

Position Paper - Valuation of Annuitized Assets (a/k/a Income Value)

Contents

I.	The Imperative (Business Case)	Page 2
	A. Background	
	B. Industry Initiative	
	C. Valuation Options	
	D. Conclusion	
II.	“Income Value” Defined	Page 4
	A. Definition	
	B. Scope	
	C. Methodology	
III.	The Potential Use and Application of “Income Value”	Page 10
	A. Household Reporting / Client Statements	
	B. Assets Under Management Reporting for Financial Advisors	
	C. Financial Planning	
	D. Tax reporting	
IV.	Operational Requirements for “Income Value”	Page 12
	A. Capability to Perform Calculation	
	B. Data Requirements for Transmission & Clearing	
V.	Implementation of “Income Value” Standards	Page 16
	A. Communications & Disclosures	
	B. Education & Awareness	
VI.	Appendices	Page 18
	A. Appendix A - Industry Survey Results for Income Annuity Valuation	
	B. Appendix B - Analysis of Income Value Methodology	

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Valuation of Annuitized Assets (a/k/a Income Value)

This paper provides an overview of the case and methodology for providing a fair market value for an income annuity contract.

I. The Imperative (Business Case)

A. Background

Immediate income annuities have long been recognized by academics and financial experts as one of the most efficient vehicles to generate cash flow for an investor in retirement. It is one of the oldest (2,000 years +) and simplest financial products available – but probably one of the least understood. Various retirement income strategies now incorporate the use of income annuities as a holding within a financial portfolio to better support cash flow needs. Because of this, the industry has been working to better align these guaranteed income contracts seamlessly with other investments and custodial accounts.

Today, allocating to insurance products in support of retirement income can be still considered a sophisticated process where simplified tools and aids are not yet readily available to the public. Therefore, it's usually up to a financial advisor to advocate and implement a plan incorporating these contracts. However, income annuities are not broadly adopted across the industry by financial professionals and are still considered a niche product. There are a few reasons for this lack of adoption:

1. Behavioral Finance Challenges

Research has shown that investors greatly value the opportunity to receive guaranteed lifetime income to support their lifestyle; however, many are unwilling to forgo any potential loss of control of their money in exchange for receiving these guarantees. Product allocation strategies that place only a portion of one's savings into an income annuity help address some of these fears (i.e., it's not an "all or nothing" proposition).

2. Awareness and Education

Many advisors (and the public) are still somewhat confused about the differences between immediate annuities and deferred annuities and associate many aspects of deferred contracts with those that have been annuitized. There is also a general lack of awareness that an investor or their estate has, in many cases, access to their remaining principal in the contract in the event of death or a change in financial needs. Some speculate that the absence of this information within various training and accreditation programs (e.g., CFP Courses and Exam) helps contribute to this misunderstanding.

3. Alignment with Common Financial Practices and Business Models

Once a purchase of an immediate income annuity is made, those assets disappear from a client's consolidated statement and, most significantly, they disappear from the AUM report of the advisory firm (the primary scorecard for performance from upper management down to the advisor). Many feel that making the income annuity holding as visible as other investments and products within internal and external reporting would help bring it more into the mainstream. Registered Investment Advisors are also becoming more interested in using income annuities within a fee based environment.

B. Industry Initiative

The initiative to create a valuation for annuitized contracts focuses on the last of these three barriers. In December of 2010, financial service organizations across the industry started to work together to define a common standard for valuation and identify information and

technology requirements for this standard throughout the financial services value chain (Research & Education, Sales & Planning, Quotes & Illustrations, New Business Processing, and In-Force Policy Support).

C. Valuation Options

A survey was conducted in early 2011 to assess current practices and preferences for what type of information and valuation options would be appropriate in various situations. Generally, the valuation of an income annuity could be applied to client statements, advisor reporting, tax reporting, financial planning, and potential fee-based practices. Various options for valuation were defined and tested including:

1. Fair Market Value (or Replacement Cost):

The actuarial present value of the remaining benefits that can be provided by the income annuity contract. This value is tied to both long term and short term U.S. Treasury Rates and can fluctuate with the market. It is also tied to a standard industry-wide actuarial table (i.e., annuity mortality table) specific to the gender of the individual.

2. Initial Premium:

The actual amount of premium (i.e., deposit) that was used to purchase the income annuity contract.

3. Commuted Value (or Liquidity Value):

The amount of money you would receive if you left the income annuity contract early before all guaranteed benefits are paid out.

4. Death Benefit (or Beneficiary Guarantee):

The amount of money your beneficiaries would receive if you die before all guaranteed benefits are paid out.

5. Cumulative Payments to Date

The total amount of payments that have been received from the income annuity to date.

Of all these options, the fair market value (or replacement cost) was the most attractive alternative. Unfortunately, this was a value that did not have a common standard and, thus, is rarely used in practice. As such, there was a strong preference for establishing a standard method for reporting income valuation. A summary of results from this survey can be found in **Appendix A**.

D. Conclusion

Based on the results of the survey, financial service organizations decided to define a common methodology and process to communicate a fair market value (or replacement cost) for the industry. This value is referred to as INCOME VALUE throughout the remainder of this document.

II. "INCOME VALUE" Defined

A. Definition

In practice, INCOME VALUE is defined as the actuarial present value of remaining benefits from an annuitized contract.

Other potential designations for INCOME VALUE were evaluated including:

- Economic Value of Annuity Income
- Standardized Present Value
- Fair Market Value
- Replacement Value

Feedback obtained from a number of distributors and manufacturers found that INCOME VALUE was the simplest and most attractive identifier. All firms agreed that a common identifier was necessary for both internal and external purposes. Distributors may wish to provide additional context and explanation around INCOME VALUE if they report it externally to their clients. It is envisioned that there would also be a standard Disclosure Statement/Document that provides an explanation of how INCOME VALUE is calculated and clarification that it is not a cash value, etc (refer to Sec. V.A.1 in this document)

B. Scope

The market valuation of annuitized assets would cover the following products:

- *Immediate Income Annuities (Fixed or Variable)*
- *Deferred Income Annuities (i.e., Longevity Insurance)*
- *Fully or Partially annuitized assets of a Deferred Annuity Contract (Fixed or Variable)*

C. Methodology

The base methodology defined below focuses on fixed rate annuitization since this is the most common form selected in the market today (i.e., >95%). Variations to this methodology are addressed later in this section for variable annuitization as well as other features like inflation adjustments.

1. Overview of Calculation

a) Summary:

- (1) Depending upon the mode of payment (e.g., monthly), each income payment is discounted back to the valuation date using a common industry benchmark for **economic value**.
- (2) Then, the **probability of survivorship** is calculated for each payment period based upon a common mortality table.
- (3) Finally, the economic values are **combined** with the mortality probability to derive the INCOME VALUE. This calculation may happen as frequently as daily depending upon the need of this information.

b) The details (formula) of the calculation are as follows:

x is the age of the annuitant(s) at the valuation date

t is the time (in years) between the valuation date and the income payment

i is the discount rate for each income payment

$$(1) \text{ Economic Value of Income Payment} = \text{Income Payment}(t) \cdot (1+i)^{-t}$$

$$\text{Economic Value of Death Benefit} = \text{Death Benefit}(t) \cdot (1+i)^{-t}$$

(2) Probability of receiving income payment at time t = Survivorship Factor(t)

- If the payment is not life-contingent, the survivorship factor is 1
- If the payment is life-contingent, the survivorship factor is the probability of the annuitant surviving from the valuation date until time t
 - For joint annuitants, the survivorship factor is the probability of either annuitant surviving until time t

Probability of receiving death benefit at time t = Mortality Factor(t)

- The mortality factor is the probability of surviving from the valuation date until time $t-1$ but dying before time t
 - For joint annuitants, the mortality factor is the probability of at least one annuitant surviving until time $t-1$ but both having died before time t

(3) Income Value for each payment period =

$$\text{Income Payment} \cdot (1+i)^{-t} \cdot \text{Survivorship Factor}(t)$$

$$+ \text{Death Benefit}(t) \cdot (1+i)^{-t} \cdot \text{Mortality Factor}(t)$$

- Total Income Value (for all payment periods) =

$$\sum_t \left[\begin{array}{l} \text{Income Payment} \cdot (1+i)^{-t} \cdot \text{Survivorship Factor}(t) \\ + \text{Death Benefit}(t) \cdot (1+i)^{-t} \cdot \text{Mortality Factor}(t) \end{array} \right]$$

Note: Consistent with current practices, the time period for life contingent payments will stop at age 115.

2. Variables Used in INCOME VALUE Calculation

a) Discount Rate for Economic Value

(1) The Income Annuity Yield Curve - Summary

- The *Income Annuity Yield Curve* is a spot rate curve that is derived on a daily basis from the average retail payout results of the top income annuity providers in the industry. Using this curve as the discount rate helps better calibrate the present valuation with the actual pricing and credit experience of guaranteed income manufacturers.

- As a **point of reference** and education for investors and financial advisors, two sub-components of the *Income Annuity Yield Curve* are also provided:
 - a) *U.S. Treasury CMT Value* – Treasury values for 1, 5, 10 & 30 years are provided.
 - b) *Crediting Rate Spread Value* – Spread values for 1, 5, 10 & 30 years are also provided. The Treasury and Spread values added together should equal the 1, 5, 10, and 30 year rates on the interpolated *Income Annuity Yield Curve*.
- A **Sample Valuation Table** is also provided that would allow a user/firm to validate or audit that their INCOME VALUE calculation is accurate against the industry standard.
- An independent third party (i.e., CANNEX) will calculate and distribute the *Income Annuity Yield Curve* along with the other components described above.

b) Mortality

The appropriate mortality tables and improvement scales defined in this process would be available from existing sources in the industry.

(1) **Gender (Sex Distinct)**

Sex distinct tables will be used for in all cases including situations where unisex mortality rates may be used in pricing for certain states (e.g., Montana, Massachusetts) or fund types (e.g., qualified).

(2) **Mortality Table (A2000)**

The A2000 table is the most commonly used and recognized table in the industry.

(3) **Improvement Scale (G for Male; G/2 for Female)**

The most common use of projection scales is also applied.

(4) **Mortality Projections**

Projections of mortality will be limited to a static basis only. In other words, a static projection of 12 years (= 2012 – 2000) is used to update the mortality table to the current year of valuation from the base year of 2000. In 2013, it will be projected 13 years and then 14 years in 2014 and so on. Dynamic projections are not used for income valuation.

c) Variables that are Excluded from INCOME VALUE Calculation

The following elements are excluded from the calculation:

- State Premium Taxes
- Other Taxes (i.e., Qualified vs. Non-Qualified Funding)
- Compensation, Loads and other expenses specific to a carrier

Expenses like premium tax will not be factored into the calculation since this is a one-time event at the time of purchase, similar to the deduction of any load on investment products (e.g., mutual funds) for commission. The objective is to treat all contracts consistently. Therefore, the INCOME VALUE is not so much a representative of Replacement Cost as it is an Economic Value.

3. Construction and Management of the Income Annuity Yield Curve

a) *Methodology (Income Annuity Yield Curve)*

The following standards have been defined for producing and providing an *Income Annuity Yield Curve* for the industry. The accurate calculation and management of this curve is necessary to ensure the integrity of INCOME VALUE standard.

(1) How Many Carriers are represented in the Curve?

- There are over 60 manufacturers in the U.S. market today that provide some form of income annuity product. It would be impractical (and unnecessary) to incorporate to entire universe of SPIA rates in calculating a spread.
- It is recommended that the top 10 payout results on the CANNEX SPIA Exchange are used to derive the daily Income Annuity Yield Curve. Actually, the first two (2) results would be eliminated so as not to distort the curve due to competitive decisions by some carriers, so therefore the results from **#3 through #12** are used for the calculation. This approach is similar to other benchmarks in the market, like the Lipper Indices for Mutual Funds, where the top and bottom sets of results are excluded from a calculation to eliminate the outliers.
- There are some other assumptions about the carriers used to derive the Income Annuity Yield Curve:
 - Credit Strength (e.g., at least an A Rating)
 - Competitiveness (e.g., #3 through #12)
 - Independent Calculation of Payout Results (i.e., not self reporting)
 - Commitment to the Income Annuity Market

(2) How is the Curve derived?

- An average premium amount for \$1,000 per month benefit is derived from 20 representative carriers in the market for the following scenarios:
 - Contract Types: Life Only; Life with 10 Year Certain
 - Genders: Male; Female
 - Ages: 55; 70; 85
- A series of calculations are performed that detects crediting rates that most closely matches the average premium amounts from the 12 scenarios.
- The interpolation of rates will be done on a LINEAR basis.

(3) How often is the Income Annuity Yield Curve Updated?

The curve will be updated on a **daily basis**. Various distributors and carriers may choose to calculate and update INCOME VALUE on a monthly basis, however, the point in time they perform that calculation may vary during a particular month.

(4) Where can you obtain the Income Annuity Yield Curve?

CANNEX Financial Exchange will perform the Yield Curve calculation and provide the supporting information (U.S. Treasury and Crediting

Spreads; Sample Income Value Table). It is anticipated that you can obtain the curve either directly from CANNEX and eventually through a third party data site like Bloomberg, etc.

4. Application of Methodology for Different Types of contracts

a) *Joint Life, Single Life, Period Certain and Temporary Period Contracts*

The methodology would not vary across these types of contracts. The INCOME VALUE would reflect the state of the existing benefit.

b) *Deferred Income Annuity Contracts (DIA / Longevity)*

The same Adjusted Discount Curve can be used for DIA contracts. The appropriate discount rate will be used for Income Payments that are scheduled to begin later (i.e., rates from the longer end of the curve). If there is a death benefit during the deferral period, the present value should factor that in as well.

c) *Variable Annuitization*

Substitute the current AIR in force with contract instead of the adjusted discount rate curve to derive the economic value of each income payment.

d) *Inflation Adjustments*

- COLA/fixed adjustments:
Fixed increases to income payments (i.e., COLA) can be accommodated with the methodology.
- CPI Adjustments:
Apply the current CPI to future income payments

5. Other Considerations for Methodology

a) *Frequency of Income Valuation (Monthly)*

Although some distributors may wish to receive valuation information on a daily basis, it is suggested that INCOME VALUE be updated on a monthly basis for a variety of reasons:

- To align with the clearing and transmittal capability of the majority of carriers in the market today.
- Aligning the change in value to the payment mode (e.g., monthly) may be sufficient for such a long term instrument.

Distributors or carriers may choose to update INCOME VALUE on a variety of dates on a particular month:

- End of Month
- On the Payment Date
- New Contract Issue Date

For this reason, a VALUATION DATE (i.e., “value as of date”) would be required as part of the valuation information transmitted between a carrier and a distributor (see Section IV below – Operational Requirements).

b) Variance in valuation between Carriers

It is recognized that there will be some minor differences in programming and assumptions used by insurance carriers in calculating INCOME VALUE. Since valuation is essentially different from annuitant to annuitant based on the specific profile of consumer and the type of contract they hold, this variance would be minor. Examples of these differences include:

- a. Different rounding rules
- b. Age definition as of the Valuation Date
- c. Pivotal Date for the income value calculation
- d. Different methods to calculate Cash Refund and Installment Refund
- e. Monthly vs. Annual cash flow models

6. Validation of Methodology

Various test cases were run that reflected variations in discount rates and mortality assumptions. The results demonstrated the difference across various types of contracts. A summary of this analysis is found in **Appendix B** of this document.

7. Monitoring & Future Enhancement of Methodology

It is anticipated that over the course of time there may be some changes necessary for certain inputs or processes used to support the calculation of INCOME VALUE.

Insurance carriers who are accommodating this calculation on their administrative systems should take this into account. Some examples of potential changes include:

- Industry update of mortality tables used (e.g, from A2000 to “A2012”).
- Common adoption of enhanced improvement scales (e.g., G2 for valuations being discussed by SOA).
- Evolution of DIA pricing over time separate and distinct from SPIA pricing and experience which may result in the need for a different adjusted yield curve.

It is assumed that there would be ongoing monitoring and a periodic review of the methodology by an industry committee to discuss best practices as well as propose and agree to any necessary modifications. For now, the Retirement Income Industry Association (RIIA) will sponsor and host a periodic review within the industry to share best practices in adopting INCOME VALUE and identify any necessary enhancements to the methodology and standards going forward.

III. The Potential Use and Application of INCOME VALUE

A. Household Reporting / Client Statements

1. “To Disclose or Not to Disclose”

It is assumed that each distributor will position and display INCOME VALUE in a manner that is consistent with their retirement income philosophy as well as their marketing and communication standards.

- a) Some may choose not to display INCOME VALUE on any client statement or reports since they do not want to give the impression that the value is readily accessible without penalty or consequences.
- b) Some may choose to display INCOME VALUE in a section that is separate from any aggregated values from other products.
- c) Some may integrate the INCOME VALUE with other product values to form a Total Account Value for the client.

2. What’s In a Name?

There was strong feedback from the survey that the designation INCOME VALUE should be referred to consistently across the industry and market. Variation on the name from distributor to distributor could present confusion to both advisors and consumer and potentially diminish the impact of this platform improvement.

B. Assets Under Management (AUM) Reporting for Financial Advisors

1. Internal Reporting & Incentives

Distributors should be able to apply INCOME VALUE to certain AUM reports and provide a more accurate accounting of the amount of assets they manage on behalf of their clients. Under their own discretion, certain distributors may also choose to incorporate INCOME VALUE as part of any advisor level qualification or incentive programs.

2. Billing for Fee-Based Advisors

The fee based segment of the advisory market continues to grow. In fact, a large portion of financial advisors incorporate both commission and fee-based programs as part of their revenue model for the services they provide. Using a standardized method for INCOME VALUE would be an improvement from what some firms use today under this practice (e.g., a proprietary calculation of either fair market value or another form of value like commuted value or initial premium). INCOME VALUE for annuitized assets may be more consistent to using current market value for investments in a transparent, fee based model.

a) How does it work?

The most common practice today is for an advisor to charge a fee at a level consistent to a bond or other fixed income instrument. In the case of an annuitized asset, the fee cannot be deducted from the product itself, but rather from another liquid holding within the portfolio (e.g., a cash account, other investments) or paid as an expense from a bank account.

b) Is this practice “Legal”?

Some advisors have traditionally viewed an income annuity as a “dead asset” and therefore do not feel that they can justify a fee against a portion of a portfolio “they

can't manage". However, many advisors have adopted this practice (with supporting opinion letters and approvals) because they view the management of an income annuity as part of an overall portfolio that needs to generate cash flow to support a variety of financial needs in retirement. The advisor is still able to make both short and long term decisions regarding the income annuity product itself and/or how it is allocated within a broader portfolio – a different service than managing a portfolio for just accumulation and growth.

C. Financial Planning

Today, there are a variety of financial planning concepts and tools that support the allocation of an income annuity within a broader financial portfolio. Almost all of these tools are presented and implemented when the plan is first presented and implemented on behalf of a client. However, over the course of time, a client's needs or circumstances may change and rebalancing (or reallocation) of their portfolio is necessary. It is felt that the use of INCOME VALUE would improve the decision making in this rebalancing process since it takes into account the value required to support existing cash flow as well as estate planning needs.

D. Tax Reporting

Today, the IRS has certain codes that require the fair market value of an individual retirement annuity (i.e., income annuity) for certain tax reporting purposes. One such code specifies that "the actuarial present value of any additional benefits...is to be determined using reasonable actuarial assumptions, including reasonable assumptions as to future distributions, and without regard to an individual's health" [Sec 1.401(a)(9)-5]. In other words, this is a proprietary calculation that varies from manufacturer to manufacturer. It is felt that the use of INCOME VALUE would help standardize the calculation of fair market value across the industry resulting in more consistent tax reporting to the IRS.

E. Other Applications

a) Market Sizing

With the incorporation of INCOME VALUE, it may be possible to derive the aggregate size of the income annuity (and annuitized asset) market. Up to this point, market sizing of income annuities has been reported on a sales premium basis from year to year. Sizing the total market based on INCOME VALUE may provide a better perspective as to what portion of American assets are tied to income contracts as well as provide a gauge for the overall capital capacity for insurance carriers to back income guarantees across the U.S.

IV. Operational Requirements for INCOME VALUE

A. Technical Documentation

A Technical Documents for Income Valuation is available and contains the basic specifications and requirements for an insurance carrier to accommodate the calculation and transmission of INCOME VALUE. It is assumed that Broker Dealers or other receivers of INCOME VALUE will leverage existing processes consistent with central clearing organizations like the DTCC. Ultimately, the timing and expectations about what is communicated with regard to INCOME VALUE will be determined and managed directly between the product manufacturer and the distributor.

B. Capability of Product Administrative Systems to Calculate INCOME VALUE

The calculation of INCOME VALUE is a new function and process for most administrative systems that support annuitized contracts. Generally, there are two options available to the manufacturer to produce an INCOME VALUE for the contracts they hold:

1. In House Calculation

This functionality would be developed by the manufacturer. INCOME VALUE and VALUATION DATE would then be fed into the appropriate positions and values file (i.e., PVF) that is transmitted to DTCC or another recipient (see B below).

2. Outsource Calculation

The manufacture may choose to outsource the build and/or management of this functionality to a third party. The data requirements for the calculation already exist within the DTCC PVF format. The process and work flow may vary across manufacturers, however, the calculation itself would be consistent to the industry standard.

C. Data Requirements for Transmitting INCOME VALUE Data/Information

1. Existing Processes used for Annuities

a) *Full File (PVF):*

Today, most insurance carriers transmit detailed information about each annuity contract to the DTCC (The Depository Trust & Clearing Corporation) via a Full Positions File (i.e., PVF) so that distributors can apply that information to various internal and external reports. The DTCC suggests that this information be transmitted at minimum on a weekly basis; however, certain distributors require this information daily.

b) *Focus File (PFF):*

A Focus File (i.e., PFF) facilitates the daily transmission of only the valuations of deferred annuity contracts. This was provided so that carriers could transmit a smaller data file on a more frequent basis without the strain of compiling all policy information on a daily basis.

c) *New Business File (PNF)*

Another smaller positions file (i.e., PNF) that facilitates the daily transmission of new business data for any or all annuity contracts sold.

2. Adoption of the Current Process Today

The PVF process has been broadly adopted by both manufacturers and distributors and, in the case of deferred annuities, the PFF file is used by a number of firms. On the other hand, the PNF file for new business information still has not been adopted by a majority of the distributors. Even though the PNF provides a logical value to the industry, the business case for small to medium size distributors to invest the time and resources to configure to this process has not evolved.

One possible option to transmit INCOME VALUE information would be to create a new and smaller positions file (e.g., "PIF" – Income File) that is separate from the primary PVF (a process that may be more attractive to manufacturers). However, adding a 4th variation of the transmittal process may slow adoption of INCOME VALUE among a majority of the distributors in the market. Having 2 options for INCOME VALUE transmission (via PVF and a new PIF) may also create too much variation for manufacturers to accommodate. If INCOME VALUE is to be broadly communicated across the industry, then it is important to align with an existing process that is broadly adopted among distributors.

a) *Enhancements & Use of the PVF/Full Positions File*

It is recommended that the transmission of INCOME VALUE (and the contract elements that help derive INCOME VALUE) can be accomplished through the existing PVF format. Details for these requirements can be found in **Technical Document for INCOME VALUE**. The following enhancements or conditions would need to be accommodated for the PVF process:

(1) New Contract Value Code (INV = Income Value)

The following Contract Value Qualifiers are available today for income annuity or annuitized contracts. In most cases, these values are based on proprietary (i.e., non-standard) calculations from each carrier:

- AV (Actuarial Present Value)
- CV (Commuted Value)
- CMP (Compensation Based Value) for trail commissions
- PR (Total Premium or Initial Premium)

The following Contract Value Identifier would need to be added to accommodate an industry standard calculation of INCOME VALUE:

- INV (Income Value)

(2) Other Accommodations

If the carrier wishes to use the PVF to accommodate either the external calculation of INCOME VALUE, then "Gender" would need to be added to the file.

b) Frequency (Weekly minimum; Monday transmission)

It is recommended income annuity contract data with an associated INCOME Value be updated on a **weekly or monthly basis** through the DTCC to align with existing capabilities of both distributors and manufacturers. Allowing manufacturers to compile information from a separate admin system (from annuitized contracts) over a weekend would allow a larger percentage to meet the service level agreements (SLAs) set with distributors who typically expect to receive contract data early each day. For those distributors who require a daily transmission, the INCOME VALUE could remain the same throughout the week until such time the value is updated.

V. Implementation of INCOME VALUE Standards

A. Communications & Disclosures

1. Client / Investor Communications

a) *Disclosure Statements*

If INCOME VALUE is to be made available on external reports to the client, it is assumed that the appropriate disclosures would be provided by each party that communicates this data. Naturally, such disclosures would have to be reviewed and approved by each party before making it available.

A sample disclosure statement has been drafted by the industry working committee that helped define the standards for INCOME VALUE and is available either through RIIA or the CANNEX web site along with other marketing and communications material.

2. Industry Communications

a) *FAQ Fact Sheet*

A list of "Frequently Asked Questions" has been compiled by the industry working committee to help sales and service providers better prepare for inquiries they may receive about INCOME VALUE.

b) *Library of Client / Investor Material*

Over time, the industry may develop additional material that further enhances the explanation or application of INCOME VALUE. It may be appropriate to establish a central repository for these materials so that best practices can be shared or accessed.

B. Education & Awareness

1. Awareness & Adoption by Accreditation Programs

It would be appropriate to contact various associations and standards boards to introduce the concept of INCOME VALUE so that it could eventually be incorporated into any training or continuing education programs that are delivered. These groups may include:

- a) Society of Actuaries
- b) Certified Financial Planning
- c) Others

Appendix A - Industry Survey Results for Income Annuity Valuation

Executive Summary

INTRODUCTION

This report presents the results of a survey conducted on behalf of the Retirement Income Industry Association (RIIA) by Mathew Greenwald & Associates, Inc. The goals of the survey were to gauge:

- Current use of income annuity value data;
- Reaction to ways of presenting the present value of in-force annuities;
- Perceived value of adopting a standardized approach to valuation; and
- Reaction to a proposed standard for income annuity valuation.

METHODOLOGY

The survey was conducted online between February 22 and March 11, 2011. Invitations and a link to the survey were sent, via email, from François Gadenne and Gary Baker on behalf of RIIA. At least four reminder phone calls per respondent were made in order to encourage response (a message was left at the last call if the identified person was not reached).

A list of 185 firms with an interest in income annuities, including manufacturers, distributors, service providers, and clearing firms, was compiled by an RIIA working group. Of these, 49 responded to the survey, for a response rate of 26%.

Of the 49 respondents, 18 (37%) work for a life insurance company with independent distribution, and nine (18%) are with an insurance company with captive agents. Roughly one in ten works for a service provider (12%), an independent broker dealer (10%), or a captive broker dealer (10%). Thirty seven percent of responding firms are in annuity distribution, 31% distribute and manufacture annuities, and 6% manufacture annuities; 27% neither distribute nor manufacture annuities.

KEY FINDINGS AND IMPLICATIONS

Few companies provide income annuity statements to their clients (16% issue separate statements and 14% issue consolidated statements), and even fewer provide specific information about the present value of income annuities to their clients (36% of those who provide statements).

- All who report the current value of income annuities to their clients have a proprietary system in place to measure that value.

There is considerable support, however, for providing information about the current value of annuities, particularly to owners and agents.

- Two out of three respondents believe providing information about the value of the income stream on their statements would be valuable to clients (63%; 24% believe this would be *very* valuable).
- A similar share (64%) believes compensating their advisors based on the present value of their clients' income annuities would be valuable, even though most compensate their agents through commissions.

There is also strong support for establishing a standard method for reporting income annuity valuation.

- Eight in ten believe having a standardized valuation method for SPIAs would be valuable overall (80%), most often because it would provide comparable data for those who have more than one such product.
- Six in ten also believe a standardized valuation method would encourage their sales force to sell more income annuities (61%), though there is no consensus on whether fee-based advisors should base their fees against an industry standard.
- Finally, any valuation of income annuities should be easy to explain to clients and advisors, should make clear that any cash value shown cannot be withdrawn, and, if standardized, should have the same name across the industry.

A standardized approach to income annuity valuation may create some issues that would need to be addressed, however.

- Six in ten respondents, for example, believe the potential for variance in value between the actual premium paid and current value, even though it would only exist for a few days, would be a problem (61%).
- Some are also concerned about reporting the value of an income annuity that would fluctuate with interest rates (42%).

Of five different ways of determining the value of income annuities specified in the survey, the “Fair Market Value” approach is most often identified as the most appropriate, whether for AUM reporting, as a basis to charge against, or within a planning allocation process.

- A solid majority – seven in ten – agree with the proposed “Fair Market Value” valuation approach, in which the actuarial present value would be tied to both long and short-term U.S. Treasury rates (71%).
- And although many find it reasonable, some do raise concerns about whether the proposed risk-free rates are appropriate or whether advisors need additional compensation for managing SPIAs, suggesting that the benefits of this approach to both advisors and clients should be presented consistently across the industry if this approach is adopted.

Appendix B – Analysis of INCOME VALUE Methodology Options

I. Introduction

To date, attempts to place a valuation on an Income Annuity contract have been isolated and proprietary. Distributors and manufacturers agree that a standard needs to be defined for a method of on-going valuation. Different methodologies had been considered by a RIIA working Committee on this topic (e.g., Replacement Cost, Statutory Reserves, etc). It has been agreed that a common methodology for the “Fair Market Value” of an annuitized asset should be defined.

II. Proposed Valuation Methodology

a. Definition

Fair Market Value / Replacement Cost = Actuarial present value of remaining benefits

b. Calculation

Depending upon the mode of payment (e.g., monthly), each income payment is discounted back to the valuation date using a common industry benchmark for economic value. Then, the probability of death is calculated for each payment period based upon a common mortality table and scale. Finally, the economic values are combined with the mortality probability to derive a fair market replacement value of the benefit. This calculation may happen as frequently as daily depending upon the need of this information.

c. Standard Variables

i. Economic Value

1. Variables

- a. **Market Benchmark** = U.S. Treasury CMT
- b. **Terms / Durations** = 1yr, 5yr, 10yr, 30yr
- c. **Spread** = TBD

2. Background

- a. **Benchmark** - When considering the choice between U.S. Treasury and a Moody's Rate there was a trade-off between having a benchmark that aligned closely with corporate crediting rates (i.e., Moody's) versus one that provided multiple rates across a time horizon (i.e., Treasuries). It was felt that aligning a valuation across a yield curve would be more appropriate and accurate given the duration of an annuitized asset.
- b. **Terms / Duration** - For the calculation, rates will be interpolated between the 1yr, 5yr, 10yr and 30yr rates. The 1 yr rate will be used for time periods less than 1 yr (i.e., 1 – 11 mths) and the 30 yr rate will be used for time periods greater than 30 years. Consistent with current practices, duration for life contingency will stop at age 115.
- c. **Spread** - Given the choice of U.S. Treasuries, the working committee felt it would be appropriate to establish a spread to: a) improve calibration between Treasuries and actual credit/pricing experience, and b) provide a lever to correct for a severe market imbalance (e.g., 2008). The spread could be established and monitored by

an industry committee or automatically calculated based on average pricing experience from a group of carriers.

i. **Proposal: Crediting Rate Spread (i.e., discount rate curve)**

Calculate the industry average payment for specific cells at 1, 5, 10 & 30 yrs from a representative list of carriers to derive a single equivalent interest rate that would produce the average payout amount with a standard mortality assumption (see below).

ii. **Mortality**

1. Variables

- **Table** = A2000
- **Scale** = G for male; G/2 for female; open ended projection
- **Gender** = Sex Distinct, where applicable

2. Background

- **Table** - A variety of Mortality table options were evaluated. The group felt that it was appropriate to use the one that is most commonly used and recognized in the industry (A2000).
- **Scale** - At this time the group is also proposing the most common use of projection scales: G for males and G/2 for females.
- **Gender** - Finally, the use of sex distinct tables would support a more accurate calculation for replacement cost. Unisex tables will be used for those states that require it.

III. **Analysis & Assessment of Methodology**

a. **Methodology Options**

An assessment was performed the proposed set of variables by comparing the use of different options within the calculation. A sample of the combinations tested is shown here:

Methodology Option	1	2	3	4	5	6	7	8
Interest Rate Basis	U.S. Treasury	U.S. Treasury	Moody's Aaa	Moody's Baa	U.S. Treasury	U.S. Treasury	U.S. Treasury	SPIA
Spread	-0.50%	0.00%	0.00%	0.00%	2.00%	2.00%	2.00%	0.00%
Sex Distinct	Y	Y	Y	Y	Y	Y	N	Y
Mortality table	A2000	A2000	A2000	A2000	A2000 B	A2000	A2000	A2000
Projection Scale	G	G	G	G	G	G	G	G
Male Projection Multiplier	100%	100%	100%	100%	100%	100%	100%	100%
Female Projection Multiplier	50%	50%	50%	50%	50%	100%	50%	50%

i. **Interest Rates & Spreads**

It was felt that a full interest rate curve would be most appropriate for the calculation of economic value for a long term instrument like an income annuity. A single rate benchmark like Moody's would not fit the criteria. As such, four (4) options emerged in deriving a discount rate:

1. **Option 1 (Case 2 Above): U.S. Treasury Rates (with no adjustment)**

The discount rate used income valuation would just be tied to the U.S. Treasury CMT for common durations (e.g., 1, 5, 10 & 30 years). A rate curve would then be interpolated between each point. The 1 year rate will be used for time periods less than 1 year (i.e., 1 – 11 months) and the 30 year rate will be used for time periods greater than 30 years.

Advantages:

- *Tying discount rates directly to U.S Treasuries would make the concept easier to understand – both for advisors and consumers.*

Disadvantages:

- *The resulting calculation of INCOME VALUE would be significantly less accurate than other options (see below).*

2. Option 2a (Case 1 Above): U.S Treasury Rates with a Fixed “Crediting Rate Spread”

An industry defined spread would be applied to the U.S. Treasury curve to help better calibrate the discount rates with the actual pricing and credit experience of the manufacturers.

The spread is calculated in the following manner:

- An average premium amount for \$1,000 per month benefit is derived from 10 representative carriers in the market for the following scenarios:
- Using both the U.S. Treasury Curve and the standard mortality assumptions outlined in the section below, a series of calculations (i.e., runs) are performed that detects the spread amount that most closely matches the average premium amounts from the 6 scenarios.

Advantages:

- *A simple modification to bring U.S. Treasury Rates more in line with actual experience.*
- *Linking the methodology to U.S Treasuries would make the concept easier to understand – both for advisors and consumers.*
- *The “black box” element of the methodology would be confined to a single variable (the spread) versus an entire index (see Option 3 below).*

Disadvantages:

- *The use of a single spread across the U.S. Treasury curve could be insufficiently sensitive to adapt to extreme Treasury curve situations, perhaps including today’s case.*
- *The process to derive the spread may be more complex than the process of delivering a completely new benchmark with Industry Average Spot Rates (Option 3).*

3. Option 2b (Case 1 Above): U.S Treasury Rates with a Variable “Crediting Rate Spread”

Similar to Option 2a, however, a series of spread rates are interpolated along a curve and applied against each monthly payment on an interpolated U.S. Treasury Curve. .

Advantages:

- *The most accurate calibration against a common benchmark*

Disadvantages:

- *A more complex process to manage compared to Option 2a (especially if performed daily)*

4. **Option 3 (Case 8 Above): Industry Average Spot Rates**

With this method, a new benchmark would be defined and established for the industry (e.g., The Retirement Income Discount Rate Table). It would be calculated by an independent entity. This table of rates would be derived in the following manner:

- Calculate the average payment amount per \$1,000 of premium of 10 representative carriers with both a Life Contingent Contract and a Life with 10 Year Certain for a Male aged 55, 70, and 85.
- Solve for the single crediting rate for each of these payment amounts using the standard mortality variables as defined below (A2000; projection scale G for Male and G/2 for Female).
- Calculate the durations for the cash flows for each of the ages (i.e., cells)
- Set the spot rates equal to the crediting rates just determined for the respective durations of the cells for each of the three ages (e.g., 11, 8, and 5 year durations, respectively) and interpolate a curve in between points. The age 55 rate is used for any term beyond the highest duration.

Advantages:

- *This benchmark would be representative of the financial circumstances underlying the products in the market.*

Disadvantages:

- *The communication and adoption of a new benchmark with financial advisors could be very challenging.*
- *Monitoring and management of the process to identify (and update) the list of representative carriers necessary for average and the flawless calculation of the benchmark.*

ii. **Results of Assessment**

1. **Scenarios**

Each case was run with the same 6 scenarios to compare the accuracy of the results:

- Male Age 55
- Male Age 70
- Male Age 85
- Female Age 55
- Female Age 70
- Female Age 85

2. Results

Methodology Option	1	2	3	4	5	6	7	8
Interest Rate Basis	U.S. Treasury	U.S. Treasury	Moodys Aaa	Moodys Baa	U.S. Treasury	U.S. Treasury	U.S. Treasury	SPIA
Spread	-0.50%	0.00%	0.00%	0.00%	2.00%	2.00%	2.00%	0.00%
Sex Distinct	Y	Y	Y	Y	Y	Y	N	Y
Mortality table	A2000	A2000	A2000	A2000	A2000 B	A2000	A2000	A2000
Projection Scale	G	G	G	G	G	G	G	G
Male Projection Multiplier	100%	100%	100%	100%	100%	100%	100%	100%
Female Projection Multiplier	50%	50%	50%	50%	50%	100%	50%	50%

Life with 10	Case 1	Case 2	Case 3	Case 4	Case 5	Case 6	Case 7	Case 8	Cannex Survey Avg
Male 55	\$202,851.75	\$215,099.81	\$183,794.70	\$166,184.81	\$269,937.01	\$275,746.14	\$284,643.34	\$206,436.36	\$203,197.93
Male 70	\$157,116.80	\$163,866.42	\$141,374.05	\$131,578.11	\$188,257.97	\$194,212.51	\$201,348.95	\$154,875.56	\$156,256.10
Male 85	\$117,482.74	\$120,781.27	\$105,908.66	\$101,023.95	\$130,950.72	\$133,896.21	\$134,572.14	\$114,010.20	\$118,165.04
Female 55	\$210,918.55	\$224,242.18	\$191,389.85	\$172,251.68	\$285,891.69	\$294,985.05	\$284,643.34	\$215,853.21	\$210,907.28
Female 70	\$165,068.57	\$172,533.23	\$148,501.87	\$137,689.59	\$200,867.71	\$210,745.32	\$201,348.95	\$163,125.45	\$163,787.55
Female 85	\$118,289.18	\$121,646.00	\$106,623.58	\$101,655.39	\$132,023.23	\$137,058.31	\$134,572.14	\$114,814.85	\$119,516.87

Percent From Average Premium in Cannex

	Case 1	Case 2	Case 3	Case 4	Case 5	Case 6	Case 7	Case 8
Male 55	0%	6%	10%	18%	33%	36%	40%	2%
Male 70	1%	5%	10%	16%	20%	24%	29%	1%
Male 85	1%	2%	10%	15%	11%	13%	14%	4%
Female 55	0%	6%	9%	18%	36%	40%	35%	2%
Female 70	1%	5%	9%	16%	23%	29%	23%	0%
Female 85	1%	2%	11%	15%	10%	15%	13%	4%
Penalty	3.1	26.4	58.8	97.7	132.8	156.5	153.3	12.7

Life Only	Case 1	Case 2	Case 3	Case 4	Case 5	Case 6	Case 7	Case 8	Cannex Survey Avg
Male 55	\$200,840.96	\$212,740.76	\$181,777.65	\$164,280.98	\$266,951.80	\$273,070.67	\$282,571.11	\$204,193.81	\$200,859.28
Male 70	\$147,985.65	\$154,277.02	\$133,178.62	\$123,845.33	\$176,221.12	\$183,327.53	\$192,704.79	\$145,897.70	\$146,553.00
Male 85	\$85,416.69	\$87,620.56	\$77,499.11	\$74,159.22	\$90,426.55	\$96,461.89	\$98,832.03	\$82,985.18	\$83,944.66
Female 55	\$209,793.98	\$222,773.64	\$190,135.02	\$171,067.97	\$284,037.63	\$293,472.67	\$282,571.11	\$214,439.22	\$209,825.28
Female 70	\$159,178.78	\$166,273.21	\$143,155.11	\$132,647.93	\$192,989.89	\$204,233.89	\$192,704.79	\$157,257.90	\$157,583.80
Female 85	\$88,738.22	\$91,065.94	\$80,450.95	\$76,925.64	\$94,636.07	\$104,566.95	\$98,832.03	\$86,215.50	\$88,735.63

Percent From Average Premium in Cannex

	Case 1	Case 2	Case 3	Case 4	Case 5	Case 6	Case 7	Case 8
Male 55	0%	6%	9%	18%	33%	36%	41%	2%
Male 70	1%	5%	9%	15%	20%	25%	31%	0%
Male 85	2%	4%	8%	12%	8%	15%	18%	1%
Female 55	0%	6%	9%	18%	35%	40%	35%	2%
Female 70	1%	6%	9%	16%	22%	30%	22%	0%
Female 85	0%	3%	9%	13%	7%	18%	11%	3%
Penalty	3.8	29.9	54.2	93.0	125.4	163.3	158.2	8.5