

# Innovation of the year Aegon's 5 for Life

How Aegon took a successful US variable annuity product and used it to break into the Europe's biggest annuity market

PAUL BICKNELL REPORTS

NOT SO LONG AGO, you could change your car, your house and your spouse... but not your annuity. But flexibility in the retirement planning landscape has come quickly in the past few years. The US retirement landscape has seen tremendous development in the field of variable annuities – a broad church of retirement savings products that wrap mutual fund investments with income and accumulation guarantees, flexibility of investment, and death benefits.

The concept has spread to continental Europe and Asia, and in the past 18 months Hartford Life, Lincoln Financial and MetLife have all taken their US style offerings and tailored them to the UK market. Yet others – notably Axa, whose Twinstar product in Germany won our innovation award last year – have held back. But it was Aegon's 5 for Life product that demonstrated how variable annuities could succeed in the UK's notoriously difficult retirement savings market.

According to figures from the Association of British Insurers (ABI), Aegon is some way behind other life providers based on total UK net premiums, placed 15th in a sector in which 58.6% of business is processed by the top five companies – AIG, HBOS, Aviva, Legal & General and Standard Life.

But while the larger companies may have continued to dominate the sector with a range of traditional income-drawdown unit-linked products and straight annuities, Aegon deployed an innovative solution that was first invented by its US subsidiary Transamerica in 2003. And this solution in the form of 5 for Life was a real head-turner. Whereas annuities provide UK consumers with a guaranteed income for as long as they are alive, they do not usually allow policyholders to benefit if the stock market performs well – unless it is a with-profits annuity – or provide death benefits, while income-drawdown does not provide an income for life.

5 for Life enables policyholders to invest a lump sum of £15,000 or more, and provides them with a guaranteed income of at least 5% of



Mark Laidlaw

the original investment for life. Money can be invested in the plan from the age of 45, and income from the plan can be drawn from the age of 60, although it does not satisfy requirements for compulsory annuitisation under UK law by the age of 75. This much criticised rule in the UK retirement planning landscape is perceived by many to be a barrier to choice, diversification and product innovation.

Some observers believe that variable annuity launches in the UK have also been delayed because of restrictive rules, called permitted links, placed on the types of investment that providers of unit-linked products can make. Aegon has circumvented this problem by basing the product offshore, and also benefitted from a number of tax advantages. As it is a Dublin-based product, 5 for Life customers benefit from virtually tax-free growth or gross roll-up, which basically means that no tax is deducted year on year – like an onshore bond – apart from some withholding tax that cannot be recovered on certain funds.

Mark Laidlaw, finance director at Aegon, says: “There were a number of reasons for basing the product in Dublin. We wanted to get out quickly, and the speed to market was one of the issues. Another consideration was having a central place from which to manage the risk. It was more efficient to offer the product from Dublin over the UK for policyholders.

“We have saved a great deal of money by choosing not to hedge vega risk”

Josh Braverman, Aegon USA

“The regulatory benefits of basing the product in Dublin had a lot to do with the more principles-based approach the regulator takes. It would not necessarily have been impossible to launch it from the UK, but it would certainly have involved a very long and extensive dialogue with the regulator.”

Phil Naylor, compulsory purchase annuities director at Legal & General, agrees that the tax regime in the UK does not lend itself to variable annuity products, and congratulates competitors who have already made bold inroads here into this type of retirement planning: “We do not see these products as replacing the conventional annuity, but they are a useful tool for the savings aspect of pensions.”

There is potential to increase the income in line with any growth in the value of the underlying funds – which is locked in at regular intervals. There is also the option to surrender all or part of the plan – preserving policyholders’ access to money – and the death benefit of 100.1% of the surrender value of the plan is provided. There is a requirement under UK tax law for there to be a death benefit above the fund value for the contract to be an insurance product.

Aegon guarantees to return at least the original 5 for Life investment amount, and does so through a combination of income and surrender values either on death or on the 10th anniversary of the plan. Through this it has managed to craft a product that is not only seeing significant sales in the high net worth retirement income arena but has also captured a segment of the so-called mass affluent.

The sales figures for 5 for Life show a rapid increase in take-up since launch in 2007 when it netted £41.1 million for the year, despite it still occupying a niche area of retirement planning. Laidlaw says: “Q1 this year was just over £18 million, but it looks as though things are picking up even more now – with sales of £29 million, Q2 was by far the best quarter since launch.”

While these numbers may appear small in comparison with the £245 billion of insurance and investment contracts held by Aegon as of December 31, 2007, it is telling that many other providers of variable annuities in the UK are unwilling to divulge profits for their respective products.

For accounting and regulatory purposes, variable annuities such as 5 for Life behave largely like unit-linked contracts. Laidlaw says: “The basic product is treated as a unit-linked contract. The valuation of the guaranteed liability is calculated using stochastic methods, and there is a higher solvency margin on this part than for standard unit-linked contracts. Where there is a hedging programme in place, the hedge assets will also be taken into account, and valued on a market-consistent basis. Regulatory reserves take hedging into account and are low in comparison with fund value.”

5 for life is hedged in the US by an in-house Aegon variable annuity pricing and hedging platform. Laidlaw says the major strength of the platform is the fact that it has been tested during the recent market volatility. “Market turbulence has provided experience of the market during a time of increased correlation between the asset classes. They are reporting back to the product team in Dublin on a regular basis.”

The hedging programme has held up remarkably well in the current market turbulence. It focuses on delta (underlying fund volatility) and rho (interest rate risk). These greeks represent the primary capital markets’ risk in the product, and the market for instruments used to hedge those risks is relatively deep and liquid.

Delta hedges in the form of equity index futures have continued to perform within expectations during recent market periods. “Realised equity market volatility has varied over the past two years, but has not reached levels deemed unacceptable for any significant period of time for our dynamic hedging approach,” says Josh Braverman, senior vice president and head of derivatives at Aegon USA Investment Management. In the second quarter of 2008, realised UK equity volatility was only 16.7%, which was above the value of 9.9% a year ago but still below Aegon’s long-term expectation for the UK, and nearly 10 percentage points below the implied volatility

on offer for FTSE100 index at the beginning of the quarter.

Aegon's competitors, such as US giant The Hartford, have a policy of hedging sensitivity to vega (option prices) as well as delta and rho, and recently have begun hedging higher-order risks too. But in its hedging of variable annuities guarantees in the US and UK, historically Aegon has favoured simple dynamic hedging strategies, which have left vega risk unhedged.

Braverman says: "The types of vega risk we would be interested in hedging are very long-term options that are illiquid and expensive. If you look at the implied volatility of the S&P500 in the past five years, it is in the mid to high 20s, but actual volatility has been around 15%. Realised volatility levels are comparatively lower, and we have saved a great deal of money by choosing not to hedge it."

Aegon has considered hedging vega and cross-greeks such as delta-rho to help with managing the risk of the annuity minimum guarantees, and that consideration is part of a robust and exacting process that has seen these greeds actively hedged in many of their other life products, such as the variable annuity it markets in the Netherlands. The company has a team of 25 senior risk managers who specialise in hedging these products globally, keeping a close eye on residual risks and sales volume.

According to Braverman, capital markets risks have 'negative economies of scale', so as a risk gets bigger it is less likely to diversify away and more likely to require effort and expense to manage. "With the negative economies of scale, in some regions with some types of product guarantee, the risk becomes too big. We continue to monitor the level of risk we are taking in these areas as part of our ongoing strategy, but the strategic options and consumer behaviour options within the 5 for Life product mean it is not currently cost-effective. A reinsurance option to cover variable annuity minimum guarantees for 5 for Life would be very expensive because there are no natural sellers – it is a buyers' market – so

why have our profit eroded by one of the large investment banks?"

That isn't to say that Aegon doesn't look carefully at option prices offered by dealers. But rather than buying hedges, it uses the data to improve product pricing, Braverman explains. "Consumers who buy life products like guarantees, and we consider the vega risk for these in-house. Our first move is to re-price the product if, say, the market interest rates move. We price for the market-consistent hedge costs and keep it consistent as if we

"The regulatory benefits of basing the product in Dublin had a lot to do with the more principles-based approach the regulator takes"

Mark Laidlaw, Aegon

were to hedge it. It is about making a strategic decision to add value."

Simple historical methods cannot be used to price 5 for Life because it is not just the behaviour of the policyholder that the insurance company must worry about, but also the behaviour of embedded options within the variable annuity. "We use market implied volatility in the pricing of variable annuities, and properly pricing and designing products is a key part of risk management. Volatility can affect pricing of our products, and non-parallel interest rate shifts are something we take into account when considering appropriate interest rate hedges."

Braverman says advanced financial models of the embedded options have been developed by Aegon to look at the options that have been given to policyholders. This model allows the status and market sensitivities of every hedged policy to be refreshed daily by the hedging team.

There are three different investment options within 5 for Life, including using one of four ready-made portfolios built from a mix of the UK Fixed Interest fund, managed by Aegon Asset Management, and the UK Index Tracker fund, managed by

BlackRock. The multimanager portfolios are built using the UK Fixed Interest fund and a variety of funds recommended by Morningstar.

Conceivably there is credit risk in variable annuities guarantees when corporate bonds are held in the underlying fund. However, Braverman says he would generally not consider this a material risk until much later in the life of the product, when a potential claim payment is near. "At that time we might look to hedge the credit risk."

It amounts to a sophisticated business model in a market in which providers rely entirely on ever better approaches to drive costs down and improve margins. It is easy to point the finger at variable annuity providers for not hedging all conceivable risk, and contemplate whether mispricing the cost of guarantees associated with the products could seriously hit the profits of insurers in the future. All variable annuity providers have the conflict of interest between deriving maximum profit from a competitive product and hedging out enough risk to make the product safe enough for the company to offer.

But Aegon is not merely allowing for adverse conditions in the wake of the credit crunch in the way it hedges its variable annuities. It has had the acumen and the confidence to monitor across the board a far greater spread of risks than that which it currently actively hedges on 5 for Life. There is an irony in the fact that it has perhaps acted with greater prudence than the competition by not hedging against some of these risks, and one imagines it is of some pleasure to the board that they are able to generate greater profits from them as a result. 

