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Annuicide Prevention Tool

By Kerry Pechter *Tue, May 22, 2012*

By establishing a standard for valuing in-force income annuities, an industry task force hopes to reduce fear of "annuicide" and stimulate SPIA sales. "We're taking a thorn out of the lion's paw," says Gary Baker of Cannex. (Links to pdfs of task force documents included.)

The fact that investment advisors have their own pejorative term—"annuicide"—for the act of moving a client's money into a life annuity tells you just how deeply the prejudice against selling such products runs among many financial intermediaries.

Traditionally, annuitized assets were "dead assets." They might generate a modest commission and perhaps a trail for brokers, but they didn't contribute to a firm's all-important assets under management (AUM). Fee-based advisors couldn't levy a fee on annuitized assets. Income annuities, it was said, just didn't fit the distributors' business models.

But the financial environment has obviously changed a lot in the last few years. Wirehouse brokers, independent broker-dealer reps and financial planners now recognize that older clients, made risk-averse by the 2008 crisis, yearn for the guarantees (and bond-beating yields) that income annuities can offer.

"Annuicide" remains an obstacle to broader sales of annuities, but the industry is working to remove it. A task force of major life insurers, distributors, and technology companies has been developing an industry-wide standard for assigning a market value to in-force income annuities and making that value a part of an advisor's or distributor's AUM.

Assembled in December 2010, the task force is directed by Gary Baker, U.S. president of Cannex, the Toronto-based data provider, and operates under the neutral umbrella of the Boston-based Retirement Income Industry Association. Baker spoke with RIJ two weeks ago, and shared a position paper and an FAQ sheet on the project.

"We started by asking the question: 'If SPIAs are so great, why aren't more advisors promoting them?'," Baker said. "The answers were that they didn't fit advisors' business models and they're a pain to deal with, operationally. Now we're trying to take out as many barriers where advisors might say, 'I can't sell that.' We're taking one of the thorns out of the lion's paw."

A standard "Income Value" calculation

Income annuities aren't marketable securities so they don't have a market price. When insurance companies want to value them, they might use either the statutory reserve method, the initial premium, a compensation-based value, or a commutation value. But a fair market value was what distributors wanted to carry on their books.

"The large broker-dealers said, 'We need something that's market-value adjusted,'" Baker said. The values of the other holdings in a client's account fluctuated with the market, and it was felt that the value of the income annuity should too.

While there's a simple formula for calculating the present value of an annuity, the factors that go into pricing each annuity—like the discount rate—can differ by insurer. And none of the values commonly placed on in-force annuities reflect a market-based replacement value—i.e., the cost of a contract's income stream at today's interest rates.

After considering several alternatives, the task force decided on a methodology that involved the creation of a common Income Annuity Yield Curve, to be calculated daily by Cannex. To come up with a standardized discount rate for valuing in-force income annuities, Cannex will continuously monitor the top 10 payouts on new income annuity contracts, then derive the discount rates that the payouts imply. They will average those discount rates, build an interest rate yield curve out of them, and interpolate monthly discount rates.

For any in-force annuity, the value of every future monthly payment will be based on the rate on the Income Annuity Yield Curve that corresponds to that month, and adjusted by the probability (which grows smaller over time) that each payment will be made until the annuitant's 115th birthday.

By adding up the values of all those future monthly payments, they will arrive at a present replacement value or market value for each existing annuity. That value will fluctuate, going down as interest rates rise and vice versa, and it will decline each month (or quarter or year) as each new payment is deducted.

The market value of the annuity can then be carried on a distributor's books. It will contribute to the tally of assets-under-management, possibly serve as the basis for calculating a trail commission, if there is one, and perhaps count toward an advisor's bonus goals. Fee-based advisors—a virtually virgin market for income annuities—could use it as a basis for assessing fees.

"The distributor has always relied on the proprietary calculation of the carrier [for the value of an in-force annuity]," Baker said. "Now the carriers will use a standard calculation." The calculations will be called the "Income Values" and carriers will deliver them to distributors each month via the Depository Trust & Clearing Corporation (DTCC).

Merrill Lynch leads the way

One distributor, Merrill Lynch, has been especially attentive to the income annuity valuation problem. Its advisors sell SPIAs on commission from MetLife, New York Life, Pacific Life, and Nationwide, so an annuity replacement value is something they need for compensation purposes. They want a market value in order to prevent annuity assets from disappearing from AUM.

"Feedback from our specialists tells us that this was always a potential hurdle [to annuity sales]," said Robert Rohrbach, a Merrill Lynch executive who manages the approval of annuities for sale by the wirehouse's advisors, and who has been part of the SPIA task force. "Having the valuation means that, if the advisor sells a $200,000 income annuity to a $1 million household, it doesn't suddenly become an

$800,000 household."

Merrill Lynch has been using the statutory reserve method of valuing annuities (which uses the interest rate when the annuity was sold as the discount rate for future payments) but will start using the Income Value numbers in the fall.

"We knew that the industry would eventually be coming up with a value but we moved ahead with our approach. The feeds are coming in from the insurers and we're sending the data through to the advisor and they're crediting the annuity on the clients' household statements. But we'll switch over to the Income Value in September. We want to be consistent with the industry," Rohrbach told RIJ.

More splinters to be removed

Establishing a standard market value for in-force annuities is considered a necessary but not a sufficient condition for the growth of SPIA sales.

"[Market-valuation of SPIAs] is one of a handful of things that, combined, will help sales," Baker said. Evaluation alone won't be a game changer, but it will be an improvement over the status quo. It will make it easier for advisors to put income annuities into a financial plan, for instance. There are maybe five splinters in the lion's paw, Baker said, and this will take out one of them.

As for the other 'splinters,' there's still some tax code ambiguity that manufacturers are wrestling with. "The tax code was written 30 years ago, and it still defines income annuities as single-premium products that must begin paying out within 12 months after purchase. So, technically, there should be no such thing as longevity insurance," he said.

"There are also some operational issues. Straight-through-processing is still in its infancy for income annuities; they're lagging behind the variable annuity world. Advisors still feel that SPIAs are a pain to deal with. We've got to make it as easy as selling a mutual fund"—or as easy as selling an irrevocable product can be.

One unresolved question is whether firms should put the market-value of income annuities on client-facing statements. Merrill Lynch disfavors showing the value to clients, Rohrbach said, because clients might think the assets are accessible.

"The industry wants to create this value as a client-facing value," he told *RIJ*. "I'm not sure we will do that. We will have to have a lot more discussions around that, and create clear guidance for clients. We'll be using Income Value so that the advisor doesn't lose credit for those assets." Either way, he's excited about the potential for income annuity sales at Merrill Lynch. "It's never been a huge piece of our business," he said, "but it will be a bigger piece going forward."