THE VALUATION OF RETIREMENT INCOME

By Gary Baker

For many, the idea of retirement is a daunting concept, partly because it means the idea of becoming older has to be accepted. This is even true for those who began planning in their twenties – aging isn't always a desired idea. As agents, we need to learn how to educate our clients, sharing with them that retirement isn't frightening, especially if it's done in a way that makes sense to the everyday consumer.

This is true for those sharing retirement income strategies, because incorporating the use of income annuities as a holding within a client's portfolio are becoming increasingly common. The reason is they tend to support long-term cash flow needs better than strategies that don't use income annuities. While these strategies improve results for the client, they aren't as widely adopted for several reasons, including:

1. Executing and managing a product allocation plan in retirement isn't as easy for investors as managing asset allocation during the time of accumulation;
2. There are behavioral challenges related to the investor's perceived sense of loss when they are giving up control of their assets;
3. Income annuity sales don't align well with the business models of most distribution firms.

The good news is that the industry is addressing all of these issues and then sharing the information with the public. We are learning:

1. There are more tools and guidelines available to support retirement income strategies;
2. Income annuity products are evolving - over 80% of income annuities sold today have some form of liquidity or refund feature that allows either the investor or their estate to get money back;
3. Advisor disincentives to sell income annuities are being addressed.

This article will focus on some of the advisor disincentives and how they are being addressed.

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. This is now becoming critical issues for some distributors, especially registered firms like Broker Dealers and Wirehouses, because they don't want to be in a position where an advisor (or their sales manager) feels penalized if they sell an income annuity in a situation where it may be a viable option for the client.

This untenable position has resulted in an increase in demand from some of the large distributors for insurance carriers to provide a valuation for in-force contracts that have been annuitized – many of which are income annuities. Of course, the primary reason for this request is to include these holdings in internal AUM reports and other management reports. As the volume of these requests increased, an interesting dilemma came to light. There was no standard methodology to calculate a market valuation of an income annuity contract. Traditionally, insurance companies have calculated up to five different types of valuations, depending upon the need. These include Statutory Reserves, Commutation Values (a form of liquidity), an IRS Fair Market Value for certain qualified contracts, Compensation Based Values for products that paid a trail commission, as well as Initial Premium amounts. A couple of carriers even calculated some form of market value. Unfortunately, all of these calculations were proprietary to each carrier (i.e., a black box) or weren't updated frequently. Given the nature of reports like AUM, there was a desire by distributors to have something that was more transparent and tied to the market as interest rates fluctuated.

About two years ago, with the help and sponsorship of the Retirement

Income Industry Association (RIIA), a number of organizations across the financial service industry got together to begin a journey to define and implement a common methodology for the market valuation of an annuitized asset. Over time, a working committee of over 100 individuals from 40 firms representing carriers, distributors and service providers were involved in defining a valuation standard. They also worked on the processes necessary to update and transmit these values, to happen as frequent as possible, on a daily basis if necessary. This new standard, called Income Value is essentially defined as the actuarial present value of the remaining benefits of an income contract. A part of the calculation uses a discount rate called the Income Annuity Yield Curve, which represents the average crediting rate derived from the top payouts on any given day – a process similar to other benchmarks like the Lipper Average. Standard Mortality projections are also used. As a general practice, the group agreed that Income Value would be updated on a monthly basis, which is the same frequency that other insurance and annuity contracts are valued.

This fall, the first wave of carriers have begun calculating Income Value and are now able to transmit the data through the DTCC, to the distributors who are requesting it. These firms are now starting to investigate additional ways for Income Value to be deployed within their practice. Many of these options touch the client via consolidated statements, tax reporting, income planning processes, as well as a base for which fee-based advisors can charge for their services.

This expansion has led to some new insights, relative to additional inconsistencies across the industry. One interesting issue being identified is the potential for a client to see inconsistent valuations for annuitized contracts from two sources. One is a proprietary value provided directly by the carrier on an annual Tax Form 5498 for certain qualified contracts, based on the IRS defined Gift Tax methodology. The other may now be a standard Income Value, which is provided by the distributor (or custodian) on a daily or monthly basis via a client statement.

Needless to say, the inconsistencies across the industry will become more visible as valuations are transmitted to more distributors. So, the RIIA working committee recently surveyed a group of carriers and large distributors to get a better understanding of the different preferences and practices related to contract valuations. The results were quite interesting.

Valuation Practices of Carriers:

- On average, each carrier calculates about three different values for a contract
- Many (not all) provide a Form 5498 for qualified contracts. For those that do, only some use the IRS guidelines for valuation. Others use statutory reserves and some would like to investigate the use of Income Value
- Half didn't see an issue with Income Value potentially being applied differently by each distributor – half did. However, the use of appropriate disclosures was important to all.

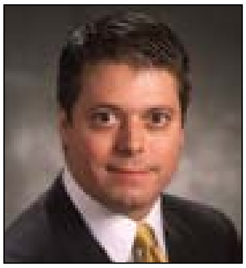
Valuation Practices of Distributors:

- Some distributors receive multiple values from carriers
- Although, most are unaware if the carrier sends a Form 5498, they will request the IRS value so that they can do RMD reporting for certain custodial accounts that hold contracts. A few will use the IRS value for planning.
- Half would use Income Value for client statements – half won't (they don't want to give an appearance of a cashable amount).
- Half would also use Income Value for Income Planning.

The good news is that firms are starting to grapple with these issues, as the use of income valuations becomes more widespread. Solving for a standard market valuation won't be the only factor in increasing the adoption of income annuity products. However, it will be an important catalyst that helps make these products more mainstream for financial planning practice that support the lifetime retirement income needs of their clients.

Readers that are interested in more detailed and technical information about the new standard to calculate Income Value can find it on CANNEX's website – see: http://www.cannex.com/usa/english/products_iycu.htm

Gary Baker
President, CANNEX USA, leads the U.S. operation of CANNEX Financial Exchanges.



His experience in the retirement market has broadly covered retail and institutional businesses as well as insurance and money management. Prior to joining CANNEX, Gary led product development and marketing for MassMutual's Retirement Income business. Prior to that, he was with GE Capital where held a variety of senior positions in business development, product development and marketing both domestically and internationally.