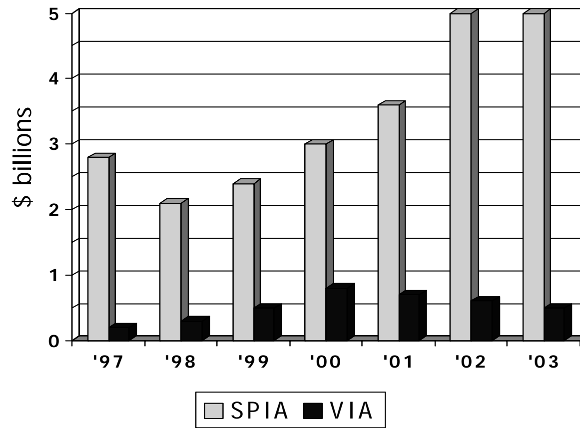
MS. SELL: Do you mean as far as a life-contingent options? None of our survey participants allowed commutability on a life-only option, but there are several carriers who have indicated that they may have the right to underwrite someone who would want to do that. I don't know whether they've implemented that or not. That may have just been the talk on the street, but it's being considered to allow that.

MR. COOPERSTEIN: I was wondering whether anybody has seen a lot of distinct changes on the distribution side besides Wachovia where salespeople are asking for product innovation and better prices. Is anybody knocking on the door about SPIAs or impaired annuities? I've seen companies wanting to get into the impaired annuity market.

Chart 1

Total Immediate Annuity Sales (excluding Structured Settlements)

SPIA Sales Grew Consistently Until 2003



Source: LIMRA International, Inc.

2