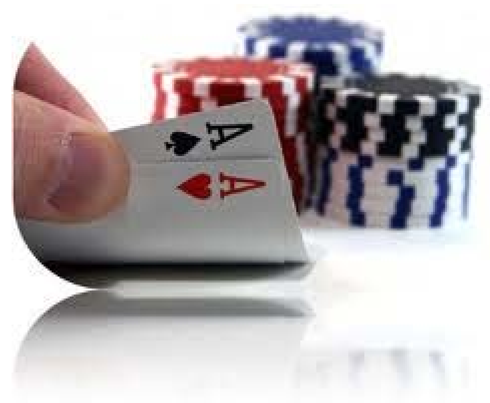

Competing In A Low Interest Rate Environment:

What Hand Will You Play?

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LEADERSHIP

GROWTH STRATEGIES

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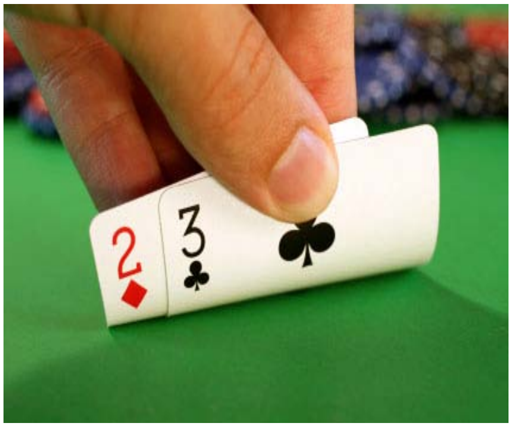


The current low interest rate environment is making it difficult for life and annuity companies to profitably manage their business. And experts believe there is currently no short term end in sight for low interest rates. In a recent LOMA survey, life insurance executives believe low interest rates will "stymie growth in 2013." One senior executive surveyed said, "In terms of profitability, the industry will continue to be challenged by the low interest rate environment, as compressed margins will continue to present challenges and put pressure on earnings."[1]

In light of this, several critical questions arise with respect to developing and implementing new products:

- How do we support product spreads with 5 year treasury yield rates at 0.88% and 10 year bond yields at 2.02%[2]?
- How can we achieve our profit goals with such low interest rates?
- What types of products should we be selling?
- Where should we position ourselves competitively in this environment?
- How do we support and preserve our distribution system?
- What do we do about valuation and nonforfeiture interest rate changes in 2013 and 2014?
- How do we avoid taking on unmanageable risks?

[1] Low Interest Rates Concern Execs in 2013 http://www.lifehealthpro.com/2013/01/09/low-interest-rates-concern-execs-in-2013?eNL=50edfa10ca9f808c1d00006a&utm_source=LifeHealthProDaily&utm_medium=eNL&utm_campaign=LifeHealthPro_eNLs&_LID=97605893

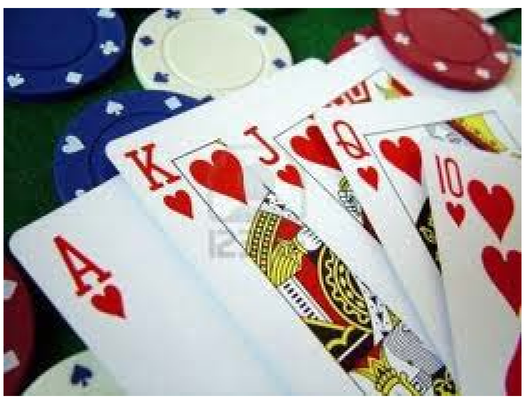
[2] US Treasury yields as of 2/12/2013 http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield

The purpose of this paper is to:

- ***Lay out a framework*** for navigating this environment and making product, distribution, and management decisions that can optimize your chances for success.
- ***List creative product alternatives*** that can improve your results in a low interest environment.
- ***Provide additional competitive ideas*** that can increase value during difficult times.

While there may be no magic bullets, there are things that companies can do to successfully compete in a low interest rate environment. At the end of this paper, we describe ways in which we can help you achieve this success.

Making Good Decisions – Choosing From the Possible



If you are a poker player, you know that a royal flush is the best hand. You are guaranteed all or a portion of the pot. However, what if the cards you are dealt (and those showing) reveal that you cannot possibly get a royal flush. Will you always fold? Any skilled poker player knows that this is not a winning poker strategy (not to mention boring). Paying the ante every hand and waiting for a royal flush pretty much guarantees you will lose in the long run. Or do you try to bluff with every hand and bet as if you actually do have a royal flush?

On the contrary, we know that a winning strategy is to selectively play hands that optimize your chances for success. Good poker players know that they have to consider the odds, read their competitors, be a little unpredictable, and make optimal decisions that may allow them to win even when their hand is not so great.

Even though the life/annuity business is not akin to gambling, there are strategic similarities that are worthwhile to consider:

- Life and annuity companies are currently being dealt some bad hands.

- They continue to "ante up" expenses during these difficult times to maintain products, distribution systems, and infrastructure.
- Since there are no automatic winning hands in sight, they need to have a strategy for evaluating choices and making optimal decisions.

WHAT ARE THE CONSEQUENCES OF OUR CHOICES?

A good first step is to develop a checklist of critical areas that are impacted by the way products are priced and sold. Then as we consider various options, we can evaluate the impact those choices have on each critical area:

a. ***Sales/Marketing –*** Obviously, the decisions we make will impact how much business we can write (capacity) and how attractive the products are to the marketplace (competitiveness).

b. ***Distribution Systems –*** We spend a lot of resources developing a distribution system. Our decisions will impact whether we lose, maintain or grow distribution in the current environment. Does the cost of losing distribution, harming our reputation with agents and customers, and having to rebuild a field force in the future outweigh the cost of providing competitive products, compensation and other support during difficult times?

c. ***Infrastructure Resources –*** Similarly, how will each choice impact company resources? For example, if we make choices that reduce new business, should we downsize the home office in order to minimize losses or do we continue to ante up expenses until the environment improves?

d. ***Financial Risks –*** Can we understand and manage the risks we take under alternative strategies? For example, investments that maximize current spreads to support otherwise unsustainable credited interest rates may cause disastrous, unmanageable, and unavoidable future risks. Take these risks and you may have to drop out of the game permanently.

e. ***Speed to Market Capabilities –*** It can sometimes feel like the current environment will never change. (Do you remember the double digit interest rates of the late 1970's/early 1980's?) But of course it always does change and often quite rapidly. How will the decisions you make affect your ability to quickly respond to future changes?

f. ***Profits and Value –*** Finally, all of these factors boil down to bottom-line profits. Not only current profitability while interest rates are low, but also your ability to take advantage of opportunities when the environment improves. What strategy will maximize your future value in a way that looks at both short-term profitability and retaining long-term potential?

CHOOSING FROM THE POSSIBLE

What is the universe of options companies have before them? Here are four:

Option #1: Hold Out For The Royal Flush

Like the poker player holding out for the royal flush, many companies default to dropping out of each hand dealt to them. If you try to price products to achieve unrealistic spreads and a "royal flush-like" profit margin, you may just price yourself out of every game. So you just keep losing your ante, not to mention your distribution system (which would ultimately result in never seeing a winning hand).

Option #2: Go "All In" Every Time

On the other hand, some companies may continue to compete with products whose profits are primarily based on wishful thinking. For example, some companies may continue to offer annuities with unsustainable interest rates backed by long-term mismatched investments under the assumption that interest rates won't rise, or that policyholders won't bolt when market interest rates do rise. This is an extremely dangerous strategy that could very quickly send a company into insolvency.

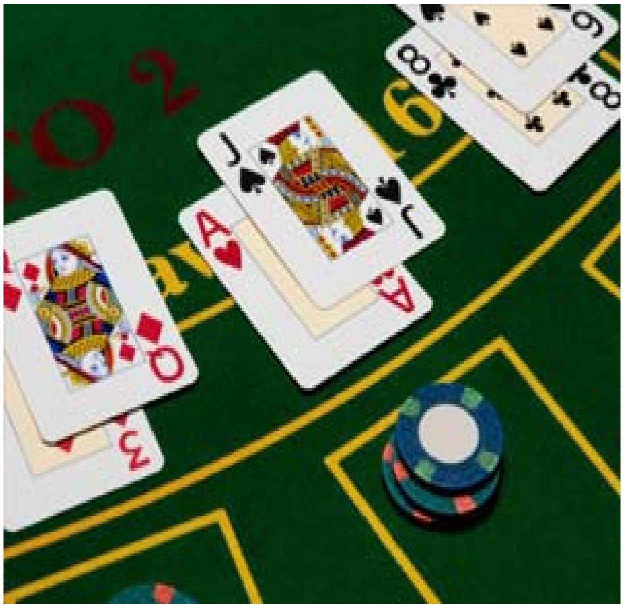
Option #3: Drop Out of The Game Altogether

Alternatively, you can consciously decide that you can't play in the current game. That seems a better choice compared to options 1 and 2 above. But to optimize this choice, you need to make tough decisions with respect to distribution systems and infrastructure. Do you continue to ante up expenses to retain your investment in infrastructure and distribution (if even possible) or do you make the hard decisions to down size until things improve?

Option #4: Skillfully Play The Winning Hands

The fourth alternative is to selectively play the game. You try to compete where you can, look for niche opportunities, maintain your resources, and optimize your results to try to come out at the other end of this interest rate environment in as good a shape as is possible, both in terms of current profits and potential value for the future. You may not win as often as you'd like in the current environment, but you stay in the game.

A FRAMEWORK FOR OPTIMIZING DECISIONS – BECOMING A CARD COUNTER



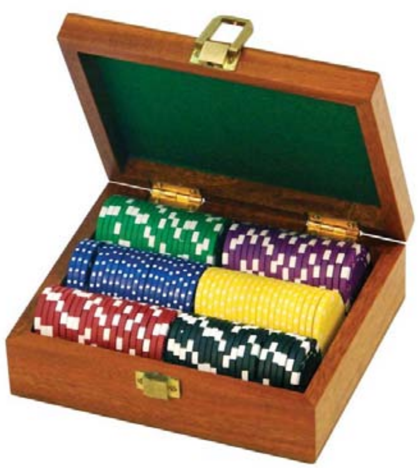
You can play your poker hands without considering the cards that have been played around the table. Or you can be like the card counter who knows at any point in time what his odds of winning are based upon all the information he has available to him. Most companies have financial projections. If nothing else, your actuaries have projections for the reserve process (cash flow testing, etc.). However, many companies do not use their financial projections as a management tool to make product decisions. While you may get reports of product profitability, experience data, etc., on a micro level…

- Does your company look at the overall projected financial results at the macro level?
- Do your management projections take into account all the potential consequences we listed earlier (sales, distribution, infrastructure, financial risks)?
- Do your projections look at alternative scenarios that consider the tradeoffs between profit margins and sales?
- Do your projections provide the marketing department a clear understanding of what sales targets are needed under alternative product scenarios in order to optimize profits?
- Are your company's financial projections straightforward and flexible enough for senior management to rely on when making strategic and tactical decisions?

In an environment where you cannot achieve your usual desired profit levels, we believe you must have a very simple objective: *To implement products and competitive strategies that optimize your value when you come out of the other end of this difficult time period.* Your value is a combination of surplus, value of business on the books, and the capacity to produce future new business. A flexible financial projection tool can help you evaluate alternatives to achieve your objectives.

One word of caution is in order. The financial projections you use need to handle expenses in a realistic and flexible way. Many projections simply project short-term budgeted expenses, but ignore distinguishing fixed versus marginal expenses for the purpose of accurately comparing alternative product and new business scenarios. This can lead to bad decisions. For example, you can look at a product and think it is not profitable because it does not support the overhead that we allocate to it. You might decide to stop selling that product. But if you don't recognize that the overhead it did cover still exists (unless you make hard decisions to downsize), the decision to withdraw may not be optimal.

Product Ideas That Can Optimize Success



There is no denying the fact that it is more difficult to develop competitive and profitable products in a low interest environment. But it is not impossible. Here are some examples of product designs we have identified that can optimize your results in a period of low interest rates:

LIFE PRODUCTS THAT ARE LESS DEPENDENT ON INVESTMENT RETURNS

If you sell products that rely relatively less on interest spreads, you can often come closer to achieving objectives with a competitive product.

Term life insurance develops little or no cash values. Some types of term insurance markets (such as level 10, 15, 20, or 30 year term) are ultra-competitive and difficult for many smaller to mid-sized companies to compete in. But certain types of term (such as decreasing mortgage term insurance or worksite term, level term to age 65, 70, etc.) can be offered competitively with less reliance on interest spreads.

If you are in a relationship market (e.g, fraternal insurance companies) where there is an element of trust, you can offer competitive *non-guaranteed level term insurance* designs that can reduce reserves by as much as 80%.

Various *modified whole life policies* can also reduce reserves and offer lower premiums. Creative dividend scales and options can defer value growth to later policy years when interest rates may be higher.

RE-THINKING ANNUITIES

In recent years, many companies have sold a lot of deferred annuity business. Unfortunately, these products have become very risky in a low interest environment. This has been exacerbated by old designs, unsupportable interest guarantees, and liquidity risk. Regulators and rating agencies are paying attention to annuity sales, forcing companies to find other sources of business.

But annuities still offer opportunities in a low interest environment. *Life income annuities* have predictable cash flows and no cash values or liquidity risk. This allows companies to safely invest long term to increase spreads or to invest strategically based on expected cash flows. At the same time, income annuities uniquely offer guarantees and solutions to one of the most important risks people face today – the risk of outliving one's assets in retirement. There are many new ideas in annuity products beyond the traditional single premium immediate annuity (SPIA). *Indexed benefit annuities* can address the concerns about locking up assets during a low interest environment. *Longevity income products* protect against outliving your assets without tying up all of your assets. All of these income products can be simple plans available to any sized company.

Finally, while it is much easier to sell the traditional deferred annuity based on high interest rates, it's a very risky strategy in today's environment. But there are other options. Much of the competition, especially in the middle market, comes from banks selling certificates of deposit (CDs) and other similar low interest investments. The economic uncertainty creates a flight to safety and guarantees. *CD annuity designs* can safely target and compete with these alternatives. You may not sell as much as offering a 4% or 5% interest rate product but; then again in today's environment, you probably do not want to.

PRODUCTS THAT COMPETE BEYOND PRICE

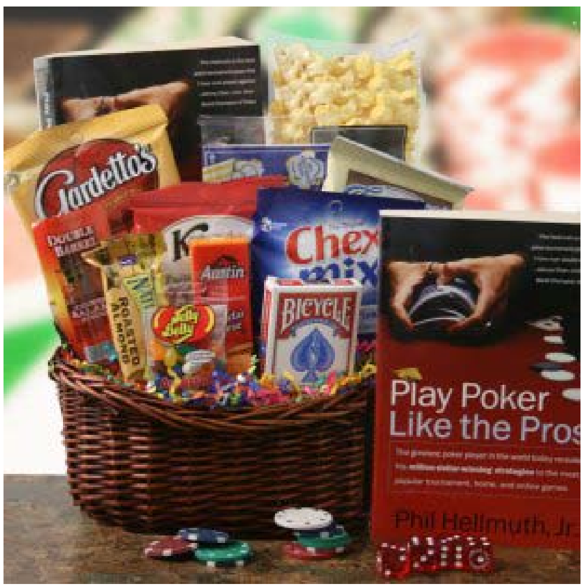
Quick issue policies that do not require medical underwriting are popular products right now, particularly as a middle market product. These plans, which offer face amounts often as high as $500K, compete more on the convenience of a quick one-stop sale than on super competitive rate levels. These are not necessarily simplified issue plans, but plans which rely on full non-medical underwriting including pharmacy data bases and other high tech/quick underwriting tools. So these types of plans can still be reasonably competitive, especially in the younger age market.

Specialty life products such as estate planning solutions (particularly with the current tax uncertainty), products designed for caregivers, charitable giving products, or other advanced sales ideas can target solutions that place less emphasis on interest rates and price.

Combination products that combine life or annuity chassis with critical illness or long-term care benefits focus on these additional benefits more so than interest rates and price.

Partnerships with other providers that offer health insurance products such as Medicare supplement can offer access to new insurance needs and build a customer base that can be cross-sold life and annuity products from a new perspective.

Nurturing Your Distribution



In the current environment, your strategy often depends on asking your distribution system (marketing, sales, field management, agents, etc.) to do more with less. While many of the product ideas we list offer valuable benefits, they can be harder to sell than products that offer a great interest rate. While it can be difficult to spend money on the field in uncertain times, it could be the most opportune time to do so. Not only is it less risky than supporting unsustainable products, it can be an opportunity to strengthen your relationships. Uncertainty and change create opportunities to compete for and grow your distribution.

CREATIVE COMPENSATION IDEAS

How can you design compensation plans with effective incentives for your distribution system? While it can be difficult to pay additional compensation when margins are so tight, it may be worthwhile to offer, say, *introductory bonuses, contests, or other incentives* that recognize the fact that selling your "new look annuity portfolio" is harder than selling the best interest rate. Offering *"asset under management" type commissions, persistency/volume bonuses, loyalty bonuses and agent retirement planning schemes* send a message that you want to make it worthwhile for your agents to do the hard work of retention and that you plan to stick with them in the long term. These approaches, while they cost money, are safer (i.e., provide a better return on investment) than offering unsustainable products.

PRODUCT TRAINING AND SALES TOOLS

Whole generations of agents have had the luxury of only selling based on the highest interest rate or the lowest premium rate. As a result, there is a need to provide the training and support to sell products that offer other advantages. *Easy to use illustration systems, supplemental needs-based sales tools, and educational materials* can all help your agents navigate their success and send a message of support for the long haul in the current environment.

SALES/LEADERSHIP TRAINING

It's easy to sell when you have the highest rate or most competitive product in the market place. In times when competition is more severe, the organization that has the most skilled distribution system will win the most market share.

To the extent external factors like lower interest rates make it harder to distinguish your product by its features, your sales force must be skilled and willing to sell when the product doesn't "sell itself".

Once you make the product as competitive as possible, the rest of the success formula rests with your sales reps and sales managers.

If your sales reps are not selling as much as you would like, then one or both of two things is true: they CAN'T sell and/or they WON'T sell!

If the problem is one of ABILITY, you need to take a serious look at four things: knowledge, skills, professional experience and support resources. Specifically,

- Do they need to understand more about your products and services and the needs within the marketplace?
- Are the sales skills they have been taught truly effective or have they abandoned the training they received?
- Do they lack experience in dealing with client situations they encounter?
- Do they have access to the support they need to do what they are expected to do?

If the problem is one of WILLINGNESS, you need to identify the source of their resistance:

- Is the problem lack of desire?
- Are emotions of anger or fear stopping them?
- Is there an effective accountability system in place?

There might also be issues with your sales managers. One or both of two things is true: they CAN'T manage and/or they WON'T manage!

More often than not, the problem here is one of ability. The vast majority of sales managers have never received any formal training, so they lack skills. That in turn makes the sales reps question the value of their manager, so respect is compromised.

The worst of all scenarios though is the sales manager who WON'T do what they were hired to do – and while the prognosis is poor, you must still identify the source of their resistance in order to prevent the same scenario from happening again. Is it a matter of burnout? Unrealistic expectations? A lack of support? Or have they lost faith in their upper management team?

What's the remedy?

Once you have identified why your sales reps aren't selling more, the answer will be a combination of sales and leadership training. No matter what challenges a company faces, sales training is the cornerstone of the solution. The only thing that will fix a bad economy (or low interest rate environment) is PROFITABLE SALES and the only thing that will prevent a company from becoming a victim of a bad economy is LEADERSHIP.

How PSE Can Help

2014 is Fast Approaching

The event of lower life insurance valuation and nonforfeiture interest rates is forcing companies to take a hard look at their products and product distribution strategies. If you have read this far, you can see that there is potentially a significant amount of work that needs to be done, especially before the 2014 deadline for implementation of reduced nonforfeiture rates occurs.

PSE can provide your company with the expertise and resources to meet the product analysis, development, implementation, and sales training needs required to play your "best hand" in the marketplace.

Our approach is comprised of these six phases:

1. **Product / Marketplace Assessment** – this involves developing the financial models so that your company can effectively evaluate what changes, if any, are needed to your existing product portfolio, given your target market and the competitive landscape.

2. **Product Design** – based on the Product Assessment, we can advise your product development team on features and pricing techniques to develop the best products for your situation. We can even design and develop the entire product or suite of products for you. We have a history of designing simple, yet creative, customized life/annuity products, including several patent pending designs. We also work with associates who can help you with health, LTC, disability, or other product lines. We can offer profitable turn-key Medicare supplement products thru our association with Ed Carroll and Associates (www.EdCarrollAndAssociates.com) and Insurance Administrative Solutions, Inc (www.IASAdmin.com).

3. **Product Implementation** – PSE also specializes in implementing product administration systems. This includes writing system specifications, systems testing and troubleshooting. We also have relationships with several TPA's who can help implement and administer products quickly and efficiently.

4. **Speed-to-Market** - One key to successfully managing your product portfolio in the current environment is to be able to quickly and efficiently respond to changes in the environment. Our state filing and compliance team has an unbelievable track record in

getting products and other forms approved ("40 states in 40 days or less"). We specialize in Interstate Compact filings and flexible, dynamic and electronic applications.

5. **Sales Support Tools and Programs –** We provide leading -edge mobile web-based sales illustrations simple-to-use and maintain. We also can build customized, creative sales and educational tools.

6. **Sales/Leadership Training & Coaching -** In order to compete in this low interest rate environment, your sales distribution force needs to take their skills and energy to the next level. PSE offers professional sales and leadership training and coaching through alliances with Leadership Growth Strategies (www.LeadershipGrowthStrategies.com), Business Growth Strategies (www.BusinessGrowthNow.com), and with Ed Carroll and Associates (www.EdCarrollAndAssociates.com),

PSE can provide superior support in any or all of these phases. We can work in tandem with your internal actuaries or you can fully outsource tasks to us, depending on your needs.

Complimentary Strategy Session

PSE has specialized in helping insurance companies assess, design, develop and implement cutting edge insurance products and systems for over 15 years. Our staff has over 100 years of combined insurance experience.

If you would like to explore how we can help your company dominate in a low interest rate environment, **contact Chuck Ritzke at 847-551-1600 or chuck@myactuary.com to arrange for a complimentary phone strategy session.**