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Annuity Clearinghouse Proposal

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This essay was submitted for the Society of Actuaries' Entrepreneurial Actuaries Section 2010 Papers Competition.

Executive Summary

Future retirees will be increasingly subject to longevity risk as employer-sponsored defined benefit (DB) plans are replaced by defined contribution (DC) plans. Yet, individuals are confused about the advantages of purchasing life annuities and expect their employers to provide the tools they need to manage their retirement savings. Our product development team has identified a potentially valuable opportunity to create an annuity clearinghouse that could encourage employers to offer annuity accumulation products in their defined contribution plans.

Background

In our last report, dated July 1, 2010, our team reported on ideas for new administrative solutions that Skyline Associates might offer in the insurance and risk management areas. With increasing concerns about how individuals will manage longevity risk after the shift from DB to DC plans, we believe that Skyline Associates should focus on developing the annuity clearinghouse mentioned in our last report.

Currently, employers are freezing and terminating DB plans and are replacing them with DC plans, a process that started in the 1980's and has accelerated during the recent financial crisis. Outside of IRC Section 403(b) plans, the majority of DC plans do not offer life annuities as

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accumulation or distribution options. Individual participants in DC plans must manage longevity risk without the benefit of risk pooling, unless they choose to roll over their DC plan balance to an individual retirement annuity.

Employers recognize that their future retirees will be increasingly subject to individual management of longevity risk, yet they are reluctant to add annuity features to their DC plans for a number of reasons:

1. Employers do not want to bear fiduciary risk for selecting the insurance companies that underwrite the annuity products.
2. Employers do not want the added administrative burden of distributing the Qualified Joint and Survivor Annuity notices required for plans that are subject to ERISA.
3. Annuity products are not portable from one DC plan to another, meaning also that plan sponsors cannot easily change recordkeepers if the plan includes an annuity feature.

Proposed Opportunity

The solution that our team proposes would respond to the third concern, the lack of portability. We propose that Skyline Associates develop and operate a clearinghouse for annuity products, specifically targeted to the DC plan sponsors. We envision that when a plan sponsor wishes to add an annuity feature to its DC plan, it would engage Skyline Associates to provide the recordkeeping for that feature. The annuity would be underwritten by one of the insurance companies that has agreed to use Skyline Associates' standard annuity contract format for its product. The insurance company would underwrite the annuity and maintain the necessary reserves, but Skyline Associates would handle the participant and plan level recordkeeping for the contracts. The plan sponsor could retain Skyline Associates to provide full recordkeeping services for its DC plan. Alternatively, it could retain Skyline Associates to provide recordkeeping only for the annuity product, using a different recordkeeper for the remaining investments offered under the DC plan. In either case, when the plan sponsor desires to change recordkeepers, it does not have to liquidate the annuity contract in order to change providers. Independently of a recordkeeper conversion, the plan sponsor could change the insurance company underwriting the annuity product, without requiring transfers of participant records and accounts. Assets supporting the products would transfer from one insurance company to another, but the participant records maintained by Skyline Associates would continue without interruption.

Action Plan

The first stage of development would be to determine the costs of establishing the clearinghouse, including development costs, marketing costs, and ongoing administration costs. Next, our product development team would work with the Business Development Group to establish annual fees for recordkeeping the standardized annuity products, based on the number of participants and the complexity of the annuity product. Per participant fees would be charged directly to the plans or plan sponsors, while each annuity provider would pay Skyline Associates a fee based on the number and type of annuity contracts that Skyline Associates is recordkeeping.

The second stage would be to establish a set of standardized annuity features which would facilitate portability. Skyline Associates would work with the dominant annuity providers to create a manageable list of standard features and provisions. Preliminary pricing estimates determined in stage one would be updated to reflect the standardized annuities established in this stage.

The third stage would be to develop the software to administer the standardized annuity products. The software would be a specialized application of our participant recordkeeping platform. In addition to accepting payroll feeds from plan sponsors' payroll systems, data inputs from the annuity providers would update interest crediting rates, mortality and expense charges, and other data elements that affect the value of the annuity contracts. Additionally, the data interfaces would include transmission of files from Skyline Associates to both the recordkeepers and the annuity providers to report the updated annuity contract values. Files would be exchanged daily to allow daily reporting of contract values to participants via the recordkeeper. This stage would also include developing the administrative functions necessary to communicate with the plan sponsors, their recordkeepers, and the annuity providers.

The fourth stage would be to contract with selected plan sponsors and insurance companies to be beta testers for the clearinghouse software and data interfaces. Discounted fees would be offered as incentives for 3- to 5-year term contracts.

Following testing of the software and refining the suite of administrative and reporting services offered by the clearinghouse, the final stage would be to develop the marketing program. Our marketing should emphasize the uniqueness of this offering—to our knowledge, there is no comparable service being offered in any geography. We anticipate that Skyline Associates could establish similar clearinghouses in every geography with a critical mass of annuity providers and DC plans. After we establish a U.S. clearinghouse, there would be incremental costs to establish a clearinghouse in another geography, but the major elements would already be developed. Because Skyline Associates would not be underwriting the annuities or holding the reserves, we expect minimal involvement with insurance authorities, at least in the United States. Our legal counsel should confirm the legal requirements in each geography before proceeding with this opportunity.

Because this concept is completely new, there will initially be no competition. However, the concept will not be successful unless we can attract a significant number of major plan sponsors and annuity providers. We anticipate that it will require approximately five to 10 years to determine profitability of this opportunity. If successful, we also anticipate that the major players in outsourcing and recordkeeping services will be attracted to provide similar services. Our advantage lies in being first and cementing relationships with the major annuity providers. For that reason, development of this opportunity must be highly secretive until launch of our first marketing campaign. Communications with our beta testers will require execution of confidentiality agreements, but enforcement will be difficult. Another barrier to successful development and execution is that this will be a substantial undertaking, requiring a substantial investment of resources to develop and test the software. We believe that Skyline Associates will need at least a 5 percent increase in technical staff for the development phase, followed by a 2 percent to 3 percent increase in recordkeeping staff for the testing and implementation phases.

Conclusion

We are excited about this new opportunity and believe there is a significant need for the proposed clearinghouse. Our initial estimates are that engagement by approximately 40 large plan sponsors and 5 major annuity providers could double our current annual revenue. In the long term, this offering could increase the size of our company tenfold in the United States, with almost unlimited opportunities abroad.

Our team looks forward to answering your questions about the proposed annuity clearinghouse. We will be pleased to summarize this information for inclusion in your report to the Board of Directors for their upcoming meeting in September.

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