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Session 84 PD
Payout and Income Annuities—The Next Best Thing ... Again

Track: Product Development

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Panelists: Anna Hart†
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Summary: With retirement on the horizon for baby boomers, there has been an increased focus on income annuities. Impending tort reform has created an even greater interest in structured settlements as cases are pushed to settlement before this reform is enacted. Insurance companies have had mixed results from their recent marketing and business development activities. However, the appeal remains strong and the opportunity is substantial.

MR. NOVIAN JUNUS: My name is Novian Junus, and the presenters are Eric Sondergeld and Anna Hart. I am with Milliman in the Seattle life practice. I've been keeping up to date with the development of payouts and have a huge interest in development of payout products. I have helped a few companies review the pricing and design of payout products. Milliman also has performed a survey of payout products and pricing, from which we found some interesting results, as has the Life Insurance Marketing and Research Association (LIMRA), a/4444/s Eric is going to share.

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†. Anna Hart, not a member of the sponsoring organizations, is underwriting consultant at ARHart Consulting in Eastland, TX.

Note: All handout materials are available through the link on the table of contents.

This is the overview of the topics. Eric is going to provide an overview of current product designs and considerations for future designs and information on the current market for income annuities and evolution. Quite a few companies out there are developing interesting designs. I have asked Anna to help us with some of the approaches to and maybe even will discuss the need for underwriting income annuities.

The first presenter is Anna Hart. Anna works closely with actuaries to determine and develop appropriate underwriting requirements to understand the appropriate risk class, and she's going to provide more background on her experience with underwriting annuities. She has provided consulting assignments, including helping appropriate underwriting requirements, assessment application, design, review and analysis. Eric, as most of you should know, is from LIMRA, and his overall 4567890responsibility is for LIMRA's2 retirement research program. Eric also heads up LIMRAI0's Retirement Resource Center. He offers a lot of client education materials on retirement planning and he is a noted authority and well-known spokesman about retirement issues. He has been active in the retirement sphere and the implications for both consumers and providers.

Let me give you a brief view of the market and how it has evolved. Simplistically, the current evolution of designs has started with a fixed single premium immediate annuity (SPIA), and this is your normal fixed SPIA with multiple benefit options, including cash refund and cost of living adjustment (COLA). Some of them are true COLAs tied to indexes. Most companies allow commutation of the fixed period if the person has died so the beneficiaries can receive a lump sum immediately, instead of receiving payments over time. Then a few years back, a few companies developed variable annuities with liquidity provisions, including some guaranteed payout annuity source, and more recently, some fixed and variable single-premium annuities with death benefits, and this is on top of the cash refund feature. You guarantee a death benefit such as 10 percent of the premium.

Companies market variable annuities with guaranteed minimum income benefits (GMIBs) and guaranteed minimum withdrawal benefits (GMWBs), including the latest versions that recently came out. I guess people, even distributors, view that as a payout annuity as opposed to a deferred annuity, and companies have dabbled in trying to sell substandard immediate annuities. Usually these are just for a small rate, and this is apart from substandard structured elements.

We've got some retirement income SPIA activity, but the most interesting thing right now that companies are starting to develop and that one has come out with is longevity insurance. It is kind of reverse term. You sell it to somebody at age 65, but you can only get an income at age 85. I guess the designs are such that you can even have a death benefit or no death benefit included. Eric is going to go over some of these designs in more detail.

Regarding the current evolution of marketing approaches, there's the typical income for life. I think that's what an SPIA is, and when I retire I'm going to buy an SPIA to cover some of my income needs. I think there's a definite need. Those who are in the know will want to buy it. The question is, Do people realize the risk they're taking, and are people in the know enough to make that decision?

For split annuities, they'd likely do deferred and immediate so that you have a perpetual income stream. Systematic withdrawals is where most retirement income is being sourced. A lot of people will put money in the CDs and just get interest from it or whatever. Mutual fund providers or financial planners want to develop some kind of retirement income program for their clients, so they just take withdrawals out of the accumulated funds.

More recently, you have a company with dollar cost averaging, fixed SPIA. Instead of buying an SPIA immediately, you buy it over time whenever the need arises, or maybe at a scheduled interval. Another way of marketing, of course, is developing a retirement income program. This is a program where you take systematic withdrawals out and maybe even include some immediate annuities in there to fund your retirement income needs, but it is a totally packaged program.

That's just to whet your appetite. Now I will get Anna, and she will discuss underwriting issues with SPIAs.

MS. ANNA HART: My experience comes from working in reinsurance for 12 years, and I worked for a large Swiss reinsurer, Winterthur Life, that has gone through several aliases since then. But we did impaired annuities in Europe. That's where I learned to underwrite impaired annuities and to do a comparison—kind of an historical group comparison of what Europe does versus what the U.S. does and what each can do and cannot do. I'll try to look at and lead into what Eric is going to talk about in terms of what is the market is trying to do and hopefully will eventually be able to.

Historically in Europe, the impaired annuity market has been out there for probably over a decade. It is very developed. It's not successful in all the companies that are utilizing it, but they have over the years managed to revise their products where they're more effective based on at least having some experience. In the United States, while I've talked to a lot of people in preparation for this who are doing COLAs, there are not a lot of underwritten annuities. They talk about underwritten annuities, but not in the way that Europe has done them, where they get all the records and do detailed underwriting on a variety of elements. It tends to be limited partially due to the product design, and there are some tax restrictions. When I worked for Winterthur, we tried hard back in the early to mid-1990s to bring the impaired annuity market to the U.S. market. This was a fight with the U.S. tax code and some other things, so it has taken probably another decade for that to come into play.

The question comes, What is the need or another way of saying that is there is a need or a market for underwritten annuities? If you've attended several of the other sessions, there's been a lot of talk about life settlements and some of the securitization types of things, and some of these options for the older age market are particularly enticing.

What are the approaches to underwriting an annuity. Is it possible to underwrite an annuity? Yes, it is. Do a lot of people do it? No, and they have limited ways of doing it. What type of annuity is appropriate for underwriting? Three types are generally described: structured settlements, care annuities and impaired annuities. Structured settlements often involve disabling injuries; job injuries through workman's compensation, medical malpractice, divorce or estate settlement. Care annuities involve more catastrophic events. In a nursing home you might have a care annuity. It tends to be the higher end of substandard in the care annuities, so you've got your older people and more severe impairments. Then you have the basic impaired annuities, which is limited in the U.S. market, although there are some people who are talking about making some changes to do some things. One of the other things I want to mention is using it for this basic enhancement, retirement enhancement, so you get the 60 to 70 age group and maybe your 60 to 75 and varying degrees of impairment, so maybe your 60 to 70 would be a low mortality, 100 percent to 150 percent in grading up to the care annuities, which have the higher mortality.

Approaches to underwriting methods vary, but age rate-ups are common. When I talk to a particular company, its application is such that it answers a select number of questions. The underwriter looks at that, and basically there is an age rate-up, so if the mortality is 150 percent, he rates it up from whatever age that is to an age up. Then he will put on the company's application. If you're interested in more aggressive underwriting, please submit some medical records, and we'll have our underwriter review that information and maybe give you a better rate-up, basically.

I guess this comes from working around actuaries a lot. At Winterthur I reported up to two actuaries, which is hard to do, but I worked with a lot of actuaries and mortality tables, particularly in this market. There are a lot of changes in the life industry about tables, and in some of the work I'm doing, there are preferred tables and older age tables that are under development now. It becomes more important to use the correct table, particularly when you're underwriting an annuity.

The choice in the mortality table impacts the slope as well as the pattern of the future mortality. I've listed three different tables that are considered: a life table (the ultimate version since policy is not underwritten from life principles); an annuitant table (with enhancements), which considers mortality improvement; and, a population table, rarely used.

On the annuity table, one of the things in considering the mortality improvement is the cohort effect, particularly if you're underwriting annuities in the older age

market or moving toward that age group from the 40s and 50s. That's going to have a worse mortality, and it is called a cohort effect, and we're starting to see that in some of the bad mortality.

These are interesting tables, and they are comparisons of the 2001 VBT ultimate, male and female (see Hart, page 4). I've taken the attained ages, 60 to 85, and compared them to the UP94, which is the uninsured pensioner; 1999 U.S. life table; and the 1983 IAM, which down here is the individual annuitant mortality. I looked at the rates going across and going down. I'm not going to try to be an actuary here, but you can see the difference in the patterns with the males. It kind of stays flat, and it's high right here, of course, in the U.S. life table. I'll let you make your own conclusions. Then for 2001 VBT ultimate female, you can see there's an extremely different pattern. The male table goes 99, 103, 110, 105, 104 and 98, while the female table goes 68, 89, 93, 98, 107, 108. When you go to the women, we live longer, and you have a different pattern and a different slope. It's interesting to note.

I've done an example on life expectancy (see Hart slide 1, page 5). I took a male age 60 and figured the life expectancy base using the UP94 of 16.5 years, and the 2001 VBT ultimate is 17 years. Your payout patterns would be similar in both of the tables. Again, you can go back when you get these 1994 and VBT so that the patterns would be different in that. If you did the life expectancy for a female age 60, again the difference between male and female mortality is 20.4 in UP94, and in 2001 VBT ultimate, it is 20.1. The important thing to remember is there's going to be much more payout in the early years using the UP94 on women.

Mortality improvement is on everybody's talk-about list, and nobody seems to know exactly what to do. Everybody thinks it's going to get forever better, which it's not. There are only so many miracles you can perform, and I think that while mortality will improve, the patterns will vary. In terms of male and female mortality, when you get to the older ages, you're going to see some reversals in what you expect from mortality. When is it appropriate to use it? Probably less so with care annuities because you're looking at high substandard mortality, so you're not going to expect much improvement, particularly in the older ages. More so with your substandard, your impaired individuals particularly, if you can make those low substandard types of things, so you've got to again consider the miracles of modern medicine and how far they can go. Will there be a cure for everything? No. Will there be improvements? Yes, but it's not to the extent that some companies are putting it in their pricing.

Traditional life insurance for many of these people has declined, and therefore the product options become narrower for people who are looking for something else. The senior market, again with its higher degree of impairment, just by basis of age often, is looking for lots of options. One of the previous sessions talked about life settlement and the pros and cons of selling your life insurance and using the money to buy another life insurance, so a lot of people are trying to conserve their life

policy rather than sell it. However, the senior market is looked at as being another option possibly for them to be utilized. If you can develop an impaired product where it gives them much more money for what they think they should get, they are much more interested in partaking in what you're selling.

Financing becomes important because of the higher wealth structure and multimillion dollar policies, and then you get into the issue of premium financing, where a lot of people are going in and buying reverse annuity where they will finance their life insurance and have annuity on the back end. That is a real issue for the reinsurers, and they don't like it. They often won't reinsure it, so it becomes for the product development actuaries to develop a product that would make that less of an option.

What we can't do in North America but can everywhere else or many other places is genetic profiling. You can do it in Europe. Regarding geographic profiles, the U.K. divides up its part of the world by little areas, and depending on the population in that area, if you have a mining district, you may have a slightly more substandard population. On occupational profiles, they also do that in Europe, but we could in the United States. If you have received an application on an impaired individual for an annuity, you could write up for the pulmonary disease, and that person worked as a miner for many years, so there are some ways to get around this. You can't underwrite using occupation necessarily, but you can based on the disease resulting from the occupation.

What are the methods of underwriting an annuity? Age rate-ups are frequent. Individual underwriting is less so but is becoming more of an interesting option. Regarding in-structure settlements, you see a lot more of the underwriting specifically, but impaired annuities are a growing market that has some opportunities. Again, we have structured settlements for injury or malpractice. There is little space for underwriting using health and lifestyle factors, particularly if you have smokers, nonsmokers, table ratings, flat extras and one of the other things on the health profiles, which is under this third area.

When you're talking about health and lifestyle factors, you could do some underwriting. The health profile will give you more serious impairments such as cancer, heart attacks, stroke or diabetes. Or you could look at it from a more simplistic health profile of people, whether they're just overweight and have high blood pressure and cholesterol. The nation is overweight, and blood pressure and cholesterol are so much more important that a standard annuity is not usually a standard annuity anymore if you took a close look at some of these people's health factors.

Regarding payout patterns, the difference between a population life expectancy (PLE) and an underwritten life expectancy (ULE) is life expectancies for males after attained age 60 are similar irrespective of what table you use as your underwriting, while females show a strikingly increasing pattern. The take-away from this is that

your mortality increases faster after age 60 using the annuity versus the ultimate table, and your benefit patterns and your payout patterns will be greatly different with your females versus your males.

In terms of tools, there are some reinsurance manuals, but again, they're not underwriting annuities, so you have to take that with a grain of salt. A lot of clinical research and online sources are available. Activities of daily living (ADLs) and individual activities of daily living (IADLs) become important from the perspective of care annuities particularly. Cognitive assessments are particularly important in the older ages. I know there are some long-term-care issue policies out there that would use some of these particular tools.

One of the things I think as a gerontologist by training is that the mobility question is missed often. I think that's something you'll see more in your underwriting, whether for life or annuity. Frailty is directly associated with early mortality. There are some specific tools that are being used. You can get in a chair and have a person sit down for five or six times and see how well they do or how long it takes. It is a predictor of early mortality.

Specifically, why is the conservatism of this important, and yes, I can count: 10+10+10 is 30, but not always. It depends on whether you're looking at this from a perspective that some cases are synergistic. It's important to identify the primary impairment, and it's not again your age rating out, but if you're looking at underwriting an application, and you have somebody who's highly substandard, has heart disease and has cancer, it's not just a matter of a decline in its kind. You can decline a person only once, and then it becomes a matter of determining the right combination of factors and the combination of mortality to make that reasonable, particularly in terms of comorbidity.

Is there innovation? Yes, and Eric is going to talk at length about that. There is a change of attitude toward substandard annuities in the U.S. market, and I think we will begin to see more of that. There are some design changes and some creative actuaries. People are in a competitive market, and that's probably what's going to make it for some companies. Finally, I'd say that the impaired market is growing and is available for evolving products.

MR. ERIC T. SONDERGELD: Good afternoon. How many of you were at Session 70 on "Consumer Misperceptions" this morning? I may say one or two things that I said this morning, so I apologize in advance. During that session one of the questions that came up was the concern that most income annuities available today are priced for people with good health, so they're built with antiselection in mind. The person making the comment was saying that what we need is annuities for your average person. Anna just talked about annuities for people whose health is below average, but what I think we need to figure out is how we can create annuities for all types of people regardless of their health. What you were talking about is an important part of that whole framework.

As Novian mentioned, I'm going to give you some background on the size of the retirement market opportunity, particularly for retirement income. I'm going to talk a bit about the demand as I see it, including some consumer perceptions regarding retirement income and the barriers that we face in terms of increasing this market and maybe what we can do about some of them. Then I'll talk about what's been going on in terms of product design as well as sales of these products.

I've got a question for you. How many baby boomers are there? I love this. I asked this question last week at another presentation, and I keep wording it incorrectly. How many baby boomers are there in the population? There are 78.2 million. What's happened is the boomers get so much attention that you have boomer wanna-bes who are in that number. Immigration has outpaced the boom population, and the previous estimate is more like 76 or 77 million from the 1990 census projected forward in the 2000 census with the 2004 projection being 78.2 million. We'll get back to the pop quiz in a minute. Let's talk about the size of this opportunity.

As we said, there are roughly 78 million baby boomers. There are the people who are 40 to 58 this year. They control a substantial amount of net worth, about $17 trillion. In 2001 the oldest boomer was turning 55, so there is a one-year overlap between this set and the group just ahead of it (ages 55 to 74), which also has a lot of money. When I talk to companies in the industry about the retirement opportunity, a lot of companies think that the market is not here yet.

True, the boomers have not yet begun retiring in large numbers yet, but there are lots of people who are retired or recently retired who have substantial sums of money. They probably could use things like income annuities but aren't being approached with that product as a product option and retirement assets. They hold a lot of retirement assets, as well. In terms of net worth, I believe each of those numbers is something around 40 percent to 43 percent of total net worth in the population, so between ages, in that case it was 37 to 74, about 85 percent to 86 percent of the nationwide net worth. Also, the amount of money becoming available each year from retirement plans available as a lump sum is approaching $300 billion each year.

One of the ways to look at this market, particularly as fewer companies are offering defined-benefit (DB) plans that even approach the common health insurance, is people have to recreate their benefits packages. I said that there are 78.2 million baby boomers, and as of this year, those are people turning ages 40 to 58. That's 19 birth years. How many people do you think are in the 19 birth years following the boomers? These are people ages 21 to 39? Take your contributory actuarial coats off and say, "I'm going to take a guess." Someone said "68" when we were talking millions, so how many people? There are 77.1 million people in the 19 years following the boomers. How about the 19 years after that, ages 2 to 20? They're catching on. It's the same. It's 77.6 million, and perhaps if we continue having that

positive immigration outpacing deaths, those groups could exceed the boomers by the time they reach the age the boomers are today.

What's different is that for the first time, we're going to have large numbers of people entering the retirement years. Instead of maybe 2 or 2.5 million people per year turning 60, we're going to have 3 or 3.5 million, and by the peak, 4.5 million people. It is going to drop off some, but then it's going to level off around 4 million for a long time. One of the challenges is that this industry, and I'm speaking broadly about financial services, including consumers, has been focused on accumulating assets and saving money for retirement. The real challenge is how to do it. You can't ignore that. We're going to have people accumulating money for a long time, and that's going to be the bread and butter of a lot of organizations, but we can't ignore the people who are facing the retirement years and need solutions that you can bring to them.

I mentioned the $300 billion becoming available each year from rollovers. Here are our estimates from this, which we'll be updating again next year. We survey people who change jobs or retire in the previous three years and had an opportunity for a lump sum from one or more retirement plans at work, and we project that onto the whole population to come up with estimates like this. These numbers do include job changes as well as retirees. Historically, the job changes have had about 60 percent of the assets and outnumbered the retirees about 7:1, but the average amount the retirees have is much larger than the average job changes. It's more like 160,000 compared to about 34,000. I imagine that those ratios will begin to shift as we see more of these people being retirees and controlling a larger percentage of the pot going forward.

We mentioned the decline in DB plans. Fewer and fewer employers are offering them and are replacing them with a defined-contribution plan, which doesn't necessarily provide a lifetime income payout stream. These are preliminary data. We just collected these data last month from a survey of 900 employers that offer a 401(k) plan to their employees. I thought the first number was a little bit lower than this, but a little over half of employers that have a 401(k) have one or more annuity options available as a payout form of distribution when people retire. We asked these employers, "Do you recommend a specific payout option when your employees retire?" Two out of three of them said they did, and of those, I have split the results between those firms that offer an annuity versus those that don't.

Of those that have an annuity option, one or more in their plans, only about one in six recommended an annuity form; about half recommend taking a lump sum or getting the money out of here and then enrolling it in an IRA. That sentiment is fairly pervasive when we do studies of employers regarding rollovers. They typically don't want to have to deal with the burden of trying to track where people are. They just want the money out of the plan and do not want to have to worry about it anymore. Of those that don't offer an annuity, eight in 10 say they recommend a lump sum or an IRA. They want the money out of there. If you follow some of these

numbers through, let's say you work for an employer that offers a 401(k) plan, and the chances that that employer has an annuity option and recommends it to you is about 6 percent. I don't think people recognize that this feature exists within their 401(k) just as they don't with annuities, which we talked about this morning.

This is from a survey of people we did last year with at least $50,000 in investable financial assets (see Sondergeld slide 1, page 4). We asked people about different activities they've done as part of their retirement planning. What we found, if you look at the far-right-hand bars, is that only one in three retirees and only one in six of those not yet retired have created an asset to income plan. In other words, they've figured out how they're going to convert their assets to an income stream. A lot of people have estimated how much income they either need or expect and may have estimated how many expenses they'll have in retirement, but they haven't put the two together and asked, "How am I going to meet those expenses with an income stream?"

For the next few minutes, I'm going to go through some of the good evidence about the benefits of, the need for and desire for guaranteed lifetime income. This is from a study MetLife did a couple of years ago where it took retirees in the HRS study and looked at what percent of their income was in guaranteed income sources in putting pensions and lifetime annuities. It excluded Social Security from this calculation and looked just at other guaranteed income sources.

The more guaranteed income they had as a percentage of their total income, the more satisfied they reported being with retirement. We took that same concept and applied it to some of our own data where we had assessed how concerned people were about various risks they faced in retirement and found a similar result. The more guaranteed income people had, the less concerned they were about longevity risk. In addition, there are some other good things that came with having a higher portion of their income guaranteed. People were more likely to have enough income to pay for expenses beyond the basics, even having enough to meet their expenses and feeling as financially secure in retirement as they thought they'd be. Similar to that, because we had people who were as secure or even more so versus less so, it improved people's standards of living in some cases.

This is from a study the SOA and the Academy did this past year where they asked workers who participated in at least one retirement plan at work how they prefer to receive their benefit when they retire. Eighty-six percent said they prefer one of the various types of lifetime income that were offered. There was only one that combined an annuity with a lump-sum distribution, comprising 12 percent of the survey. There's always an option labeled "Don't know" for 4 percent that when you're close to running out of money, you can stop worrying about it.

From the same study they asked people how important various considerations were when deciding what payout option to take from their retirement plan. The majority of people all marked lifetime income, amount of living assets and joint and survivor

lifetime income higher than any of the other options. Again, people think that lifetime income is important.

This is from the same study of people with at least $50,000 in assets ages 50 to 75 (see Sondergeld slide 2, page 6). We asked people if their income from guaranteed income sources, such as Social Security, DB employer pensions and income annuities, would be enough to provide for their basic living expenses in retirement, such that they would not have to dip into their assets to supplement their income. What we found is 41 percent of retirees and 60 percent of those not retired said those sources are not going to be enough to meet their basic living expenses. We're not talking lifestyle; we're just talking about meeting the basics. For those who said they wouldn't have enough guaranteed income to meet their basic expenses, we asked them, "How interested would you be in converting a portion of your assets to create a lifetime guaranteed income stream to meet that income-expense gap?" The right-hand bars represent 36 percent of retirees and 55 percent of those not retired. I think that's encouraging because you have a lot of people who are interested in the annuity concept if you translate what I just said.

We took those numbers and extrapolated them onto the population, and we assumed that on average people would annuitize 20 percent of their assets. We got that number from another study we did of people who had annuitized the deferred annuity or purchased an immediate annuity, where on average they had annuitized 20 percent of their assets. What we came up with was an estimate and this, I think, is a conservative estimate of about $200 billion split between a little more than half of that money held by current retirees. Remember, earlier I said not to ignore people who are already retired or the remainder of people who aren't yet retired, so in that left-hand pie, those numbers will grow over time as people save more and their investments grow.

Looking at some of the industry results, the income annuity market has been fairly flat for the past several years. There was a little bit of increase recently. I think some of that has come from what I call it mortality arbitrage. We're calling it premium financing. I think some of that has been influencing the growth because otherwise it has been fairly flat, as has the rate of annuitization from deferred annuities. It's been hovering just under 1 percent of mean assets each year.

Before I get into the sales and product information, I thought I would spend a couple of minutes talking about some of the barriers, as I see them, to annuitization, and I'll end with product design, which will be the rest of the presentation. I mentioned earlier that there are a lot of people in accumulation mode right now. You have virtually all the boomers who are accumulating, and you have two populations following them if you take that 19-year construct and repeat it twice of similar size, so your companies are going to have to be helping people save for retirement for a long time. But we need to also adopt a distribution phase mind-set, and that's going to be a challenge to have two focuses at the same time.

Producer compensation is obviously an issue. We have a survey that we're fielding next week to producers about their attitudes regarding immediate annuities, and many of the questions cover compensation. One of the big reasons I think is going to be that compensation is too low. Immediate annuity compensation is lower than on deferred annuities. I think the average total marketing allowance, including field payout, is around a little more than 4 percent, where it's probably a couple of points higher on the deferred side. In addition, there aren't many companies that offer trailed commission on their immediate annuities, and of those that do, the trails are typically pretty small. The most common are 12.5 basis points to 25 basis points. I've seen one or two that are 50 basis points, and one company does pay 1 percent annual compensation. It uses a variety of different methods of calculating the compensation. It could be based on initial premium, the payment or the underlying reserve. There are a variety of ways of calculating the compensation from a trail perspective.

We covered producer attitudes a little bit this morning, particularly if you talked about your traditional financial planner, whom I think is well-positioned in this market on the retirement side. It's less of a transactional mind-set, and we need to be more consultative when helping people plan their retirements. It's not a real demand product sale, such as selling someone an investment vehicle to accumulate, but a lot of those planners' value proposition is, "I can do this for you. I can manage it for you," so this competes with that. We have to convince them that it doesn't and that this is the right thing to do. I think some of them are coming around. The bear market plummeted a lot of planners and said, "I guess this 6 percent withdrawal rate didn't work the past three years." The assets have dropped like a rock as a result of that and the withdrawals, so I think some of them are coming around.

Consumer attitudes are less of an issue than a lot of people think. I just showed you several slides demonstrating that people want, need and think guaranteed income is a good thing, but one of the big issues is awareness. People aren't aware this is available to them, and when they first hear of the concept, they react negatively to it, I think mainly because it is foreign to them. As I mentioned this morning in responding to a question, when we talk to them for a little while about the concept, they may react negatively at first, but they come around to the concept fairly quickly. They think it's a good thing and then wonder why no one ever told them about this, so it's a neat 180 to watch happen, and we have focus groups that show that.

Last is product design, and I did put it last on purpose for two reasons. I put it last because I'm talking about this next, but also I don't think it's the primary barrier. Product design will be helpful to get this market going and help it grow; I don't think it's the primary barrier, but innovation will help. It's different from, say, the deferred annuity marketplace, where companies have been successful. I was reading an article in *The Underwriter* by Tim Pfeiffer the other day where you have the if-we-build-it-they-will-come attitude. If you build a new deferred variable

annuity with all the latest features and throw it out there through your distribution channels, they will gobble it up. And those same types of companies that were successful with a deferred annuity product would come out with the latest and greatest immediate annuity, and it wouldn't sell. I've seen several companies do that, so they probably assumed that what worked for deferred annuities worked for immediate annuities, and that's not the case. It requires a lot more focus and attention than simply throwing product out there.

Sondergeld slide 1, page 8 compares annuitizations and immediate annuities to see where annuitizations in total are coming from. It's almost 50/50 variable; in fact, it's a little bit more fixed than variable. From an immediate annuity perspective, the vast majority of sales are indeed fixed. The variable market was growing, but it did slow down in the past couple of years. I think it was about $500 million last year. It hasn't broken the billion-dollar barrier yet.

Most sales are nonqualified, particularly on the fixed side. One of the reasons that qualified is slightly bigger on the variable side is that the leading seller of immediate and variable annuities does a lot of qualified plan rollovers.

The sales sizes are fairly similar right now. Nonqualified is a little bit bigger than qualified, and variable is a little bit bigger than fixed, particularly on the qualified side. But if you go back three or four years, the fixed annuitizations and fixed immediate annuities were much smaller than variable. But we've seen an equalization there, and perhaps money that would have been annuitized as variable a few years ago people now are annuitizing as fixed, and maybe they're getting more conservative after the bear market. Perhaps that's influencing it somewhat.

In terms of distribution channels, we are beginning to see a little more action in some of the noninsurance agent channels. If we went back seven or eight years, we would probably see the vast majority of sales in those two biggest buckets—independent agents and career insurance agents—but we are seeing more companies begin to offer income annuities through banks, stock brokers and financial planners. I think we'll see that trend continue. I've always thought the banks were a great channel for these products because they hit this demographic more than any of the other channels do.

Looking at the payout options people are selecting, most of the payouts are indeed for some type of lifetime income, although they do have a lot of contracts that are for period certain only. But they represent a smaller dollar amount, so in total if you look at the dollars, the vast majority is lifetime income of some sort.

We just did a study of immediate annuity products, but I haven't published the results yet. As part of that we asked companies questions about their pricing assumptions, including mortality assumptions and interest rate assumptions. The majority of companies are now using the annuity 2000 table. More than half of them are using it as is, without any kind of mortality improvement factors going

forward. Those who are making modifications are more likely to use projection scale G, either as it was used to develop the table or some factor of that. Some companies are adding age setbacks to the table, whether it's for all years and all ages or greater than over time, and some companies are just taking a flat factor like 85 percent, hitting the whole table with that and using that in their pricing.

Similarly with the 83 table, companies are primarily using projection scale G with that table, and a few companies are using a factor, but in this case the factor is typically just north of 100 percent, such as 102 percent, 105 percent or 110 percent. The others are mainly proprietary. Some of the larger companies that have a lot of experience are using their own table or their own table combined with some industry tables.

On an interest rate assumption, most companies are using a term structure of interest rates rather than a single rate to price their immediate annuities. Other companies probably should have checked the term structure. They said they're using spot rates, and there are a bunch of companies that use one rate when they're pricing a period-certain-only annuity and use a term structure when they're pricing a lifetime annuity.

The remainder of the talk is going to focus on these products and some of the features (see Sondergeld slide 1, page 12). This is a breakdown of the number of products that we analyzed so far in the study: a total of 81 products of which 61 are fixed and 20 are variable. The majority of these products are stand-alone immediate annuities, but there are several companies that use one of their deferred annuities. They market the annuity as an immediate annuity sometimes. When we did a study of these immediate variable annuities several years ago, it was about a 50/50 split between stand-alone versus deferred sold as an immediate, but since then many companies have developed their own stand-alone immediate variable annuity (IVA) and have stopped using a deferred to sell as an income annuity on the variable side.

Let's start with liquidity features. Novian mentioned commuting the remaining guaranteed payments and said a lot of companies will let the beneficiary commute the remaining guaranteed periods on a period certain annuity, so that's a liquidity you have to die for. We are seeing more and more companies offer liquidity options in their income annuities. What was interesting was that we last did the study, as I said, about six or seven years ago, Only some of the variable companies said they offered liquidity in their product, and then companies later found out that there's an SEC requirement that with the period-certain payments, you have to offer commutation of the remaining period-certain payments on variable payouts. A lot of companies didn't even realize that. We are starting to see more companies offer liquidity of the lifetime payments. I'll get into some of those in a moment.

Some companies do offer or do charge the market value adjustment or a surrender charge for early surrenders or withdrawals from the product, and many companies

still have some type of a contingency before they'll let you take money out of the contract. There are some companies that will let you take money out if you have a nursing home stay. That's typically prepared certain-only or remaining period-certain payments. One company will give you a return of premium if you are diagnosed with a terminal illness with a life expectancy of one year or less. Another company will let you have access to your remaining life payments if you have a significant nonmedical financial emergency because they want to make sure you're in good health. Some companies even reserve the right to verify that you are still in good health so you don't antiselect against them in liquidating your remaining lifetime payments.

There are companies that will let you take out money at certain periods in time, and there's even one that after the sixth year allows you to get an unconditional return of premium, so in the sixth year or seventh year or eighth year, you can get all your money back regardless of how much money you've been paid on it so far.

We're seeing more increase options, as well, particularly more of the CPI-based, but that's still not common. The most common type of increasing annuity is on the fixed side. On this whole page we're primarily talking about the fixed side, which is where the customer chooses to have his income grow at 1 percent or 2 percent, up to 6 percent typically, and he selected them in advance because that determines the first payment and the growth pattern. Zero percent to 6 percent is by far the most common range that companies allow. One company lets you select up to 15 percent, so your first payment is going to be small with that one. You must expect to live a long time if you're going to select 15 percent.

Many companies offer the choice of simple or compound interest. There's one company that offers 10 percent growth in your payment every three years, and after this preselected guaranteed period, it increases by the CPI capped at 3 percent per year. That acts as income manager annuity.

Regarding increases for disability or health issues, one company will increase your payment by 30 percent if you're partially disabled and by 60 percent if you're fully disabled. The increase lasts only as long as you're disabled, but my guess is a lot of these disabilities don't go away at some point. Another company will increase your benefit 10 percent to 20 percent depending on certain health conditions that you might come down with during the time that you own the annuity. We are seeing more, but not a lot of, companies offer CPI-based true inflation-adjusted income annuities, more likely with some type of cap, such as 3 percent, 4 percent or 5 percent, so your increase is never going to go more than 5 percent. But there are a couple of companies that have an unlimited CPI-based annuity.

Have you all heard about the inflation fighter IVA? This is a great idea that I came up with, so that's why it's a great idea. I wrote an article about it this past winter in LIMRA's *Market Facts* magazine. It was an article about inflation and how there's a lack of good solutions for people to hedge that risk in retirement and have an

inflation-adjusted income stream. It's forgetting about the fact that we don't necessarily know that people's incomes need to keep up exactly with inflation because their needs do change over time or can change over time. Most of the CPI-based products out there, including Social Security, are not based upon a market basket of goods that older people buy. Social Security is based on urban wage earners. I don't think too many people on Social Security are urban wage earners, but they could become, I guess, if they wanted to.

The idea with this inflation-adjusted IVA was a way to provide inflation-adjusted income with little or no cost to the customer at minimal actuarial risk to the insurer. Does it sound interesting? The idea was to create a rainy day fund, where the customers would put a certain amount of money up front into this rainy day fund. It would be invested conservatively or the customers could invest the money however they're investing the rest of their funds in their IVA. After the first year, when the company goes to determine what the payments are going to be in the second year, unless the inflation went up 3 percent, it's going to increase the payment to the customer 3 percent, and that's what it will send them. If the IVA's payment would instead have spun off an increase of 6 percent, let's say the market did well that year, the company would skim the difference off and park it in this rainy day fund.

The fund has money in it, whether the market doesn't go up enough to offset inflation or not, and you can decide how much you want to put into that fund to begin with. Whether it's a full year's payment or some other amount, you could then tie it to a guarantee that if the rainy day fund runs out of money, you will make sure that the income keeps up with inflation. You can even structure it so that you can reimburse yourself in future years when things do better than inflation.

The concept behind this was the fact that too many people state that equities are an inflation hedge. Equities are a terrible inflation hedge, unless you want to compare prices today with prices 10, 20 or 30 years from now. Equities are a fairly good hedge, in other words. They beat inflation over long periods of time, but over short periods of time, equities are a terrible inflation hedge. Just look at the years 2000-02 if you want an example. We had positive inflation and negative equity returns, but over the long haul, equities can be a fairly good inflation hedge. This rainy day fund takes that differential and smoothes out the differences by still getting that long-term hedge. Anyway, you can play with that idea. I think there is one company that was trying it out.

We're seeing more companies offer various ways of stabilizing income in the variable income annuity because depending on the assumed interest rate you select and how you allocate your funds, your income could be fairly volatile, and there are some ways to mitigate that. For example, some companies offer a future where your income can only increase, so they're dampening some of that volatility. Others let the income fluctuate up and down, but never below some preset amount, which could be the amount of your initial payment. It could be 85 percent or some other

factor of that. There are companies that limit the downside, in this case 15 percent per year, and this last one is one we've seen for many years. I think we'll see more companies offer it, and this is where you select monthly income. Rather than have your income fluctuate each month, the company will have your income change annually, but you get paid monthly.

We're seeing some newer designs. We've seen a couple of companies make announcements on a design where in your defined-contribution plan, you can elect a funding vehicle that isn't the Fidelity Magellan Fund or the Putnam whatever fund; it's guaranteed income. You're buying an option on future guaranteed lifetime income. I think we'll see more of those. By the way, most of the innovation is not coming from retail annuity providers. They're coming from institutional retirement companies, companies that are big in the 401(k) and DB markets but that also have retail businesses. This first one is an institutional product.

The second one is an institutional product that also has a retail version of it, but it first came out as an institutional version. Insure the tail. This is longevity insurance. MetLife made an announcement a couple of weeks ago. I guess they announced their institutional version earlier in the year, but this is where a 65 year old wants to self-insure his life expectancy, so he's going to manage his income stream for the next, say, 20 years. You buy the longevity insurance and get paid nothing until 20 years from now, and then your lifetime income starts. The pricing is interesting from the consumer value perspective. MetLife wasn't the first company to do this. In our study of products, I noticed that there was one other company, Presidential Life, which has had a product like this for many years.

In both cases, I think we're going to see more of these. Between Novian and me, we can probably count five or 10 more companies that are thinking of coming out with some type of longevity insurance, insuring beyond life expectancy. This cannot only be sold as a product for someone who is retiring now; it can also be sold as a true deferred annuity, so you can lock in your retirement income now rather than wait until you've lived beyond life expectancy.

This next one is the same product that Novian referred to earlier about dollar-cost averaging fixed. It's the principal-income IRA. The company has another new product out that I'm not familiar with yet, but with that one, you're invested in variable accounts, but you dollar-cost average into lifetime income. It even ends with lifetime income with COLAs of CPI with a 5 percent cap. Is it 6 percent now? I think it was 5 percent when it first came out. And it offers substantial liquidity in that product, particularly during the first several years of the contract, even with the ability to reject the income and have it go right back into the account without having a taxable event, so there are some interesting designs.

Novian also mentioned this last one, deferred annuities built with income in mind, and there are products like GE's or Gen Re's retirement answers that are built as a retirement income product several years from now. Similarly, with the deferred

variable annuities with the living benefits such as GMIBs and GMWBs that have a strong income component, so as long as the GMWBs I think they're using it as an income replacement or an immediate annuity replacement vehicle. Some of the newer designs are even offering a specific withdrawal amount guaranteed for life, not just for the principal. That, in effect, becomes a type of lifetime income annuity with liquidity, although I think that would impact the benefit if you took out more.

The GMIBs are at least planting the seed in people's minds that this product can create lifetime income because as I mentioned this morning, only one in five deferred annuity owners realized that their annuity can do that. What I don't know is what percentage of people with a GMIB are aware the lifetime income feature is higher. I would assume it is higher.

That's it in terms of product designs. What I want to leave you with is something to think about. Sondergeld slide 2, page 14 is a comparison of the working phase versus the retirement phase and the risks that people face in both of those phases. A lot of the risks that people face in retirement are ones they faced all along, but now they're becoming more responsible for them because they don't have that employee benefits package anymore, so when you're working to take care of uncertain death, things like life insurance come into play.

On the retirement side, there are things like life annuities, pensions and Social Security. When you're working and become disabled, there's disability or workers' compensation. When you retire, there's long-term care. With inflation, typically pay increases outpace inflation over time, such that you can maintain, if not increase, your living standard during your working years. When you're retired, Social Security does provide some cost of living, but not for all your income. A pension is unlikely anymore, and few annuities offer true inflation adjustment, so they're not that readily available today.

Regarding market volatility, time is on your side when you're saving for retirement, and you can buy low right now. If you have many years left until your retirement, a down market isn't such a bad thing because you're buying low for a time and hopefully things will catch up over time. But when you're retired, you need income, you have to take that withdrawal, and if you're invested in equities and you're relying on those assets, you get a double whammy, where your assets are falling, and you're taking money out and then they're falling. It can limit the chance of success in having income.

In health-care costs, you have health insurance from your employer, hopefully, but then there are gaps in Medicare you have to provide for. People have a lot of issues that they face in retirement, not just longevity or not just income. We're seeing that when companies are developing strategies for the retirement phase, the focus is typically just on retirement income, and we have to think more broadly than that if we want to help people manage and plan for a successful retirement.

Here are a couple of thoughts to leave you with. How can we meet retirees' needs going forward, how can income annuities meet a growing list of complex needs that people face in retirement, and how well do income annuities fit alongside other products that manage other risks in retirement? Should products be more complex or simpler? We've seen some fairly complex designs come out, and from what I've heard at least anecdotally, sales have not been stellar. I mentioned some of the companies that came out with the latest and greatest variable income annuities that had lots of features, and they didn't sell.

I'll answer this question two ways. Obviously, you'll answer from your own perspective, but one is from a more complex perspective. More dabbling and more innovation are certainly needed as we try to figure out what resonates with consumers. At the same time, I think we need to try to keep things as simple as we can because retirement is a complicated thing to figure out. If we layer on top of that complicated product, is it going to turn people away? Distributors, the salespeople who have to market these products, get frustrated when the products become too complicated. They can focus only on one or two things, and they may not focus on this as one of those things.

Is product design the answer? I did put it last in my list of priorities a few minutes a go, and I think product design is *an* answer. I don't think it is *the* answer. It's one of those things that we'll learn from over time, and the fact that companies are doing more product development and innovation in this market is evidence that companies are putting more emphasis on this market. The emphasis by itself is a lot more telling than just having the latest, greatest feature.

MR. ZACK GRANOVETTER: I have a comment and a question regarding substandard payout annuities or impaired payout annuities. We have discussed this concept, and there is a public relations concern in the sense that the insurance industry has always been a proponent of healthy lifestyles, of people maintaining as good health as possible and of the idea that people might appear to be rewarded in terms of a better rate. If they're not healthy or if they have an unhealthy lifestyle, it's somewhat of a concern in that it might require a lot of education to show that we're trying to put people on a level playing field.

The question is (and this could be whatever you view) whether you think that a simplified underwriting would work as well in the annuity areas as it does for life insurance. The concern, I think, is that life insurance has a good, built-in deterrent so that if there's an early death after somebody has gone through a simplified underwriting process and something was left out of the application, you can deny the death benefit. It doesn't seem to be as obvious a deterrent on the annuity side.

MS. HART: I'll say one thing about that. If you're looking at the age rate-up, the simplistic form of the application as it may be, though it's not handled the same way as traditional underwriting, there are specific simplified questions. They set a barrier about what kind of age rate-up you can get. We're going to be cautious and

conservative and then come back on the back end if you're not satisfied. Give me more to prove that you're as sick as you say you are. I see your point. I'm not sure. Europe looks at everything. Of course, it has simplistic products and more detailed products and so will look at the medical records. There's just not a real chance of people lying if you're doing some substandard annuities. In the U.S. market, you're right, it's a fine line between insuring people. Traditional insurance looks for healthy people, and so when you start changing the paradigm, it does take an education process and a rethinking.

MR. JUNUS: I think it's a good question. I don't think enough people spend enough time thinking about it because with life insurance, if someone lies on the application, you can take it out of the death benefit. But if someone lies on a simplified questionnaire and says, "I've got cancer and heart disease," and you give them a higher annuity payout, they live long and they didn't have those things, you can't get the money back. So it's tricky.

MR. SONDERGELD: The literature that I've read suggests that it does seem to work in the U.K. to some extent.

MS. HART: Yes, it does.

MR. RICK BERGSTROM: I'm asking this question mainly out of ignorance, so I'll ask it to any of the three panelists. What spawned it was looking at two of Anna's slides where she was comparing mortality table rates versus the ultimate VBT table. To me there was a dramatic difference between the male comparison versus the female comparison. Eric, you asked how we can get together and create an annuity for the average Joe. The extension of this question is going to relate to substandard issues, as well, but what is the statutory valuation basis if we would do something like that? Are we still constrained to using the annuity table 83IM with extension or something like that because that to me would indicate that there's a huge surplus rate, even trying to create a benefit for the average Joe or for someone who is impaired.

MR. SONDERGELD: Do you want to answer that, Anna? You're an underwriter, right? I'm not going to take a stab at that one because I don't get involved in pricing income annuities in my current role. I don't know if you can shed any light on that one.

MR. JUNUS: If anybody else in the room wants to answer, feel free. It depends on how you use it, but if companies start pricing as mentioned before, there are only a few companies that price using mortality improvements, and that itself will create strain, too.

MR. KEVIN GOUGH: One of the things I'd like you both to address maybe in a different way is in talking about these products and product design. The mentality of the accumulation phase, etc., was mentioned. It does seem that there is a

disjoint between the way people consider their financial assets and the way people consider insurance. I've always thought in trying to look at payout annuities and SPIA, in particular, individual payout annuities, that one of the major problems people have is being able to do a cost comparison or understanding what they're getting because these are their financial assets. They spend a lot time accumulating them and have the mentality of turning them over to someone else: "I don't want to make a mistake; I don't want to do something stupid with my money."

I think what most people would like to see is pricing on these things and on illustrations not in the actuarial sense, but in a marketing sense based more on CD rates. Here is what you can get for a dollar of premium. It will buy you this much annuity payout. You can compare rates at 40 different places or something easily. That seems to be a problem basically with the product design of these things. Then, you add the underwriting piece to it, the fact that to get a better deal people are going to have to do underwriting: "These are my financial assets. Why do I need to have them underwritten?" That seems to throw a monkey wrench in, so I would like to hear both panelists' views on that general subject.

MR. SONDERGELD: Once they're presented with the annuity concept, they do think about it more as a financial vehicle, not insurance. I wish people would think about this product more like insurance, like it truly is, than as the gamble that the media talk about it as. I think it's difficult, though, to compare the product with other investment vehicles. It's not impossible, but you have to make sure that they understand that the annuity includes a return of principal and interest and not just interest, as with the CD comparison. Income annuities do compare favorably against CDs if you use the called buy term and invest the difference in an immediate annuity. Play on the buy term, and invest the difference.

Here's the idea. Let's say you have somebody who had $100,000, and he's a conservative investor through a bank. He just wanted an income stream and wanted to pass the principal off to heirs, so he buys CDs, lives off the interest and when he dies, the principal would go to his beneficiary. If you take that $100,000 and instead buy an income annuity and use part of the payment to fund life insurance, on an after-tax basis, you're better off.

You buy life insurance for the amount of principal that you're trying to protect. You get much better after-tax income than you do with the CD, even if you use the $100,000 to buy single-premium life insurance and then use the remainder to buy an income annuity. The net income is a little low, but you have incredible liquidity now in that single-premium life policy. There's a lot more we could do to illustrate these products against other scenarios or other types of withdrawal strategies. We're seeing more of that, but we certainly aren't there yet.

MS. HART: When you talk about again the European model working well in the past, many of the people have pension money that they must do something with when they turn 65, so it's not an option to keep it and put it under their

mattresses. They have to invest it somewhere, so the annuity market and the substandard annuity market developed more quickly over there because they had to do something. You've got the payout-certain periods, and guaranteed periods built in some of that. There was much more involvement of the population because it had no other options. In the U.S. market, there have been so many other options available that the underwriting does become important in looking at a simplified issue of an annuity. It's just creating ideas, and it may work. Again the education process and looking for what you can do are important.

MR. JUNUS: One of the key differences, I guess in England, the United States and even in Canada, is the fact that until recently, in Canada when you reached retirement age, you had to annuitize. Now we are able to take it out and take a lump sum, so when you have to annuitize, that's when you shop for substandard annuities. When you've made a decision to get an income annuity, that's when you start shopping. Trying to determine how much better it is with the different kinds of annuities is a major barrier. The distributors who are transaction-oriented just want to sell the product. It's going to be hard for them to sell annuities that way, be they immediate annuities or fixed immediate annuities.