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CURRENT IRA (UNITED STATES) AND RRSP (CANADA) DEVELOPMENTS

Moderator: GARY N. SEE. Panelists: HERBERT N. BEILES, WILLIAM H. BOWMAN, GARY G. GRAHAM, BRUCE E. NICKERSON.

1. Which products have proved successful.
2. Regulation problems that have developed.
3. Taxation problems.
   a. Handling of valuation interest
   b. Handling of guaranteed interest in excess of valuation rate
   c. Handling of interest in excess of guaranteed rate
4. Rollover problems.
5. Commissions on increases.
6. Competition from other financial institutions.

MR. WILLIAM H. BOWMAN: ERISA is now almost two years old and the legislation permitting Registered Retirement Savings Plans in Canada is over 15 years old. Both of these laws created opportunities for financial institutions to accumulate money from individuals on a tax-deferred basis. Herb Beiles will comment on the situation in Canada, and I will mention a few of the more successful products in the United States.

ERISA permits an individual who is not a member of a qualified pension plan to contribute up to $1,500 per year to an Individual Retirement Annuity or Individual Retirement Account (IRA). Although Herb plans to comment in more detail about the competition that insurance companies have received from banks, I would like to mention that banks have designed some very attractive plans for the Individual Retirement Account market. In the advertising that I have seen, banks emphasize the high rate of interest that they will pay on deposits. Usually this interest rate is guaranteed for only 4 to 6 years, but is projected at the same rate for 30 or 40 years. Obviously, since most banks will have no commission expense and a very small annual maintenance cost, the accumulation at the retirement age can be quite substantial.

This competition has led insurance companies to design new products or revise existing products to fit the IRA market. The Variable Annuity, first introduced in the 1960's, is one product which will fit the IRA rules and allow the policyholder to invest his funds in equities.

An even more successful product, however, has been the Flexible Premium Annuity. This product gives the policyholder flexibility in his premium payments (which was envisioned by ERISA), and provides both minimum rates of accumulation (through minimum cash values) and guaranteed settlement option rates. As I understand it, sales of Flexible Premium Annuities were quite high in 1975, and companies look for even higher sales in the future. If the policyholder decides that he also wishes insurance coverage, even though its premiums will not be tax-deductible, he may add a Decreasing Term Rider to the Flexible Premium Annuity, and the combination will be very similar to a retirement income policy.

The Flexible Premium Annuity and Variable Annuity seem to fit the IRA market quite well, but there are several other products on the market which do not seem as appropriate as the two mentioned above. Endowment policies and retirement income policies, if they are sold with level premiums, do not allow the policyholder as much flexibility as ERISA envisioned. For example, if a policyholder wished to increase his premium payments, he may have to purchase an additional retirement income policy, with its high initial loading and surrender charges. On the other hand, if a policyholder has a retirement income policy with an annual premium of $1,500, he may find that he has a reduction of income in one year which would not allow him to deduct the full $1,500 premium. In this case, if he pays the full premium, he will be subject to a tax on the overpayment, or else he may make a partial surrender of the policy and possibly be subject to the rules covering premature distributions. Thus, the inflexibility of the retirement income and endowment products does not seem appropriate for the IRA market.

Finally, some Flexible Premium Annuities that have been introduced have been successful because of the high interest rate that can be offered. Some mutual companies have considered all policyholders who buy Flexible Premium Annuities in the calendar year 1975, say, to be in a single dividend class, and the interest rate payable for that class would be closer to the new money interest rate than the portfolio interest rate for the annuity line. Another approach for obtaining high interest rates is to set up a group annuity contract with a bank as the trustee and treat each individual buying the annuity as a certificate holder. This allows the insurance company to use the higher investment year rates of the group annuity line for this business.

MR. GARY N. SEE: I will make a few comments about our company's new policy, which was developed in the latter part of 1974 and sold more annualized premiums in 1975 than in the preceding sixty years of the company using the annual premium (traditional) deferred annuity. Basically, the product is extremely simple, has a level ten percent load, and, at the time we started, had a first year interest guarantee of 7.5 percent. The interest guarantee in years two through ten is 4 percent, with a 3 percent guarantee thereafter.

The policyholder is guaranteed the highest of three amounts:

1) the sum of his contributions to date, 2) the accumulation of his net deposits at the guaranteed interest rates, or 3) the accumulation of his net deposits at the actual yield rates. We credit interest on a daily basis and keep all three accounts running at all times. They are updated every twenty-four hours.

There is no policy loan provision, but partial withdrawals are allowed. The total commission to the writing agent and general agent is 35 percent in the first year and 1.5 percent in renewal years.

MR. BOWMAN: Gary, you said your new product is a level-load contract. Prior to ERISA, a number of companies had flexible premium annuities, though not with level loads. They had a very high first year load, with a smaller renewal load. I think ERISA has emphasized the competitive disadvantage of this type of product, so more companies are turning to either a level load or a much smaller first year load than previously used.

MR. JOHN M. BRAGG: The panel has discussed a product for the I.R.A. market called the Flexible Annuity. I would now like to describe an alternative product involving the use of a Retirement Deposit Account. This is in the form of a rider which is attached to a standard retirement annuity or endowment contract. The R.D.A. is a general account product. Deposits to it are flexible within certain prescribed limits. It carries a guaranteed interest rate such as 5% for 10 years, then 4% for the next 10 years, and 3½% thereafter. Excess interest is paid, as declared by the Company. At retirement, the R.D.A. proceeds are applied under the Settlement Option provisions of the basic contract to which it is attached. As a general rule, no commissions are paid on the R.D.A. deposits. The basic contract is the vehicle under which all commissions and expense margins are generated. The issuance rules require a basic policy of sufficient size that the package as a whole is viable.

The R.D.A. approach has certain advantages, such as the following:

1. The R.D.A. may be attached to a variety of "qualified" products, even including the Whole Life contract in the case of pension prototype business.

2. Since it is entirely separate, the R.D.A. can often be handled more simply under data processing systems.

3. The waiver of premium benefit can be readily made available under the basic contract, since it has a fixed level premium.

MR. JOHN A. HARTNEDY: There is a company using Jack's idea, and I wonder if anyone here has tried it, because I would like to know of any problems they have had. The company's approach is to tie the Retirement Deposit Account to an ordinary life plan and use it in the IRA market. The IRS, after receipt of the filing, has approved their right to sell this plan.

It appears to solve some of the problems Bill Bowman mentioned. The total contribution is fixed, but the mixture between the insurance policy and the retirement account can vary. The portion for insurance probably should be held to a maximum of 40 percent, since, for younger issue ages, roughly 60 to 70 percent of the total contribution must go to the retirement account to accumulate by age 70 to an amount at least equal to the face amount. We have experimented with this concept and find that problems arise with excess interest granted, at some issue ages and policy durations. For a time, the policyholder might contribute only to the life plan and still keep the plan qualified, but administration is a problem because of the above three factors.

We believe this approach will solve a problem I have heard mention of in Canada -- very poor persistency once the policyholder on a flexible premium annuity learns what banks can do for him. We need to deliver something that is mainly an insurance product and thus unique as compared to banks' products. Further, we should try to reach that portion of the market that needs some kind of insurance product in addition to a retirement type account. The idea of an insurance plan plus retirement account would give the insurance companies a unique package of benefits to offer, plus allow them to pay their agents full commissions on the life plan, to which they are accustomed, while paying virtually no commission on the side fund. Hopefully, this approach will appeal to both agents and customers.

MR. BOWMAN: In regard to the question of waiver of premium on a flexible premium annuity, we do offer it; when the policy is issued, it is written for a "normal" annual premium, and the flexibility is based on a certain percentage above and below that "normal" premium. The normal premium is the premium waived during disability.

MR. A. ALLAN GRUSON: With respect to the endowment contract and the idea that, with its fixed premiums, it is inflexible, I think it is important to consider the opposite situation --where the prospect becomes ineligible for an IRA through participation in another qualified plan. The level premium under the endowment contract becomes an excess contribution and, in effect, forces a lapse. This problem concerns us regarding the propriety of the endowment plan for IRA's, although we are still offering them.

MR. HERBERT N. BEILES: RRSP stands for Registered Retirement Savings Plan. They were introduced in Canada in 1957 and are intended primarily for self-employed individuals, although participants in a registered pension plan may participate in an RRSP. Originally, a participant, if not in a pension plan, could contribute the lesser of $2,500 or 10 percent of earned income, while members of pension plans were restricted to the lesser of $1,500 or 10 percent of earned income, less pension plan contributions. These limits have been increased to $4,000 from $2,500 and $2,500 from $1,500, as of 1972. Last week they were increased again in a Canadian budget. The limits now are $5,500 for self-employed, or $3,500 less pension contributions for those in a pension plan.

When RRSP's were introduced, all of the insurance companies began selling annual premium deferred annuity products and insurance options, since, in Canada, you are allowed to register the savings of any insurance contract. There is a regulation describing how to calculate this savings portion, so most insurance contracts in Canada are registered for tax savings. The characteristics of these early products were high/low commission scales, very low early cash values, fixed premiums, and the use of portfolio interest rates. The product was <u>not</u> very flexible, but the insurance companies still had most of the market, primarily because of lack of competition on the part of banks and trust companies. But in 1972, when the limits rose, the banks and trust companies entered the market with much advertising. Insurance companies began to feel the pinch and decided a change of ways was necessary to remain in this market.

The inflexibility of insurance contracts became apparent in pension plans. For example, a person contributing 5 percent of salary to a pension plan found his RRSP contributions decreasing as the salary increased, because of the RRSP limitations. This situation obviously would not function very well where the RRSP's are funded with fixed premium insurance products. Thus, Canadian insurers changed to products with more flexibility: level commissions, level front-end loads, flexible premiums, new money interest rates, side funds to receive employee contributions, and, as a new product, group contract RRSP's to reduce expenses.

MR. BRUCE E. NICKERSON: The most important current regulatory problem for IRA's is undoubtedly the proposed disclosure regulations which the Internal Revenue Service released for comment on April 6 of this year. These pro-

posed permanent regulations differ substantially from the temporary regulations which the IRS put into effect last November. While the temporary regulations were not perfect, most people seem to feel that they were basically sound. In contrast, the proposed permanent regulations involve a substantial amount of overkill.

Perhaps the loudest objections concern the removal of the seven day free look provision and the requirement that, with a few very limited exceptions, the disclosure material must be given to the prospective purchaser seven days before the sale is made. When combined with the specific information which must be disclosed -- information that depends on the insurance or annuity plan, age and sex of the policyholder, amount of contributions, etc. -- the effect would be to require the agent to visit the prospect at least three times in order to make an IRA sale: First, to interest the prospect and obtain the information necessary to complete the disclosure document; second, to deliver the disclosure information; and third, to take the application and put the policy in force. If, at some point in this process, the prospect should change his mind about the plan, or the amount of contributions, or if he should turn out to be a substandard risk, additional visits would be required. In any event, the prospect would have no protection against death, disability, or change in insurability during this required deferral period.

Insurance companies are not alone in objecting vigorously to this proposal and urging retention of the free-look alternative. For example, the banks may be even more unhappy. They have no salesmen and depend on "walk-in" business. They are far from overjoyed at the prospect of having to say, "We'd love to open your IRA account. Come back next week."

A second major problem for insurance companies is the proposed requirement for disclosure of the "charge" for sales commissions. In the case of most insurance company products, this "charge" is not only undefined in the regulation, but is undefinable. If the intention is that actual commissions be disclosed, the problems with this interpretation should be apparent to all of you. The information is irrelevant, since the purchaser is interested in the benefits that he will receive for his premiums. In many cases the information is worse than irrelevant; it is misleading. The total sales expenses, under policies of various companies, certainly do not relate directly to the value of the policies. Mortality, persistency and investment experience often have a far more direct bearing. But by focusing solely on the portion of the total sales costs which are determined as a percentage of premium -- that is, commission -- the distortion is magnified. A question of unfair competition also arises, since sellers of IRA products who do not incur commission expenses would not be required to make any disclosure concerning sales expenses.

There are a number of other problems with the proposed regulations. For example, the present language would require projections of dividends, rather than illustrations of current dividends. The requirement to include a specimen copy of the contract establishing the IRA as part of the disclosure material would appear to cause substantially more problems for insurance companies than for other sellers. In most cases, it would be technically impossible for an insurance company to illustrate the benefits that would arise from a level annual contribution of only one dollar.

Fortunately, these problems would become real only if the proposed regulations were actually adopted and made final. Although I have no "inside" information, I find it hard to believe that the IRS will not make substantial modifications in their final regulations.

So far, no major problems seem to have arisen under regulations actually in effect. There are some traps which need to be avoided. Particular care must be taken to avoid employer involvement -- or even active employer sponsorship -- since this would turn the IRA plan into an employee pension benefit subject to the Labor Department provisions of Title I of ERISA. At the least, this would create massive problems, and, for some types of IRA arrangements, I do not see how compliance would be possible.

There are a number of other potential areas for future regulatory -- or legislative -- activity affecting IRA's. The Federal Trade Commission and some state insurance departments have already expressed concern that some IRA advertising and marketing procedures may be misleading. Particular questions have been raised as to whether some companies are placing misleading emphasis on the rate of investment return credited on the net amount remaining after deductions for expenses, rather than on the effective return on the participant's gross payments. Questions have also been raised as to whether some marketers have placed undue emphasis on hypothetical illustrations, as opposed to guarantees (if any).

The competition in deferred annuities has become much more vigorous recently, and the IRA market has undoubtedly contributed to this. The use of high long-term interest guarantees has exposed substantial problems with the Standard Valuation Law, especially as applied to group annuities and flexible premium individual annuities. The lack of a standard nonforfeiture law for deferred annuities has also become a concern in many quarters. Since this subject was covered in Concurrent Session F* yesterday afternoon, I won't try to review the current activity this morning. However, the NAIC may well adopt a model annuity nonforfeiture law this December and hopes to adopt clearer and more suitable annuity valuation standards before the end of 1977.

MR. GARY G. GRAHAM: Form 5498 could be quite surprising to IRA participants because item four of that form, as we understand from contacts in Washington, is to be based on the actual contributions made to the plan. If you compare the actual contributions to the year-end accumulation, the accumulation will frequently be less than the contributions.

Another problem, as Bruce mentioned, is minimum nonforfeiture values for annuity contracts. About the clearest definition for annuity minimum cash values is contained in Section 408A of the Maryland Code. In many other areas, though, virtually nothing is defined.

Texas gave us difficulty in obtaining approval of a flexible premium retirement annuity contract. After agreeing to set up a deficiency reserve, we finally obtained approval of the contract. I do not agree with the terminology "deficiency reserves," but apparently Tennessee, Texas, and a few other states have used that nomenclature. What seems to be involved is an accumulation of the premiums to the maturity date based on the guaranteed interest rates. Our company's contract guarantees 6 percent in the first four policy years and 4 percent thereafter. Our net premiums are

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90 percent of the total premiums in each of the first four years, with 92½ percent as the net premium thereafter. Essentially, we are required, for deficiency reserve purposes, to apply to the cash values in the first four years a factor of 1.06 in the numerator, depending on the duration, and a factor of 1.04 in the denominator. Tennessee valuation regulations state this quite clearly; furthermore, Tennessee makes the point that their deficiency reserve requirement applies to all policies a company issues, not just those issued in Tennessee.

MR. ROBERT M. SMITHEN: In regard to problems with employer-sponsored IRA's, does anyone sell them, and, if so, are they using custodians? What success have they had in sales?

MR. BERNARD FENSTER: We have just started with employer-sponsored plans on a payroll deduction basis. They are individual contracts issued to employees not covered under another qualified pension plan. The employer sponsors the plan only to the extent that he allows employees to elect payment of contributions via payroll deduction, with the premium remitted directly to the insurance company.

Earlier, Bruce mentioned something that frightens me. For Title I of ERISA - are we in violation of something?

MR. NICKERSON: Not necessarily. You should take a careful look at the Labor Department regulations defining employee pension benefit plans and employee welfare benefit plans. As long as the employer's involvement is limited to making payroll deductions and not sponsoring the plan(in the sense of actively encouraging his employees to enroll), it generally appears to be acceptable. An employer may make the payroll deduction facility available without creating an employee pension benefit plan, but it would be best to check those sections of the rules carefully as to the extent an employer can go. It probably isn't very far.

I wish I had the regulations with me. As I recall it, the employer need not charge his expenses to administer payroll deduction. If he pays the expense charges for the plan, it is my understanding that the plan is then an employee pension benefit plan subject to reporting requirements, joint and survivor option requirements, prohibited transactions, etc.

MR. BEILES: Initially, Canadian advertising focused on the long-term nature of RRSP's and the objective of savings for retirement. Insurance companies used this approach in the early years of RRSP's, but, with the increased competition of the 1970's, they shifted their advertising to emphasize the immediate tax savings and high interest returns in the short term. Thus, the Canadian public began to see RRSP's as a short-term investment, and they became very disenchanted with insurance company products after noting the low cash values and general inflexibility.

The insurance industry, to avoid binding themselves, as it appears may happen to American insurers, decided on a policy of self-regulation. In September of 1974, the Canadian Life Insurance Association issued guidelines for insurance companies. These guidelines contain twelve recommendations, of which I shall mention several. First, insurers should deemphasize advertising tax aspects: do not mention tax savings and downplay tax

deferral as much as possible. Also, advertising should not contain mention of immediate deregistration, surrender, or withdrawal. Field forces are to be well-versed in RRSP regulations and related matters. Each participant should receive appropriate disclosure information, so that he is better advised on the program. An RRSP application should contain sufficient information to allow the insurer to financially underwrite the applicant and decide whether he should buy an RRSP, whether he can afford it, and whether he is paying an undue proportion of his salary into an RRSP, leading to an early termination. Insurers were instructed not to sell RRSP products differing only in commission scales. When insurers began offering segregated funds as options to individual RRSP policyholders in the late 1960's, certain provincial Securities Departments became concerned that the insurers were actually selling securities instead of insurance contracts. Note that in Canada the sale of securities requires a prospectus and a licensed salesman. Hence, regulations were issued to require insurers to file with the appropriate provincial Security Commission and, further, to give each policyholder a very detailed information folder describing the variability of funds as well as any contract with a guaranteed maturity value of at least 75 percent of the contributions, plus information concerning death benefits. These regulations do not apply to group contracts, since the employer is assumed to be more sophisticated and has the use of lawyers and accountants to aid in making his decisions.

Last week, a new budget was announced which contained something that is detrimental to insurance companies -- all Registered Retirement Savings Plan contracts in Canada must include a provision for the refund of a part or all of the contribution overpayments a participant might make until the year following the year in which notice of assessment is issued. The current rules allow a taxpayer to contribute more than the $4,000 limit to his RRSP, but he can only deduct up to the $4,000 limit. However, no taxes on the accumulation in the fund of <u>all</u> contributions are payable until the accumulation is removed from the fund. For many cases, this was very attractive for a participant as it far outweighed the disadvantages of non-deduction for contributions exceeding $4,000. Many taxpayers deliberately overcontributed, but now they must pay 1 percent per month tax on any contributions in excess of the current $5,500 limit. In addition to this new classification of "deliberate overcontributions," there is the group of participants who innocently overcontribute. This latter group contains people who contribute more than 20 percent of income without exceeding the $5,500 limit ($3,500 if in a qualified pension plan). He may have his money returned for a period up to two years after the contribution. Now insurance companies are directed to amend their contracts to allow such an individual to remove his money from the contract. If insurance is sold as an RRSP, and repayment of his contribution is required after two years because of an overpayment, what is to be done about the two years of insurance coverage he has enjoyed? Must all existing plans be amended? That would be an horrendous task. How are refunds to be made on fixed premium life insurance or annuity contracts? Are cash values changed? Is a new face amount calculated? Suppose the person is in more than one plan. Can he antiselect against the insurance company, perhaps by leaving the plan with the lowest rate of return? He might decide to leave the insured plan because he had free insurance coverage in retrospect. If his funds are segregated and he wants to surrender some of his units, then,

because of fluctuations, he may surrender more units than purchased. What is to be done about commissions paid on the policy? Contribution surrender values are also a problem. The above gives you just an idea of the problems arising from one apparently small change.

MR. NICKERSON: The United States IRA market has what I believe to be a very real tax trap. As I understand the law, if an individual contributes to an IRA during a calendar year but toward the end of the year ceases to be eligible for IRA participation, he is considered to have made improper contributions and is then subject to an excise tax. One possible solution is to have a monthly accumulation procedure outside of the IRA contract, with provision for placing the entire accumulation in the IRA at the end of December.

MR. SEE: Our next subject is taxation, a subject our discussions have already touched upon, although primarily from the policyholder's viewpoint. Let us now look at the taxation problem from the insurance company side. For flexible premium annuities, the first year interest guarantee may well depend upon the company's tax situation. For example, if the company is in a Phase II situation, then it should obtain full deduction of the interest as a dividend. For Phase I companies, those in Category 2, by audit guide standards, should be in an acceptable situation, but for companies in Category 1, an interest rate very much in excess of their current rate may present a problem. This is one reason why we used a separate account facility, although contributions are invested primarily in bonds, as opposed to stocks.

MR. GRAHAM: Our company is presently taxed on gain from operations rather than taxable investment income, because of losses on a number of A&H products and large life writings. We include the reserve on flexible premium annuities in Exhibit 8, Section B, including interest in excess of the guaranteed rate, since if we eventually are taxed based on taxable investment income, we will segregate the reserve for excess interest and treat it as a full interest expense deduction for tax purposes.

MR. BOWMAN: The general consensus at a taxation workshop I attended was that flexible premium annuities would be treated as pension reserves for tax purposes. The nature of guarantees in these contracts plus recent court decisions led workshop members to feel that the best approach was through pension reserve deductions.

MR. SEE: As I mentioned earlier, we developed a new product the latter part of 1974. It was considerably more competitive than anything else we had and we had immediate pressure from our field force to roll over existing business, particularly where competition was threatening.

What to do might be characterized as the debate of the century in our company. Be that as it may, we did the following:

1. Any Retirement Income policy or Annual Premium Deferred Annuity sold in the last twelve months could be converted to the new

policy with a complete reversal of all accounting entries or, in other words, a full application of all premiums paid.

2. Any existing contract beyond its first policy year could be surrendered and the proceeds applied to the new policy. We arranged a special commission schedule in which the first year commission was about one-third of the way from a renewal to a full first year commission.

During 1975, we had a rather traumatic experience as we watched some of our retirement income blocks disappear at the rate of 10% each three months.

Now that that is all past, the hot debate has changed from "Should we do it?" to "Should we have done it?"

I would be interested to know of any other panelists or members of the audience who have gone through this.

MR. NICKERSON: For policies more than twelve months old, was the transfer to a new policy made on a net basis?

MR. SEE: A charge was made, although it varied by the size of the roll-over amount. For amounts less than $1,000, the normal sales charge was made, with commissions adjusted to the group level, which are lower than those for individual contracts. Rollover amounts exceeding $1,000 were used to purchase single premium contracts, and thus embodied the full load charge.

MR. GRAHAM: The first problem with increases arises when a person's earnings have increased or decreased and thus the maximum contribution changes slightly since he is permitted to put in 15% of earnings up to $1,500. The problem is really no different than under Defined Contribution Pension Plans where small additional policies have to be issued, except under IRA the person should not be deprived of even the smallest amount of premium increase. If the insurance contract is a flexible premium contract, there should be no problem; however, if the retirement income endowment or fixed premium continuous annuity contract is used, then administrative problems may arise. Since infinitesimally small insurance contracts would be improper, additional monies should be held in an auxiliary fund for the client and applied to purchase additional annuity either under the annuity contract or settlement option. A second problem in connection with increases involves the payment of commissions. It is my feeling that in the development of the pricing of the contract the probability of increases should be taken into account, using assumptions that increases would be eligible for renewal commissions only. It would be possible to follow a course of action similar to group insurance where increases in premiums are paid first year commissions from the point in scale; however, because of the individual contracts and their relatively small size, this procedure probably would be more costly than its value. Moreover, history would advise us that there will be more chances of reduction in premiums over the years than increases, and increases will take on the appearance more of "drop-ins" rather than scheduled increases. Thus, the likelihood of material values being gained by recognizing first year commissions on increases would be more apparent than real. Lastly, since currently $1,500 is the maximum contribution, a great proportion of the IRA's issued will be

for the maximum where increases are not possible and, should the law be changed, more often than not the new maximum will cause the agent to write a new contract rather than apply the increased premium to the old, even though a flexible annuity contract is the insuring vehicle.

The maintenance of persistency figures can be a problem when increases occur. It is necessary to define the annual persistency rate which will be determined from your figures. For example, suppose there are two contracts of equal amount and one had a premium increase of 10% going into the second year and the other lapsed, is the persistency rate 50% or 55%? Our procedure is to recognize the contract for the amount of premium with which it entered the contract year and then for the ensuing contract year to recognize it at its changed amount. The problem here can be clarified with an example. Suppose the Company had a contract that had received a 10% increase and another that had continued into the second contract year without an increase, and at the end of the second year the contract which had an increase in the first year lapses at the end of the second year. How much premium lapses - the original amount, or the 110% of the original amount? The actuary establishing the premium rate or establishing the load factors for the flexible premium contract must define, for his data processing unit, the persistency rate to be developed by statistics and whether he wishes to have in addition an "increase or decrease" factor for his use. This is particularly important in pricing a contract where changing premiums might be expected, such as a 403-B (Teacher Business) where decreases very often occur at the end of the first contract year.

A last problem with respect to the recognition of increase or decrease occurs when the insurance vehicle has a loaded structure varying by contract year. For example, our contract has a 10% load during the first four years and a 7½% load thereafter. If your commission scale follows the loading structure and an increased premium comes in near the point of change in load or a contract is revived from an inactive status after the lower commissions go into effect, the Company has a problem of defining which contract year the revised premium must be associated with. Assuming, for example, that one of our contracts ceased paying premiums and became inactive midway during the contract year and revived one year later, is the premium received during the 4th calendar year after the issue date to be associated with the 5th contract year, or tacked on to the premium history which terminated during the 4th contract year? It makes a difference in the reserve value of the contract to the contract holder and the commission payment to the agent. We will be associating the premium payment with respect to the period of time since the issue date of the contract, regardless of the number of drop-out months.

MR. NICKERSON: IRA's present a problem since, from a government point of view, they are calendar-year products, while the insurance industry is oriented to policy year products. Suppose an individual purchases an IRA policy in late December and the next year makes his contribution a week or so earlier in December than in the previous year. I find it unconscionable to charge him a first year loading on both payments, even though they were received within one policy year. Certainly from the participant's standpoint the payments were made in separate years, since he undoubtedly attaches more significance to Internal Revenue Service calendar years than insurance company policy years.

MR. JAMES L. HARLIN: Our company has been in the annuity market since 1960 and has been selling flexible premium annuities since 1966. With respect to agents' commissions on increases, we have found that paying the agent a onetime bonus on the amount of the increase provides a sufficient incentive. Also the mechanics of paying this onetime increase are much simpler than other methods, such as treating the increase as a new policy would be treated.

On the question of persistency, we are currently measuring persistency in two ways: by contract, and by amount of original premium. We believe that both of these methods leave much to be desired, because they don't effectively measure the economic impact of increases as well as other special flexible premium annuity features. The LOMA EPAC Committee, which acts as a forum for annuity discussions, has recently been discussing some possible measures of flexible premium annuity persistency. This may someday be a source of information for resolving problems in this area.

On the problem of loadings, commissions, etc., by duration, we have recently developed a new contract which we believe overcomes many of the problems associated with conventional policy year changes. Our new contract's loading and commission structure varies by amount of consideration paid, instead of policy duration. The table illustrates a loading structure.

Consideration	Loading %
$ 0 - 1,000	7½%
1,001 - 5,000	6
5,001 - 10,000	4
10,001 and up	2

This method removes the incentive by agents to get increased considerations in the first policy year in order to get larger commissions since his commission rate will change by the amount of consideration paid.

This loading structure does present several problems in the methods and procedures of processing.

MR. STEPHEN C. CARLSON: In response to Bruce Nickerson's comment, we felt the problem was potentially very serious. We arrived at the following solution. If the premium payment mode is annual, semiannual, or quarterly, date the policy using the first of that calendar year; if the policy was paid via check-o-matic or payroll deduction, date the policy on a regular basis. Also, the application contains a figure for the anticipated annual premium, and if the contribution exceeds that anticipated premium, the load shifts to another category.

MR. HARTNEDY: I believe Georgia is the state with a limit on renewal years' loads. Thus, unless the load is very small and first-year loads are paid on increases, a problem exists in at least one state, where the renewal load is subject to a maximum amount. Several other states allow extra loads on increases.

We pay first-year commissions and, hence, assess a first-year load, only on the first $1,500 of contribution. This is an obvious disadvantage for

anyone intending to contribute some lower amount per year. As yet, we have not solved that problem in relation to what Bruce Nickerson mentioned recently.

We date policies when they are issued, but we consider the first renewal year to occur on January 1, and we pay a first-year load on any premium in a policy year that exceeds the highest premium paid in any prior year. Note that the policy year is now equivalent to the calendar year. Our experience with this method has been such that we are seriously considering a return to regular policy dating. We have had many problems with administration of a January 1st anniversary date. Also, our agents expect first-year commissions during the first twelve month period.

MR. ARTHUR B. LINCOLN: We have marketed flexible premium annuities for many years. We handle the problem of increases by carrying a double record --the highest premium in any prior year and the current cumulative total. Whenever the cumulative total exceeds the highest premium of any prior year, then a commission, at the first-year rate, is paid on the increase. Since the commission rates are graded by duration, the increase must be measured from the year of the increase to obtain the correct duration for the commission. As for the problem of year of receipt of contribution, we use a double date situation --a contract date and succeeding anniversaries to govern the contract year, and an effective date to reflect the date contributions are received and credited. Thus, a policyholder may pay the first premium of the second contract year while in the first year. Interest is credited as of payment date, but commissions and loads are considered to be in the second year.

MR. BEILES: The following discussion refers mainly to Registered Retirement Savings Plans since they have been in existence for a number of years and there is, therefore, more experience to draw upon. IRA's will more than likely evolve the same way.

RRSP's were first authorized by the Canadian Income Tax Act in 1957. The prime objective was to enable self-employed persons to make tax-deductible contributions to their own individual pension plans. Even though many employees were participants in registered pension plans, they were also permitted to establish their own RRSP's within defined limits.

The Act states that RRSP's may be issued by:

(a) insurance companies that are licensed to carry on an annuity business in Canada,

(b) Canadian Trust Companies,

(c) certain investment companies, and

(d) the Annuities Branch of the Unemployment Insurance Commission.

Banks offer RRSP's by trusteeing them with an authorized Canadian trust company. Initially, RRSP's were regarded primarily as long-term arrangements to provide retirement income. For nearly 15 years the RRSP business was sold mainly by insurance companies that issued mostly conventional individual retirement annuity products. The characteristics of these early

contracts were high/low commission scales, low early cash values, fixed premiums, and portfolio rates of return rather than new money. The trust companies and banks were not very interested in this market until 1972 when tax reform increased the contribution limits. It then became possible for an individual to contribute the lesser of $4,000 and 20% of earned income if he were not a member of a pension plan, or the lesser of $2,500 and 20% of earned income less pension plan contributions if he were covered under a pension plan. With this change, trust companies and banks intensified their marketing and the competition was accelerated by:

(1) a massive advertising campaign, particularly by the financial institutions operating without commissioned agents, and

(2) tax-free rollover provisions in the Income Tax Act permitting transfer of funds from one RRSP to another RRSP.

The great race for RRSP business was on! Sales soared. The emphasis from the non-insurance institutions was on short-term high rates of return, "no load" funds, and immediate tax savings (there is no excise tax on surrender). Since trust companies and banks cannot offer guarantees on future contributions, and since unlimited rollovers are allowed, the sales thrust was on short-term one-shot type contracts. If the policyholder was dissatisfied with the results, he always had the option of transferring his account to another RRSP carrier. Naturally, the traditional insurance company products with front-end loads, relatively high commission, and low early cash values could not compete in this market. The insurance companies were therefore forced to make major changes and began to introduce contracts with flexible premiums, low front-end loads, and segregated fund options. Commissions were reduced and normally paid on a level scale. In addition, insurance companies began marketing RRSP's on a group basis in order to reduce expenses.

Trust companies and banks were emphasizing the fact that they pay no commission and that therefore they had no load. In actual fact, expenses are normally recovered through a management fee of approximately 3/4 of 1% per annum. The insurance companies, on the other hand, were stressing that RRSP's are complex and should therefore be purchased from experts in this field. They emphasized that the small commission paid to this "expert" was well worth the cost. The insurance companies also tried to accentuate the fact that RRSP's were primarily for retirement savings rather than short-term investment or an immediate tax saving.

Under the Canadian Income Tax Act, interest on a loan is tax-deductible only if the loan is made for the purpose of producing investment income. Recently the Income Tax Act was amended in order to allow money borrowed to invest in an RRSP as specifically included in this category so that the interest paid is tax-deductible. Banks were therefore able to lend money to clients for investment in one of their own RRSP products and normally very favourable loan terms could be negotiated under these arrangements. The banks have therefore managed to capture a significant portion of the RRSP market.

The Canadian Income Tax Act was also amended in 1974 to allow a taxpayer to contribute up to the maximum limit towards an RRSP for the benefit

of his spouse. Any such contributions are deductible from his own income for tax purposes but the benefits when paid are included in the spouse's income. This added fuel to the short-term immediate tax savings philosophy which most non-insured institutions were pursuing.

Figures recently published show that life insurance companies during 1974 captured approximately 40% of total RRSP sales, while in 1962 the percentage was 57%. This decrease was due mainly to the recent sales thrust of the trust companies and banks.

In the U.S. the banks and savings and loans are also competing strongly for the IRA dollar. The relatively lower deductible amounts and the restriction that an individual cannot also be a member of a pension plan tends to minimize IRA's relative importance as a universal savings vehicle. Also, the 10% excise tax on early surrender and the limit of one tax-free rollover every 3 years keeps individuals from using IRA as an immediate tax-saving gimmick. However, insurance companies are feeling the competitive pressure from the non-insurance type organizations, and it is not uncommon to be projecting cash values on flexible premium annuities at rates of 8% or higher. Increasing the $1,500 limit and allowing pension plan participants also to establish an IRA have already been recommended in testimony before Congress and, when this happens, we can expect the same boom that occurred in Canada.

ERISA UPDATE--INSURED PENSION PLANS

Topics Discussed:

1. Enrolled actuary - more valuable than FSA?

2. Position of Academy.

3. Funding assumptions.

4. Actuarial certification.

5. Special valuation problems.