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Session 9PD
Moving From Accumulation to Income

Track: Product Development

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Summary: Product development for annuities focuses on the accumulation of assets. As the population ages, there is renewed interest in the products available to convert that accumulation to an income stream. This session takes a market-backed approach to variable immediate annuities and substandard underwriting for income annuities. Attendees gain a greater understanding of a large and currently untapped market for retirement assets.

MR. NOVIAN E. JUNUS: I'll begin by offering a brief description of the session. It is moving focus from accumulation to income. We've been talking about payout products for a long time, and that will be happening here soon. I think it's come to a point now where a few things are happening. People are looking at really low equity returns and 401(k) plans and a lot of reduction in their retirement accounts, and I think a lot more people are finding out that single premium immediate annuities (SPIAs) or guaranteed income is looking better and better nowadays.

I think a lot of companies are trying to develop ways to capture that retirement income market. What we would like to do in the session is to provide some sense of the obstacles and realities of trying to build that business, and that's why we have GE here presenting, along with Matt and Frank. I think they're both active in the immediate annuity or payout market—I would rather call it payout because it's not necessarily all immediate annuities. We'd also like to provide sense of some of the

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current practices and strategies that companies are employing and some observations in terms of what they're trying to do and how successful or unsuccessful they've been. We'll discuss some of the opportunities that we see, and there are a lot of opportunities here. The question is whether they will stick or whether they will pan out, depending on how companies go about doing it. Then, essentially, we'll provide some sense of future direction in terms of the market and the business itself.

First of all, I think there are a lot of players in this payout market. You have insurance companies, of course, with SPIAs and systematic withdrawal plans (SWPs)—people living off their income, people living off their accumulation, and we provide that in deferred annuities. We also have, with banks and mutual fund companies, systematic withdrawals, asset allocation and just skimming off interest from CDs. That's a lot of what's happening right now in the banks. People are living off the interest on CDs as a kind of retirement income.

You also have defined benefit (DB)/defined contribution (DC) plan providers who provide immediate annuities when people want that option. So, there are many players out there, and many alternatives. As I said, mostly they're trying to skim income off accumulation vehicles. You have reverse mortgages, which are not accumulation vehicles, but are assets they can try to get some money from. There are deferred annuities, mutual funds, certificates of deposit, and then the life expectancy minimum required distribution options. So, instead of taking an immediate annuity and trying to get an income guarantee, they would actually just recalculate income based on the life expectancy every year.

Another reality is that there's currently a low sense of need for payout products. That has a lot to do with the fact that a many people have DB plan payouts. They're getting pension income, so they feel safe with it, although right now a lot of companies are even trying to reduce the DB pension plans for retirees, and that's starting to hurt some of them. Social Security is still strong, so to speak, and you still have Social Security benefits.

I think the current perception of low need exists because they don't fully appreciate or understand the risk. I think it's come to a point now where people are starting to understand and appreciate the risk. I think it's come to a point that people are thinking, "Maybe it will be good if I have some portion of my retirement accumulations invested in a SPIA, an immediate annuity, so that I can have some kind of guarantee, some kind of minimum income." I think that's a recent occurrence, but it's not really pervasive yet. And then the current low need is caused in part because there's no apparent, readily obvious solution that anybody can sell—that insurance companies can sell—as the magic product. And then, those primarily in 401(k) plans are still accumulating as opposed to retiring right now. I think there will be a point in time within the next few years when a lot more people will retire, and most of their retirement funds are in 401(k) plans as opposed to DB pension plans.

So, what have companies started to do? They're trying to solve the problems and get into the market to build a business. They've developed all these features to try to allay some of the concerns or fears and to resolve some of the issues that customers may have with SPIAs. So they provide liquidity and death benefit provisions. They've put in their cost of living adjustments (COLAs) or cost of living increases. They've even developed substandard SPIAs, which basically allow you to get a higher income from the payout if you can show that your mortality is not as good. Or if you're a smoker—basically, a smoker discount—then you can actually get a higher income of the payout. They're offering a combination of the variable and fixed immediate annuities, providing minimum guarantees on variable immediate annuities and adding this long-term care and nursing home option. Basically a lot of features here are designed to enable customers to access some of their funds from an immediate annuity.

And then there are trail commission options. This is more from the distributor's point of view. They don't want to sell this product and just get a one-time commission only. They would rather have an ongoing income stream, so to speak, from this product. Again, you just make SPIAs more attractive.

In terms of current marketing developments—and this is my view of what they are—I'll just categorize them into three areas. One is program approaches to marketing these products, and really good examples of these are Lincoln and Principal. They develop a marketing program, a payout program, per se, around a certain product. Instead of just selling the SPIA, they will sell the program, which may include accumulation vehicles as well to try to manage people's retirement income.

Quite a bit of the focus on payout business development is on education and coaching. Someone once said it's really internal education as well because there's such a perception that immediate annuities are not a good deal. I tend to think otherwise. So, really it's just a matter of internal and external education in terms of the benefits of immediate annuities. Now, it's interesting that recently at a National Association of Variable Annuities (NAVA) conference on payout variable immediate annuities, most of the focus of their presentation was on fixed immediate annuities and the benefit of fixed immediate annuities. There are a lot of users for fixed immediate annuities. If you combine a mutual fund with a fixed immediate annuity or some kind of accumulation vehicle, you can achieve a better risk/return profile or investments to manage your retirement income. So again, education and coaching, internal and external, are important, trying to stress the point that there is a good chance that you'll outlive your assets and be faced with income shortfall. The most interesting aspect of it is that selling a SPIA is not all or nothing. It's part of your retirement income plan, but it's not like you have to put all your money into a SPIA. So that's one of the things that companies are doing to market SPIAs and build this immediate annuity or payout annuity business.

Then we have this new development, what somebody has termed a DB in DC plan. Let's say a company has a 401(k) plan. Instead of this 40-year-old putting money into just any kind of funds within that 401(k) plan, they will put this money into this fund that would guarantee a minimum amount of income at age 65. So, the concept is DB in a DC plan. So, that's a twist to trying to sell these immediate annuities, and I think that has a strong appeal to employers if you sell it to them as part of the benefit. Maybe once they start moving away from providing DB pension plans, they can provide some type of income guarantee instead. I'll leave Matt to expand on Retirement Answer, but basically GE's Retirement Answer is a product similar to a DB in DC—in fact they came out with it first—but it's marketed to individuals, and now they're, I think, moving in a different direction as well. They're trying to garner business in this market.

And then a lot of work and repackaging has occurred regarding SPIAs to try to sell the benefit of SPIAs. There's been a lot of good press about immediate annuities, fixed immediate annuities. Even Ibbotson is very high on it. Ibbotson Associates compiles a lot of statistics on asset allocation and on asset allocation strategies and historical performance of different mutual funds and different assets. They have developed this illustration capability that shows how you can manage your retirement income much better with immediate annuities. So that's interesting, and a lot of companies are trying to repackage and rebrand their SPIAs in such a way that it becomes more appealing, which is part of the education and coaching focus that they have right now.

The key point to take away is that SPIA is part of a retirement income solution. It's not the entire solution. In fact, I will buy a SPIA; I will not buy a deferred annuity. I guess I believe in that, and for me that's a barometer in terms of how good a product this is. Right now it is a niche market, but that's mainly because of the lack of acceptance, exposure and understanding of the benefits of this product. I also think the timing is not right yet because of the current alternatives that are out there. Really, companies are trying to break the code. There are some interesting developments out there. There's a lot of room for people in companies to become innovative or for actuaries to be really innovative in terms of trying to meet this need because the benefit is there.

I have a DB pension plan with my old company. It won't give me much when I'm 65, but hey, it's something. I don't know about looking forward to it, but at least there's something, peace of mind, so to speak. I think companies are learning to crawl before they walk, and that's part of the education and counseling focus that companies are trying to do. There's a lot of experimenting and market testing occurring. They're trying to make sure that when they do come up with an idea, they don't want to spend $10 million on it, but they want to spend some money to try and build it. They're basically not making a huge bet on developing this business. As I said, there's room to be very innovative in terms of what we can deliver and what we can think about—what payout products we can deliver and design, how we market them and how we illustrate them.

So, what will it take to succeed? Frank Sabatini will provide an industry perspective. Matt will show how GE has thought this through and discuss its method of operation in terms of trying to build this business. They've actually done quite a good job. I'm just trying to give some kind of overall product and market overview on what it'll take to succeed, so I have some thoughts and comments on that. I think if you want to provide liquidity and the flexibility for the SPIAs, you want to add it without adding too much complexity. I think part of the reason you want a liquidity feature in an immediate annuity is because it's an all-or-nothing. If you put all of your money into an immediate annuity, then you want some liquidity. But what if you only put a portion of it into an immediate annuity? Then you may not need the liquidity.

Another thought that I have is that there are a few companies that are providing minimum guarantees on these variable immediate annuities. Sometimes instead of providing that minimum guarantee, you may just do a mix and match, meaning that you would put a portion of your money into a fixed immediate annuity and the other into a variable immediate annuity, so you will have some form of guarantee in the fixed immediate annuity instead of developing a variable immediate annuity with a minimum guarantee built into that.

Depending on the pricing and the risk you want to accept when developing that product, you may want to go mix and match versus providing some kind of a minimum guarantee, such as a guaranteed payout annuity floor (GPAF), on a variable immediate annuity. You should market as part of an overall retirement plan, income plan and market a SPIA as such. I think one of the realities is that the fixed immediate annuity marketplace is a very competitive marketplace. Since price is the primary difference and can be easily compared, then agents and brokers will more often choose the lowest price. The reason for that, I think, is that a financial counselor develops a retirement income plan for a client at the start and then does a lot of analysis and a lot of work. They're trying to determine what kind of asset accumulation vehicles or income vehicles will be suitable for them. At the end they start looking for what to buy to make this plan work.

So if it is at the end when they are looking for the fixed immediate annuities to put into this program, then it's all dependent on price. The one with the highest payout will win. So, if there's a way for insurance companies to get into the first phase, then I think that may work best. Actually, Principal has developed a program that will essentially enable them to do that, and you might want to take a look at the program that they've developed.

I think SPIA has a place in someone's retirement income plan, and what you want to do, what actuaries need to do, is showcase the benefits. How do you present it in such a way that it becomes compelling for people to actually buy or sell SPIAs? Start small, introduce and adjust and tweak along the way. There's a lot of market testing going on right now. Unless you're sure of your bet, I don't think when you develop a product it will catch fire just like that. It will not make a lot of sales immediately. So, you might not want to spend $10 million on systems to develop that product and then see it falter. You might want to start small, introduce and then adjust and tweak along the way.

MR. MATTHEW P. SHARPE: I plan to give you a different kind of view, and it's really a marketing distribution view of the income spaces as we see it. I work for GE Financial, and I'm based in Richmond, Va. I want to talk to you today about how we see it from a retirement income perspective. I'll cover three things.

1.Why would we want to be in this space at all? We fundamentally have to answer that question for ourselves.

2. Why even bother? It's pretty small right now, right? All the outward signs say teeny tiny. So we'll talk about that for a couple of seconds.

3. And then how we, as an industry, should be approaching it. And then, finally, I'll talk about what we're doing in the space, how we're approaching it, and maybe you can learn something from what we're doing.

So let's dive right into it and start off with the number one thing—why? Because it's big. That's the only reason. Novian said it's tiny, right? The income space is tiny is from an insurance company perspective. But put it in perspective—$4 trillion over the next 10 years will be moving from accumulation to some sort of spend-down or income strategy. That's 25 percent of the total financial assets in the United States. That's why we'd want to look at the income space. During the last 100 years, we've spent almost all of our time focused on that one side of the mortality curve that we don't like to talk about as individuals, and that's premature death, mortality, life insurance, right? I propose that over the next 100 years, maybe the conversation will switch from death possibly to life and the ability for us to outlive our life expectancy or live significantly longer lives as we go forward. And do you know what? That's great news for the insurance business because we're the only ones that can do it, right? Everybody else claims to do it, but we actually are chartered to do it. We play in the mortality space. That's what it's about. It's our space. Nobody else can play that.

So, that leads us to the first question. You have to eat, so who will feed you? You can't say, "Oh, I'm sorry. I ran out of money. I won't eat anymore, okay? I'll just stop eating." You can't. It's essential, right? So that's the first question we have to ask ourselves. What is essential? Essential means different things to different people. The dictionary says it's something necessary, indispensable or unavoidable. Novian likes meat, dog food, that kind of stuff, right? Frank actually prefers fish. So, the bottom line is that essential means different things to different people, and that is a fundamental truth.

So, how do we provide for what is essential to each individual customer? What is current wisdom? Current wisdom means the preponderance of acceptance. If you ask your neighbor, your neighbor will say, "Yes, I agree with that." Current wisdom is that a properly allocated portfolio and a systematic withdrawal spend-down strategy will deliver the income that you require to deliver not only your essential income requirements, but also all of your lifestyle requirements as well. The financial industry, financial managers in particular, have developed very, very sophisticated methods to synthetically manage assets for a lifetime. Those are fancy words for a spend-down strategy, a systematic withdrawal strategy. The two most common tools are asset allocation and, in your words, a deterministic view of a customer's income requirement.

So, let's take a look at that. The latest enhancement to that in the retail space is called Monte Carlo. It's stochastic modeling. The financial and marketing folks are trying to use a stochastic model to add some views of a spend-down strategy or of an income strategy. However, no matter what you do, no matter how you do it, all the tools in the world, and all the financial demonstrations that we can give them will not save an individual from making a potentially fatal mistake in his or her retirement income plan. Let me give you an example. How many of you have changed your asset allocation in the last three years? Okay. So, the asset allocation model that you used no longer applies to you. You've now switched. So, all the assumptions that went into that asset allocation no longer apply for you because they assume, as a deterministic model does, that everything remains constant.

How many believe you can beat the market? Everybody does. You may not admit it, but there's a part of you that says, "You know what? I can do better than that. Eight percent? No way. I can do 10 percent." It's true. It's human nature. There's a gambling element to our psyche. But the realities are this. Ibbotson did a quick stochastic run of asset allocation to see how the asset allocation models actually performed in a stochastic environment. They did a 5 percent spend-down, adjusted for inflation of about 3 percent. In 25 percent of the scenarios, they ran out of money at age 88, 23 years into the individual's life. You are actuaries. I think you know what the mortality table looks like, especially when you're looking at a joint life. Even in a single life you rate at the mark for life expectancy, right?

That, to me, means that a lot of people are still alive. Is that not life expectancy? Isn't that approximately a midpoint? That means that 25 percent of the time in 25 percent of the scenarios you ran out of money before you ran out of life, and, as we talked about earlier, you can't just not eat. So, if you were to build a product that had a tail that was that significant, would you launch that product? No, most likely you wouldn't. It depends on what the risk is, right? What's the downside risk of failure? The downside risk of failure in this case is pretty dramatic. I think we'd all agree that running out of money would not be a good thing to happen to you as an individual. The bottom line is, it's a significant risk, but most people don't recognize the risk. Many in this room would deny the risk themselves, given the opportunity to avoid the facts.

But the bottom line is, when you start looking at this as an individual—not as an industry, not mathematically, not academically, but as an individual—two things happen. One is that you get very optimistic about the returns that you'll receive over the next 30 years. I'll do 10 percent, right? Well, there are fees, charges and all that other junk that comes into play. Ten percent on a deterministic basis looks pretty good. The realities are that we don't live in a deterministic world. We live in a stochastic world. The other thing that happens is that we say, "I'm not going to live that long." We suddenly become very pessimistic at the same time about your life expectancy. I'm optimistic that I'll beat the market, and I'm pessimistic that I'll live too long. The bottom line is that reality may not line up with the fantasy that we all create.

As risk managers, which all of us are in this business, how do we solve for the risk of the tail happening to us as an individual? I submit that the only way to do it is by pooling that risk. By pooling the mortality risk, the insurance industry accounts for the unaccountable, often unpredictable, individual human factors that an individual should not and would not really want to take on if they understood what it was. We understand that. I'm preaching to the choir. You know it intrinsically, intuitively. The bottom line is that if everyone outside this room understood it, it would be a huge market. That, in and of itself, is the challenge we as an industry face. Thirty years from now, I hope we're successful at getting that message out because I don't want to be the good advice that our customers just didn't take.

So, there's a movement afoot. We think it should be a revolution. More and more research efforts are being directed toward income. The Society of Actuaries' Mathew Greenwald's Research Around Retirement Risk survey contains information about how consumers view retirement risk, and they're pretty far off in terms of mortality and return. The only problem that comes from that is there is no market acceptance of annuitization as a solution. Other industry trade groups, such as NAVA, have commissioned studies to talk about this topic. They commissioned the value of lifetime annuitization study a couple years back. The results are in. If you use an income annuity, you will never run out of money. I needed a study to tell me that? Boom! The tail risk is gone.

Unfortunately, the industry—meaning distributors and consumers and the press—need a study, somebody other than us, to tell them that with a lifetime income payout annuity, you will never run out of money. They don't always understand it, so to them it's really big news. To you and me, it's probably not so big news. However, the word is getting out, albeit very slowly. From the industry press to the consumer press, the Fifth Estate is reaching the same conclusion, albeit late—but better late than never.

So, there is a place for income annuities in a customer's portfolio. Now the conversation is starting to shift from: should you use an income annuity to how much should you use? Consequently, the message is unclear and conflicted, and that leads us in this room and others in our companies to: how much and when?

Who will leave that message? Who will drive that message in the public, in the press and with our distributors? Are we seizing the opportunity to tell our story, as others in the industry are? Let me give you an example.

The mutual fund business, which is a pretty big competitor in the income space—mutual funds and systematic withdrawals, especially in the required minimum distribution category of qualified funds—is lobbying Congress, saying that if you use an annually recalculated life expectancy, they can never run out of money. It's absolutely true. If I were in a court of law and the prosecutor asked me, "Matt, if you use annually recalculated life expectancy, will you ever run out of money?" The answer is no. So the insurance industry isn't the only one that can provide lifetime guaranteed income. That is correct. You can actually use an annually recalculated life expectancy and, to my legal team's point, we aren't the only ones. But I submit that there is a pretty big difference between $1,000 and a penny. While they may get a check, it may not be the check that they actually need or want.

How have we done so far at getting the message out? Well, I would say we're not seizing the opportunity. It's a pretty teeny tiny market, $500 million in sales in the immediate variable space, $4 billion in the income space, or the fixed immediate space. So, how do we get our message out there and get our share of the $4 trillion moving in income, 25 percent of the U.S. financial assets? Well, since I'm in Washington I had to use some sort of Washington reference, right? We at GE Financial look at it like a campaign, and if I were looking for an analogy for a campaign, who better to choose than our old friend Bill Clinton? He was a little-known southern governor who surrounded himself with zealots. Those zealots, with extremely limited resources, by focusing on key jurisdictions and creating a buzz with an extremely simple message—do you all remember it? "It's the economy, stupid"—vaulted himself to the presidency of the United States.

That's what we're doing. We're following essentially the same pattern. That's how we're approaching it. In concert with our distributors, we're using an advance team, what we refer to as income zealots. These are individuals whose sole focus, nothing else, is around distributing income solutions, which includes products, and they do it in an extremely focused way. They are focusing on key strategic individuals within firms with a very simple approach and a very simple message.

Let me tell you a little bit about how we do it by demonstrating how we do it. It all starts with one person, a key individual. We look at our distributors' entire distribution base, and we ask who within the distribution base carries the largest amount of thought leadership? In other words, what individuals within the firms, if they started doing business with us using income solutions, would be able to translate that across and drive that message across the firm? And those are the only people we talk to. We actually have a group of wholesalers who do tell the income story, basically to keep the message fresh, so that when the producers hear ultimately from the solution-based side they will recognize it as an actual solution that's available to them.

However, all of our assets are focused on these key individuals that have been identified through our research as being the thought leaders in the group—education and training—but not only of them. Because these guys often have elaborate teams of 10, 12 or 14 individuals supporting a single producer, we also have to train all of their team. They do most of the work, and most of the recommendation work is done by those teams. Then we support the heck out of it until that sales team implements the income solution into their customer base. We don't leave them until they do, and when they do, we ask them for referrals.

I'm a marketing guy. I'm not a rocket scientist. It just seems pretty natural to me that if we have happy customers, they might be willing to refer us to other people. But I don't want a list. I want you to hand-select two or three people who look just like you, and I want you to call them for me, make the appointment and tell them why. And they do. They're happy to do it because it's a great solution that they've incorporated into their business. So they call a couple of friends, and they say, "Hey, you need to take a look at this, talk to these guys and work with these guys." And we do the same thing with these two guys—education, training and support—until they get it, and then you know what? We ask them for referrals, and they lead us to the next four and so on and so on.

We do the same thing over and over until we get a large enough group to form what we call a study group, which is actually a lever for us. We use the study group to expand our distribution faster because it starts off one at a time. But once it builds inertia, especially in a study group, these guys are now incorporating it into their business, they're using it every day and they're sharing information back and forth about uses and how it fits and where it fits and how to sell it and how to position it. It's an amazing thing to watch. And then we ask the study group to invite their friends and so on until pretty soon, you have acceptance. It's amazing how fast you can actually gain acceptance by following this approach. In one example, we can trace a large portion of our distributors' production, which is now a whole bunch of producers, to a single key individual. If you follow the legacy all the way back, you can find the one guy who started the entire chain. It's amazing. That is guerrilla marketing. That, ladies and gentlemen, is what it takes to succeed today in this space, due to lack of market acceptance of our product line.

So, is it the income road less traveled? Yes, and that's exactly the point. Why? It's an uncrowded space. We can get high margins. We have few irrational players in this space. But most of all, it's what we do. We protect our customers, and we do it in a way that no other competitor in this space can do, and I'm proud to be part of it.

There are three key takeaways. There's $4 trillion—I don't think you guys missed that one—25 percent of U.S. financial assets. Only insurance companies can do this, and we need to keep it simple because there isn't market acceptance yet. And it's guerrilla marketing. It's one at a time. So, how can you translate this into action? I mean this from the heart. I believe it's up to you in this room. With your creativity and your ingenuity, you are the engine that will take our industry, your companies, and our customers to a better place. I applaud you. I empathize with the challenge that you have in front of you. But more than that, I count on you to make a difference because it's what you do. That's the way I see it. Thank you very much.

MR. FRANCIS P. SABATINI: I'm Frank Sabatini with Ernst & Young. I'll tell you right away—this is not point/counterpoint because Matt and I go to the same church, and we sing in the same choir. You'll hear a slightly different theme than the one Matt gave, but one that's very much consistent with what he's had to say.

What is retirement income? Let's define that for a minute. Nobody's really defined it yet in this entire program. It's when you stop accumulating and start distributing. That's it. There's a line in the sand. But generally, from a lifestyle point of view, you go from accumulating, and you move into distribution. It's a different issue. It's a different set of problems. It's a different world. And you know what? The people who are living it day to day, they get it. They understand it. The people that sell them the products and the services that support them don't.

It's not a simple problem. It's cash flow. It's, "Will I have enough money?" You sort of know. Genetically you know how your parents did. You know what the propensity is for things in the family. But do I have enough? I know how much I have, but will I have enough? I have somebody telling me I should spend 5 or 6 percent of my income a year, but will that be enough? Do I know? How many people here think their parents know whether or not they have enough, unless they're really rich? If they're really rich, don't raise your hand. But if they're normal people, they're in the bottom 90 percent, how many people really are convinced that their parents think they'll have enough money to live off until they die? It's a very small percentage, and it goes to point.

Cash flow is a big issue. For most people estate preservation is something they'd like to do. It's not important, but it is a big part of what many people want to do. So that's the second element. And then the third element is, what if I get sick? What happens? Will I have enough money? I saw some statistics recently that said that most nursing home stays last less than three years. But if you do some of the math, most three-year nursing home stays will wipe out the accumulated wealth of an individual. Do they understand that? I think they do intuitively. They know it's a problem. They worry about it. So what do they need? They need advice. They need people to help them understand how big the problem is, and they don't need to wait until they're 80 or 85 to realize that the bank account balance isn't that large—and they're feeling pretty good, and they have another 20 years to live—because then it's like providing minimum guarantees of 5 percent on products. When interest rates get down to 3 percent, that's not the time to implement the hedge strategy. It's the same thing at 85.

So, let's go through some of the risks that we have. Longevity, life expectancy, is a big deal. Running out of money is a big deal. I have a 91-year-old mother-in-law, and I'll tell you what, we're starting to get worried. We thought she was in great shape 30 years ago. Now, she's 91, and she's in a nursing home, and it's tough. Overconsumption is another risk. You retire. You have this big nest egg. You go out and fly around the world. You do Italy. You do Asia. You do Australia. You come back. The market's 40 percent down two years in a row, and you're going back to work.

You need to know how much you have to spend. The other side of it is underconsumption. You're so afraid that you'll run out of money that you don't spend any. If you're the child of one of those couples, it's nice because they'll leave it all to you. And what about the market fluctuations? I hang out with some guys on the golf course, and a couple of them are a little younger than I am. They were retired, but not anymore. These market fluctuations have put these guys right back to work. The whole plan must also address tax risk in terms of withdrawal and then, of course, the health care and the long-term cost.

So what is retirement income? It's a new game, and we need to figure out how to play it. Let's talk about what it isn't. Let's start with that. It's not about accumulating assets. It's about distributing them. People who are in that phase of life understand what that's all about, and it's not about asset allocation—it's a little bit about asset allocation, but asset allocation isn't the solution. It's not a product solution. It's not transactions. "If you buy this product, all of your problems are solved." I don't think that does it. What is it? It's financial planning. It's helping people understand how much money will sustain them over their remaining lifetime with what degrees of success and what sort of circumstances can impact their chances of success in terms of that plan.

If and when I retire, during the early years of retirement, I'll want to travel. I'll want to do a lot of things. And then later on, I know I won't be running the bases as fast as I do now, so I won't be doing as much. I won't need as much money. So we need to recognize that the income needs vary. You need to manage cash flow for unexpected events. It is illustrating the value of insurance guarantees, and you can start to see now where Matt and I are starting to converge on advice and education, and all three of us talked about that.

But what needs to change? The way we interact with a customer must change. We're financial planners, but we're really transaction-oriented individuals. If you want to gain market share, you need to make that transition. You need to change the views of the distribution system—Matt hit this pretty hard—and that gets back to education. We need to develop new products. We need to use technology, financial planning software, which I'll illustrate later on. We need to use technology to help make the business case, and we need to recognize that the timeframe's unknown, yet the resources are known and very limited.

You have to eat. You have to have enough money to pay the bills. So how should I invest? What should I be doing to protect my basic income needs? I really can't put that money at risk. If I live to 100, I have to have enough to put a roof over my head and to put food on the table. How do I understand that? What's the plan that gets me there? Then I have to decide lifestyle. I worked all these years. The vision was that I would be a club member. I would play golf three days a week. We'll travel. We planned to do all this other stuff. What is the probability of meeting that goal? Do I have enough money to do that?

Ideally in your accumulation phase, you should have been targeting this to begin with. What will happen to most financial planners is that they'll say, "You know the plan that we had to get us to the accumulation? Well, forget about that. Everything's changed now. Now we have this new plan. And there's this little discontinuity here, but let's not worry about that." I think that's where a lot of financial planners are heading. So how should my invested assets be allocated is the big question. Will I generate enough income to support my desired lifestyle? This whole idea of home equity is huge. If you think in terms of the product development view, it's huge. I don't know if reverse mortgages are the right solution. But for many of us, the equity in a home is one of our biggest assets, so using that in a financial plan and helping people recognize that home equity will be part of the longevity play is an important thing. They understand it intuitively. We, as distributors or providers of solutions, haven't figured it out yet. I think there's an opportunity, and it lends itself to the insurance industry.

Then, there's the whole health issue. It's such a big issue. And it's interesting, the number of companies that are really selling products into that market. It's probably where we got the product right at this point, but none of us sell it because we're not comfortable with the economics and the uncertainty around the product.

I want to reinforce in a numerical way some of what I'm talking about. Here are the simple basic needs—pay the rent, put food on the table (Chart 1). I think it has inflation factored into it. And there is the gap between how Social Security might have a DB pension plan—so you have sources of guaranteed income. The difference between what you need to live on and your guaranteed source income is the difference that needs to be funded from your asset base. This is a typical analysis you'll see, and some people who do good financial planning can get this right. And the deal is, though, the gap is bad. So, you buy an annuity. You overlay it, and you cover the gap. It's a simple illustration of the point, but it's pretty powerful.

It's pretty powerful, but it's not enough in my mind. This is eventually heading to stochastic simulation and helping people understand whether or not a particular financial plan is or isn't viable. Let's take a simple example of a retired couple, both age 65. They've managed to accumulate $625,000. They're targeting $100,000 to live on. Social Security and pension give them about $55,000, so the unfunded income from guaranteed sources is $45,000. It turns out—and you can do the math, but I think this is pretty much right—I can buy a 100 percent joint and survivorship (annuity) (J&S) at $45,000 for about $625,000, and if I buy $40,000, it's $555,000. This is pretty much current pricing. At one point we went to a bunch of Web sites and checked the prices.

So we do a stochastic simulation. I can describe what you're looking at and what probability of success means. If you run out of money and you're still alive, and you can't pay expenses and can't eat, you fail. If you die, and you have money in your pockets, you win. If you live to 104, and you have enough money, you win. Okay? So probability of success is measured at any attained age as the number of times you win over the number of trials. We have an asset allocation, and you can see 100 percent large cap, 100 percent bond, 100 percent money market, 50 percent bond/50 percent large cap, equally invested, meaning equally invested in the other four, and then a straight life annuity (Chart 2). What we're doing is stochastic simulation around fund returns, interest rates, although the annuity's priced at issue. If we were doing a simulation with a future purchase on annuity, which you actually purchase and want the purchases, then you get a different view.

We actually have stochastic mortality in here. We're running enough simulations so that you're flipping a coin. You live or die. We're looking at the mortality table. Some of the guys I hang around with call it dichotomous mortality. So what does this show? Well obviously, if I had $625,000 that just bought me a $45,000 annuity, my probability of success is 100 percent. But the interesting thing is to look at the other asset classes. Of course, that probability of success is very much a function of what you put into the simulation routines, but with any kind of assumptions about long-term returns around money market or large-cap equity—I mean you can do a plus or minus 1 percent—you will pretty much get the same result. By the time they're 74 or 75, there are some scenarios in which they run out of money in a systematic withdrawal situation.

The probability of success at age 85, if you're equally invested and if I get this right, is still slightly above 90 percent. By the time you're 90, it's 85 percent. I'm not saying you communicate data like this to consumers—only actuaries can understand this graph. The challenge is taking this kind of information and putting it in understandable terms for the customer. Most consumers don't understand this. There's a high probability as you get into the late 80s, a high probability 20 or 30 percent of the time, depending on your asset allocation and in a systematic withdrawal. The reality is you'll only live through one of the scenarios.

But if you retired three years ago, you have some problems right now because you're in one of the tails of those scenarios. Those of you who do variable annuity work or anything like that realize, for the business you sold in the past few years, what kind of returns it would have to have to get back to the break-even point in terms of pricing? It's a powerful illustration, and the key here is communicating to the customer and ultimately to the distributor that this is a powerful tool. It has nothing to do with the fact that we're in a very low-interest-rate environment, and the annuity is not a very good investment. It's the longevity bet. It has to do with the fact that you're giving up some of the upside, which is demonstrated in Chart 3.

This is same the scenario, the same situation—$45,000 in the annuity, only the annuity's not on the chart—and it just shows the percentage of outcomes in which the assets were less than or greater than a particular wealth level at death. So, it's measured at the point of death. You can see to the left that almost every one of these investment strategies produces a fairly high occurrence of asset balances—in effect, less than zero—at death. You can't have a negative wealth balance, but you understand what I'm trying to do here.

If you're highly invested in equities or equally invested, there's a 40 percent chance that you could end up with more than $1 million at death. On the other side of that, you have better than—on the equally invested—a 50 percent chance that you could end up with no money. That's the tradeoff. That's what we need to help the customer understand and find a way to communicate to them in a financial planning context. We need to help them understand those tradeoffs and the value of the guarantee that the insurance company provides. It doesn't just have to be an immediate annuity. It can be a variable immediate annuity. It could be a guaranteed minimum income benefit (GMIB). It could be a guaranteed minimum accumulation benefit (GMAB). It could be a guaranteed minimum withdrawal benefit (GMWB). All of those products have elements in them that help protect against the sorts of things that are producing these kinds of outcomes.

Term insurance may be the answer. I don't necessarily need a J&S. Maybe I need a lot of term insurance structure to help fund the first death. Or are there products out there that we need to design and think through that are designed to help address these issues? Chart 4 shows just what happens. I don't believe that you should have anybody with $625,000 buy an annuity with all that money. The whole idea is to help people understand how an annuity in a financial plan will help improve the outcome. All this is doing is throwing a $40,000 annuity in, leaving them with, I think, about $70,000 in cash—that's probably too extreme a scenario—and trying to illustrate the value that the annuity brings.

Now, the thing to note is that our research says that an annuity is not right for everyone. If you do the simulations right, there are instances in which, given the income targets and the asset base of an individual, they're better off not buying an annuity. They might be better off buying some other form of insurance guarantee, but they're certainly not better off buying an annuity. It has to do with how much pressure you put on the remaining assets after you purchase an annuity to fund the gap. It's not intuitive, and we'll be writing some papers on this in the coming months. But even in a financial planning context, it's helping people understand that they may have to reduce their target income goals to achieve a certain level of success.

For the insurance industry today, what are the keys to success? I think technology is the key. The customers don't know. They want to know. They need to know. Do I have enough? Will I have enough? What could cause me to not have enough? How can I protect against that? Everybody's doing surveys—the GE survey, the Met Life survey, the ING survey and consumers this and consumers that—and they're all saying the same thing: They're worried they won't have enough money. That's the question they want answered. So, if you plan to attack this marketplace, it seems to me that if you help them answer the question, they might buy your products.

I think somewhere Monte Carlo has to play, not around fund returns, but around not only the mortality but the morbidity risk or some form of simulation that says, "Without worrying about illness, here's a plan. Let's look at the plan, assuming that you could get ill and end up in a nursing home." We should help the customer understand. Here's the plan if you have a long-term-care policy, and here's one without it. You choose. It'll be interesting. Most people, particularly when it comes to their personal lives, are pretty much risk-averse. I think if you helped them understand the issues, they'll be compelled to make the investment, especially if you can help them understand that they can afford to pay the premium.

So you need to leverage a tool. If you have the tool, you can provide the advice. You paint the retirement picture and answer the burning question. It's really all about risk management. It's a risk management issue and helping them make the choices. Then once you hook them, you review the plan every year, and you keep them coming back. The next point is what I call redirect distribution, but it's really changing the business model. You can't go off and develop a product and say, "Here's our retirement income solution. Distribution system, go sell it." The major issue here is that we have a bunch of old dogs, and we're trying to teach them a new trick. And you know what they say about old dogs and new tricks.

That's one of the beauties of what GE's doing because they're just finding one old dog and they're teaching it a new trick. Then they're trying to leverage that relationship to get them to do the other. It's what we do with our customers. We don't introduce it en masse. Let's have a targeted implementation. Let's build success. Let's pilot it. Then when we get that right, we broaden it out.
Once they see the other guys making more money than they are, they'll want to do the same thing.

So, it's a different way to go to market. You need to be more patient. You need to be more thoughtful. You'll probably have to go through a couple of iterations. How every organization does it will be different. What's so unique is that the products that each insurance company sells are unique unto themselves, so you can't end up with a generic technology that illustrates a generic product because it won't really give the right answer. You can get away with that a little bit. Make it easy to provide the advice. You need to simplify. You need to tell a compelling story. And it's not five years from now—it's today.

Because what will happen is that three or four companies will make the investment—they'll brand, and they'll get market penetration—and then everybody else will be playing catchup, so you have to decide where you are. And you can't say, "We're a fast follower." I'll tell you, this isn't a situation where that game plays at all, and you really do need to spend time designing products with retirement income in mind. Thank you.

MR. JUNUS: We do have a person up front for a question.

MR. HAYWORTH ROBERTSON: If I recall correctly, about 40 years ago a small group of people was trying to put together a special insurance company that would take an annuity product, separate it into the investment element and the mortality element, and sell only the mortality element. I don't know if I've described that carefully enough. Has that been done? Are you familiar with that at all?

MR. SHARPE: I know of one company that did it. It did not actually take off, and I believe they took it down. It was just mortality tail insurance basically. I do know of one company that did it, and they didn't sell it. Did you guys?

MR. JUNUS: No.

MR. SABATINI: No.

MR. JUNUS: I think there was a concept that was floating around somewhere.

MR. SHARPE: It comes up a lot in a lot of the income conferences around mortality tail risk insurance. Maybe you will come up with a solution for us.

MR. JUNUS: There are so many things that you can develop for customers. It's a matter of whether they want to buy it, and that's what I mean by companies that are testing and experimenting in different things that may not catch on. Maybe a variation of the product may work or maybe different marketing may work.

MR. ROBERT J. KELLER: (United American.) Suppose you're a customer who has a strong desire to purchase an annuity for the lifetime income aspects that you mentioned. How do you alleviate their concerns about whether the insurance company will be around long enough to continue paying that income for life?

MR. SABATINI: I think it's no different than any other concern they may have about other products that they might buy from an insurance company. I think the only thing you can say is that, first of all, you should buy from a high-quality, well established company. But I think they also do have a put option to the regulator in the guarantee funds, and I can't think of any insurance company failures where the annuitants ever lost anything. I don't know if that's the answer you're looking for. I guess the question I have for you is what recourse does the consumer have when they go to their stockbroker and say, "And if I run out of money, what will the firm do for me?" I think in reality—this may not be related to what you asked—but the next wave of litigation may come around and challenge sales practices around systematic withdrawal and how we sell GMIBs and some other products. But that's another panel session.

MR. KENNETH W. FAIG: (PolySystems) I had a couple points I'd ask the panel to address. Many retirement-age individuals have a tremendous desire to remain in a home, even if that home has much more space than they may actually need. It seems that for so many individuals of ordinary means, the home is a tremendous percentage of the net worth. Yet almost all the plans that exist today that I'm aware of depend upon monetizing that home, if you will. So, my question really revolves around how we mesh this all into the desire to remain in a residence, which is extremely important for many people.

My second point concerns an option that once existed but, I think, exists no more. This option existed, I believe, not only before there was Medicare, but also before there was actually Social Security, and that was the option that once existed in many fraternal homes, which was simply to surrender all of your assets, whatever they might be, and be cared for for the rest of your life. That was actually the option that my own great-grandmother chose. She had been a widow for nearly 50 years and had very modest assets. In her 80s, she decided to enter the Springfield, Ohio, home of the Independent Order of Odd Fellows. One doesn't hear about the Order of Odd Fellows much anymore, but it was an extremely viable option for her. I think there were medical examination requirements, but you did surrender all of your assets, and you were cared for for life. So you essentially demonetized your life, and that's how she spent the last 10 years of her life. It seems today our society is totally monetized, and maybe we need to think about whether there is a way, at least perhaps for individuals in their 80s, so we can provide a solution that essentially demonetizes the remainder of their lives.

MR. SHARPE: The first question around monetizing your residence, I guess would be the best description I'd have for it, is actually becoming fairly popular in Europe, where they are taking homes and using some version of reverse mortgage or an outright sale of the property. Actually, one of our divisions has a fairly substantial market in that particular product line. We'll purchase the consumer's home for a lifetime monthly income in return. They remain in the home, and when they leave the home, we sell the property. So it's a very similar to the reverse mortgage business, which is also prevalent over there. In the United States, that only amounted to 13,000 mortgages last year. Even with the Federal Housing Administration (FHA) guarantees, we still were only able to generate 13,000 reverse mortgage transactions in the whole of the United States. You think the income market is small? This is really, really small.

But I totally agree with you. I do believe that monetizing your residence is one of the things that people will have to deal with, especially when they realize their accumulation plans, when they actually try to translate it into an income plan, won't be enough. Oftentimes they say, "Exclude the house. That'll be what I leave for my kids." I hear that oftentimes from consumers saying, "I'll live off my income." Hopefully, that'll be enough, but oftentimes, when you do the analysis, it doesn't actually look like it will be that way necessarily for them.

As for the endowment communities or the life care facilities, I actually did some work for a life care facility that worked just like that, and I know that the financials around running the life care facility became overpowering. They couldn't keep up with the costs, the medical costs, of dealing with their residents, so they actually made it a fee-for-service business. I'm wondering if that's why you haven't seen the demise of that type of community and their translation into the fee-for-service type operations. But if all of the predictions that are out in the financial press and the consumer press come true, we, as a country, will end up having to deal with those issues one way or the other.

MR. SABATINI: I'll just comment on the first point. One of the issues that you deal with in the situation with monetizing the home is the same as one of the issues you have in terms of the outright purchase of an annuity. There's no cash surrender value. You pretty much have made a bet on longevity, have you not? And that's part of why we think that in building the stochastic mortality or some mortality into the analysis is the idea that you need to help the consumer understand the bet. The other concept is that we're out selling annuities, and we're not putting it in context and layering in or turning $10,000 or $20,000 of income on top of a $100,000 income need and explaining what that might do in terms of wealth transfer and other things. When you put it into that context, it might not be as unpalatable as when you look at it independently and say, "I have to give you this much money to get that much income, and what if I die tomorrow?" But it's done in a very narrow context.

If you do it in a broader context, you can start to be more rational about the risk/reward tradeoffs. I think it's the same thing with monetizing the home. I think the reason it doesn't happen in the United States is that I have this asset that's worth a lot of money. I could get two checks and die, and it's their house. So, we either need to design products that address that concern, that produce some sort of residual liquidity. It's the same issue on annuities in terms of having some sort of cash value. We need to address that in the product design and still do it in a way that allows the company to make some money.

MR. DANIEL R. PATTERSON: (Allianz) Can anyone address the regulatory arena with regard to immediate annuities? Do you feel that there have to be dramatic changes, such as in state approval processes, regarding the definition of an immediate annuity? For example, we have states that have said, "You can't have a cashout. If you have a cashout option, it's not an immediate annuity anymore." I think there needs to be some strong lobbying in the industry to get the people to help us develop products for people. Do you have any comments?

MR. JUNUS: I think you may have to do some lobbying before the states will change, but I think the biggest obstacle is in the taxation of immediate annuities. If it's a nonqualified plan, a nonqualified immediate annuity, there are lots of tax issues concerning cashouts, changing the payouts at different points in time and doing all these interesting variations of product design. But I know that there is a task force within the ACLI that is actually actively—I won't say lobbying—but actively looking to that to make sure that you get a favorable ruling from the IRS. On the state regulatory side, I don't think I've heard much about that, but maybe Frank and Matt can expound.

MR. SABATINI: I don't consider myself an expert, so I'll share with you some anecdotal information. I've had a couple of clients who have said things to me—things such as the insurance regulators feel that an immediate annuity product is an appropriate product for an insurance company to sell. So generally, they'll be receptive if you're in there trying to get them to make changes to accommodate you around payout products. Now, that's more hearsay, and I could probably talk to others in my firm, if you're really interested, to give you specifics. But that, intuitively, is something that I would say sounds about right, as opposed to having some highly investment-oriented products, which is where they would exhibit a lot more discomfort now.

MR. JUNUS: I do know that for a fixed immediate annuity, if you provide a commutation feature, that's okay. It's when you provide some kind of cash value that you run into problems.

MR. SHARPE: You also may run afoul of some potential securities regulation if the product has a cash value or some commutation value. Oftentimes you can be pulled into the issuer rules, which is one of the things you'll have to watch out for, and oftentimes you don't think about them unless you're in the variable side of the business. That would be the other caution I would throw out there. The other thing is to be prepared to educate, because the regulators don't necessarily intuitively know where you're going. So you may end up spending an enormous amount of time educating them on what you're doing, why you're doing it and how you're doing it, and then the debate will begin about whether they agree with your methodology.

Chart 1

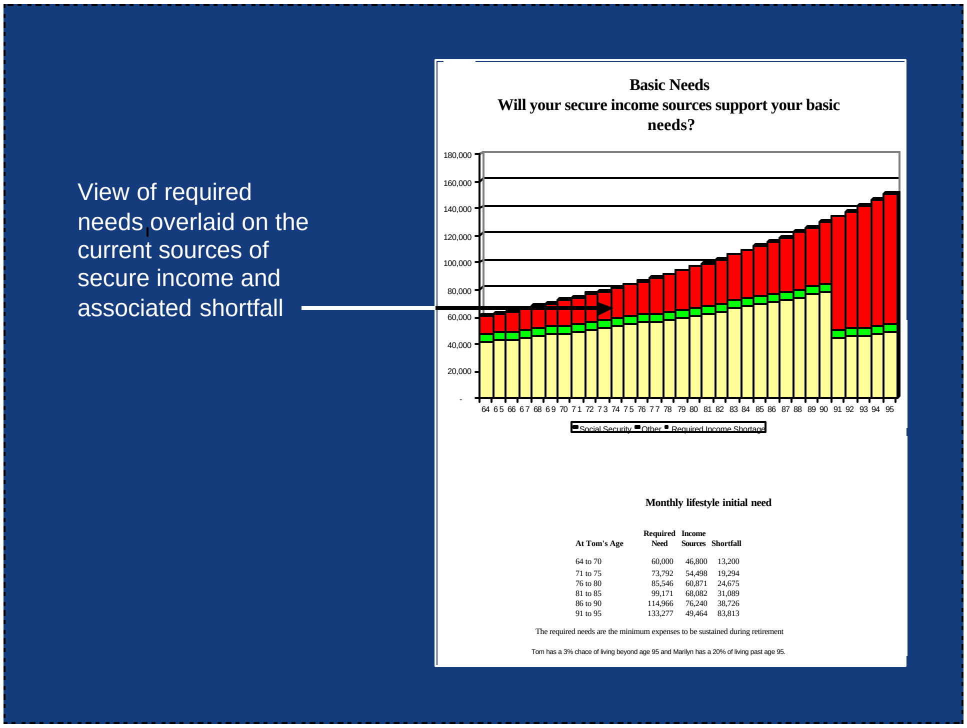

Chart 2

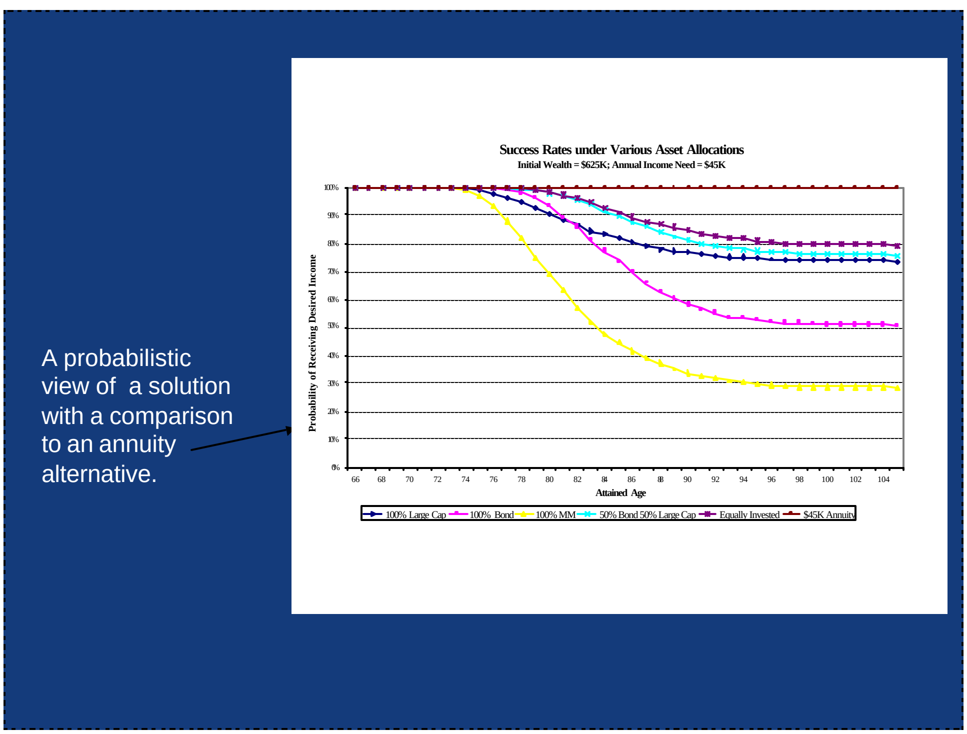

Chart 3

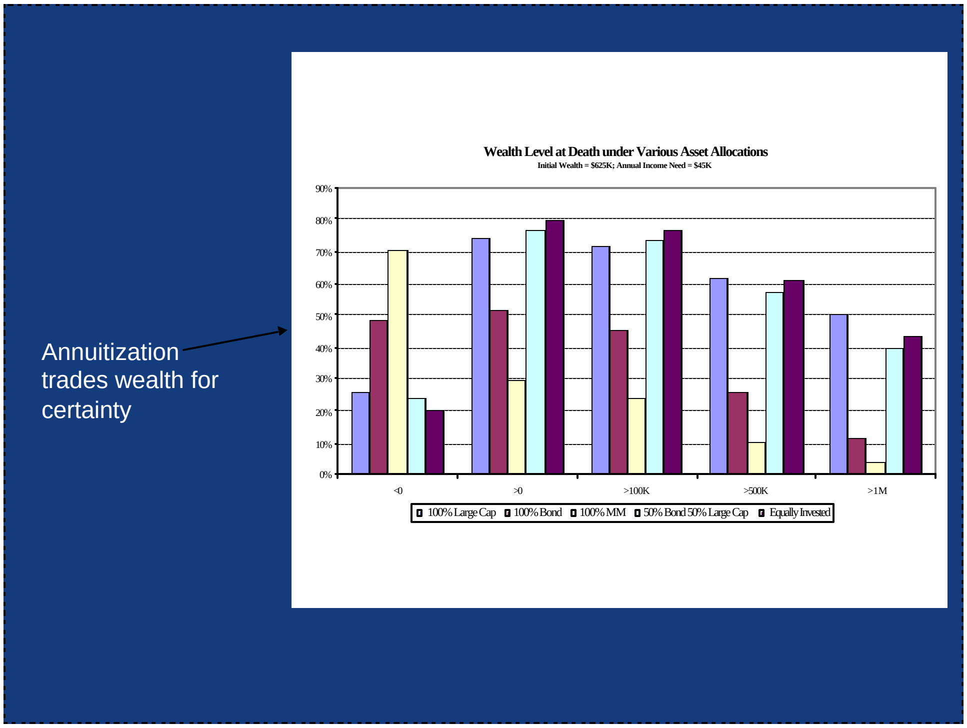

Chart 4