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INDIVIDUAL TAX QUALIFIED PRODUCTS

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1. Regulatory developments
2. What products are being used?
3. What is the effect of the current volatile money market on product design?
4. Variations in assumptions and results by market
5. Spouse IRA

MR. VERNE J. ARENDS: The individual insurance and annuity contract is the natural funding product for the small tax qualified plan--pension, profit-sharing, tax sheltered annuities, individual retirement accounts and H.R.10. In many small cases it is the only product which can be effectively used. ERISA has brought more trouble to small plans--both those in effect on the memorable day of ERISA's birth, September 2, 1974, and new plans formed by small employers since its natal day.

Survival and expansion of the small plan is important. About 40 million workers are not yet covered by a private employee benefit plan. Most of that number work for small employers. Discouraged by the complications and demands of ERISA, many small employers are terminating their plans, and many others are refusing to create new plans. If the private sector does not do a better job of covering the uncovered, the Social Security expansionists will win their battle. Or Congress will seriously consider mandating a second tier of coverage for all employers--a sort of Social Security II.

It is my hope that the regulation writers, aware of this problem affecting small plans, will do right by the little fellow and simplify as much as possible the requirements for reporting, disclosing and record keeping. It may be necessary in the end to make changes in the statute. As Don Alexander, former Commissioner of the Internal Revenue Service (IRS), said recently, "Congress created the problem by the precise and demanding language of ERISA, and it may take Congress to cure the problem...Some of it cannot be solved administratively." Al Lurie of the IRS echoed Alexander's statement: "A complete cure for the small plan problems cannot happen without statute changes."

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Until that day, however, we have to do what we can to guide the regulators into reasonable conclusions so that the small plan will continue to live and grow. The future of the private pension system depends to a large degree on the subsequent coverage of the uncovered. Reasonable men can make rules which, though they seem to bend the statute a bit, will not break it. The probability of accomplishing that goal is great if each of us uses his influence and persuasive powers in the right places at the right time. The right time is now. And one of the right places is the office of Burt Lance, Officer of Management and Budget. You will remember that President Carter has said publicly a number of times that he wants to streamline the administration of government, reduce the bodies, the committees, etc. ERISA could be an example--a starting place--to show that this desire to streamline is real and to cure the dual jurisdiction problem we all face between the Department of Labor (DOL) and IRS in the administration of ERISA. If we can convince Mr. Lance, for example, that either a super agency placed in one of the existing departments or a new department consolidating the efforts of DOL, IRS and the Pension Benefit Guarantee Corporation (PBGC) would be a front-page example of streamlining government, we might get some help from him on that part of our goal.

About regulatory developments, I will speak according to the latest information received during a phone conversation this afternoon with appropriate friends in Carter country. The first regulatory item of interest to the insurance business is the class exemption request that was filed with DOL and IRS on behalf of the American Council of Life Insurance (ACLI), the National Association of Life Underwriters and the Association of Advanced Life Underwriters. We recognize that the law, as written, makes most life insurance salesmen fiduciaries. As fiduciaries, if they recommend the funding of a pension plan with insurance policies, sell them to do that and collect commissions, they engage in a prohibited transaction and are subject to a 5% penalty tax. And if they do not correct the problem within X days after somebody said "you violated that law", they pay a second tax of 100%. Somebody who is not an actuary told me that if you sell a lot of policies under those conditions and pay 105% tax on the commissions you get, you will not make any money. On top of that, the insurance company in paying the commissions is engaging in a prohibited transaction under the law. So we said to DOL and IRS two things:

1. Please rule that in certain situations if the agent sells the policies in a certain manner, he is not a fiduciary. We would like this rule to cover the average agent.

2. If he is a fiduciary because of the language of the law, exempt him from the penalties if he makes his sale or proposal in a certain way.

They did issue a proposed exemption which was quite disturbing to the insurance industry. It said that if an agent sells policies in this manner, discloses this information, maintains these records, etc., he will be exempt from the prohibited transaction penalty. But the preamble to the exemption

indicates that the agent and/or the plan administrator may breach the fiduciary rules of ERISA even though he discloses everything the way the exemption says it should be disclosed, if, after disclosing it, he recommends the use of individual policies to fund the plan when similar benefits could be provided at a lower cost (i.e., lower premium) through a group product. In testimony the individual insurance industry said that statement was unfair. Our group insurance brothers will agree that there are differences between the group product and the individual policy product other than the premium. But the ruling implies with such an unqualified statement that if the premium is less, group insurance must be sold, regardless of other differences such as less complete guarantees.

The ruling may become a deterrent to the advancement of small pension plans, because the agent who has never sold pension business will decide to stay away because it is too complicated. And disclosure of commissions at the point of sale is going to be a questionable thing and disturbing to many agents. A number of insurance companies and the ACLI have agreed that, if we conclude that the final exemption is substantially unacceptable, we will present to the Senate and House drafts of provisions to change ERISA to remove some of these fiduciary and prohibited transaction problems. The final exemption ruling is expected soon.

The second item is the master prototype program at the national IRS office. Defined benefit plans have not been started yet because they are at the bottom of the pile in chronological order. The IRS is still working on the deluge of defined contribution plans they have received. Mr. Lurie hopes to speed up action soon and to start on defined benefit submissions. There are many unanswered defined benefit questions with which the IRS will not know how to deal when they first see them. Recently the IRS indicated that they were going to start a new system of taking cursory looks at some of these submissions and issuing approval letters with caveats that they may look more thoroughly later and require changes. And they are cutting down discussions with people who made submissions. They intend to start shipping every plan back to the sponsor with a statement of deficiencies and instructions for modification. Several people have received that kind of statement of deficiency.

The third item is the annuity rate problem in insurance contract plans. ERISA provides that if a defined benefit plan is fully insured (where insurance contracts with level premiums and guaranteed values are purchased to completely fund the plan, where premiums are paid to date and there are no outstanding policy loans or assignments) it will automatically satisfy the funding section of the law. Furthermore, such a plan need not be concerned about ERISA's three methods of determining the accrued benefit. The accrued benefit is automatically the cash value of the contract. These two provisions are a blessing to the small plan. But suddenly, we found a serious problem in that "blessing". The House bill and the Senate bill both contained this provision. Then the Compromise Committee introduced the concept of limits on contributions and limits on benefits, without recognizing that that concept

might affect other provisions of the plan. That is where we suddenly got into trouble. Suppose you have a fully-insured defined benefit plan with retirement income or retirement annuity policies. You fund toward the guaranteed rate of the contract to give a participant a $100 pension at age 65. When the participant reaches 65, you find that the current annuity rate of the insurance company is better than the contract rate. So the maturity value that was accumulated to pay a $100 a month will pay $125 under the current annuity rate. We were concerned that the plan's benefit might not be considered "definitely determinable" and thus not a defined benefit plan. Then we realized that we had Section 415 limitations and Social Security integration problems.

So the insurance industry consulted the IRS. By telephone the IRS has told us not to worry about "definitely determinable". They are not going to make an issue on that. But they declined to give a written statement to the question until they have found the answers to the two corollary problems, i.e., Section 415 limitations and Social Security integration. Just 10 days ago we sent two recommended procedures to the IRS. Regarding Section 415 limits, we recommended a regulation that if the maturity value of the contract, because of the current rate factors at retirement, will pay a pension greater than the Section 415 limit, you pay only the Section 415 limit and use the excess maturity value to reduce the employer's cost of the plan. Under that system you would make a calculation only at the point of distribution. If the current rate would give a participant $90,000 pension, the plan may only give him $84,000 and use the remaining value to reduce the cost of the plan. Regarding Social Security integration, we recommended a simple rule of thumb that the integration rules are not violated if the pension provided in an integrated defined benefit plan under the contract rate will not be exceeded by 20 percent because of the current rate.

The fourth item is commission and fee disclosure in Schedule A, Form 5500 series. We have said that there ought to be consistency between the various ways in which we are asked for commission disclosure. Currently the Individual Retirement Annuity (IRA) disclosure, the agent's exemption and the Schedule A all require disclosure in different ways. They are still working on that, and we may see that in Schedule A ultimately.

Fifth, there is a request pending for a class exemption that would permit a pension plan to sell a policy it owns to a terminating employee without being a prohibited transaction. This exemption would also permit the participant to sell the policy to the plan without being in violation. The exemption has been issued on a proposed basis, and a final version should come out soon.

Sixth, the dual jurisdiction of ERISA by DOL and the IRS is now known to be a major problem. There are two bills pending. The Dent-Ehrlenborn bill would establish a super agency with complete control of ERISA. But it is difficult to believe that the tax decision-making can be taken out of the IRS. The Benson bill, on the other hand, would retain dual jurisdiction as it is,

but divide the items that are being jurisdicted between the two departments. Each would have unilateral responsibility for its area of jurisdiction. Something will happen one of these days, and it may take legislation. But, if there is substantial change in the administration of ERISA, we may be very sorry. We will have to start doing everything over again with a whole new bunch of people. Our clients will incur extra cost in problems. As the men who are administering ERISA now become more reasonable, cooperative and understanding, we may find that we can live with it the way it is.

Seventh, we are still waiting for H.R. 10 defined benefit regulations. On April 22 the IRS said the regulations are going to come out very soon. As of today, nothing further has been heard.

The eighth item is IRA. Something will have to be done about Forms 5498 and 5329. The 1976 tax reform law allows a person to contribute to an IRA within 45 days after the close of his taxable year and still deduct it for the taxable year. But according to the 5498 rules we must have the 5498 in his hands by January 31. Rule changes will have to come, and I am optimistic that they will minimize the problems rather than maximize them.

Regarding IRA, someday in the not-too-distant future Congress will realize that IRA has been a deterrent to the expansion of the private pension system because it gives to self-employed people who otherwise would use H.R. 10 and include an employee or two the opportunity to set up an IRA and exclude the employees. Many H.R. 10 plans are terminating and being replaced with IRA. When IRA was first introduced by the Treasury Department in 1969, the initial bill did not permit self-employed to use IRA. Perhaps an amendment someday will return to that concept.

Also regarding IRA, the Federal Trade Commission (FTC) has scientifically selected 1600 persons who purchased IRA's in 1976 to whom they will send a lengthy questionnaire to find out how IRA is being marketed. The insurance industry had a chance to see the questionnaire through the Office of Management and Budget and had many comments about the tone and the content of the questions. The questionnaire puts life insurance salesmen in a particularly bad light. As of this afternoon, the 1600 questionnaires have not been mailed.

Ninth, the PBGC recently issued proposed regulations on the treatment of individual policies at plan termination. Its requirement that non-participating annuities be distributed to terminating people is very disturbing. My concern was somewhat relieved in a meeting I attended with PBGC representatives. I asked three specific questions. First, if the vested interest of a terminating employee is given to him in the form of an insurance or annuity policy and the plan is later terminated, will the PBGC claim an interest in any part of the policy? Their answer was a clear and distinct "No". By the distribution of the policy on employment termination, participating or non-participating, the plan administrator has purchased an irrevocable commitment from the insurer and its values are not to be included in the value of the plan's assets.

Second, if a policy is part of the settlement with a retiring employee and the plan is later terminated, will the PBGC claim an interest in any part of the policy? "No" was the answer. An irrevocable commitment has been made by the insurer, and the values of the policy are not a part of the plan's assets. If the 3-year rule applies, recourse by the PBGC is directly to the employee, not through the insurer. Third, if a plan terminates and the insurer is not in a position to convert participating policies to non-participating policies before making the distribution, what will the plan administrator do? The PBGC representatives said that in such a case the administrator would have to surrender the policies for their cash value and purchase non-participating annuities from another insurer or PBGC.

MR. GILBERT V.I. FITZHUGH: Prudential has a flexible purchase payment retirement annuity which, in most respects, is like those offered by many other companies in the qualified market. There is a moderate load on each payment. The loads are downscaled by size within each contract year but are no higher, for a given level of consideration, in the first year than in later years.

The contract is designed to pay the same level of commissions in each contract year. However, in markets where we anticipate stable contributions, we will heap the commissions in the first year. We partially recapture heaped commissions if the first-year scheduled consideration is not maintained throughout the second year. The client may pay, within broad limits, whatever he wants whenever he wants. He may skip contributions, perhaps for several years in a row, and then resume them at the same or a different level.

When the contract first came out, we guaranteed 3% interest on the net considerations to the maturity of the contract. We subsequently increased this guarantee to 4% until the contract anniversary in 1997 and 3% thereafter.

In the 1975 announcement letter to our field force, we said: "Net purchase payments, after all charges, are guaranteed a return of 3% from the date the payment is received in the Home Office. However, the favorable yields currently available permit a total rate of 7 1/2% to be paid in 1975. Although our dividend illustrations are based on a 7 1/2% return to retirement, the rate of interest available from new investments does change from time to time. Corporations which negotiate long term loans from Prudential generally repay their loan in installments over many years. When Prudential reinvests these installments, the prevailing rate of interest may be higher or lower than the rate at which the investment was first made. We expect our dividend scales in future years to reflect these changing patterns of available interest rates."

What we have given our field force is a good faith statement of intent, but not an iron-clad promise. Our contract simply says that it will participate in dividends as they may be declared by our board of directors. However, we do currently operate our flexible annuity as a new-money contract in that we vary the dividend payable in any year according to the year in which the

funds generating the dividend were contributed, and we intend to continue to do so. Dividend rates are based in part on the historical investment experience of the monies we have already received, and in part on our estimates of the yields we will realize on monies we have not yet received. Part of the reason for the difference between our earned rate on new investments and our flexible annuity dividends is that we must allow for investment anti-selection which exceeds our expectations. Finally, dividends may not always be declared in the form of a higher yield alone. Over time, they will also reflect traditional items of profit and loss other than interest, such as lapses and expenses. We have never had a flexible annuity before, so we do not know whether our persistency will be comparable to that of fixed-premium products, and we do not know what qualified business will look like when ERISA finally settles down. Declaring only extra-yield dividends seems reasonable while we wait for experience to emerge.

When we introduced this contract late in 1975, based on model office analyses of costs and prevailing new money rates, we declared a dividend to be paid at the end of 1975 resulting in a total yield on net considerations of 7 1/2%. At the end of 1975, we were faced with the problem of declaring a dividend rate to be paid at the end of 1976 on both 1975 and 1976 contributions. The latter, of course, had not been received yet and would be invested at rates still unknown. Interest rates were rising, but we did not know how high they would go. In the face of considerable uncertainty, we decided on a total yield of 7 1/2% on net considerations received in 1975 and 7 3/4% on net considerations received in 1976.

At the end of 1976, we had to declare dividends for 1977. We now had the benefit of complete hindsight with respect to the 1975 contributions. Any 1975 money in short term temporary securities had long since been rolled over into permanent investments at rates which we could determine. Since we had underestimated the yield we would actually get on 1975 contributions, we increased the total rate paid in 1977 on 1975 net considerations from 7 1/2% to 8%. The picture on 1976 contributions was less clear. Yields realized on funds already permanently invested looked significantly better than what we had forecast. On the other hand, rates were softening. We knew we would get additional money late in 1976 which would not find a permanent long-term investment home until the spring of 1977. On balance, we decided we could safely pay 7 7/8% in 1977 on 1976 contributions. Finally, we had to declare dividends to be paid in 1977 on 1977 contributions. This rate is of great interest to the field because it is reflected in dividend illustrations. Again in the face of great uncertainty, using our economists' forecasts and our judgment, we decided that we could safely pay 7 1/2% in 1977 on 1977 net considerations. We know of course, although we hope not to have to use the fact, that we can change the rate credited to 1977 money in future years if history proves us to have been bad forecasters.

Determining the rate to be credited to contributions made in past years introduces concepts familiar to people in the group pension field but quite new to us in the individual product field. Here are some of the things we ultimately must be able to do:

1. We must keep track of the mix of investments applicable to the flexible annuity branch. Not all of our branches of business share equally in, say, ownership of subsidiaries.

2. We must measure the effect of short term investments in the year a consideration is received. In the latter part of 1976, Prudential had about $1 billion invested in short term securities. Since the company invested about $4 billion in 1976, it appears that new considerations sit around in relatively low-yielding securities for an average of three months before we can find a high-yielding long-term place to put them. Considerations on small qualified business are very heavily skewed toward the end of the calendar year and are not put into long-term securities until the following year.

   As a very general rule, therefore, money will earn a lower rate in the year it is contributed than in the following year.

3. We must learn what the average long-term was when the flexible annuity considerations were finally invested in long-term securities.

4. We have to measure the effect of reinvestment. To date, because we have only three years' invested funds in the branch, this has not been a major problem.

We believe there are good reasons to settle for judgment and reasonable approximations at this stage in the development of our flexible annuities. For one thing, we have to declare dividends in advance. Obviously, this need limits the usefulness of precise methods for the first year or two after a contribution is made. Next, our flexible annuity portfolio to date totals about $120 million. It will be rare for a client in this market to develop equity of more than a very few tens of thousands of dollars. Most will be far smaller. The difference between, say, 7.43% and 7.47% on a single year's contributions does not amount to very much. The dividend reflects items other than interest, many of which are evaluated on the basis of judgment of trends and cannot possibly be measured to two-place accuracy. Nevertheless, as our individual flexible annuity portfolio gets larger, we will further refine our methods so as to have as accurate a fix as possible on exactly what interest earnings are attributable to contributions received in various years.

Another problem with a new-money annuity is how to minimize investment anti-selection. Obviously, if a company pays 7 1/2% on existing money, interest rates on new investments soar to 10% and annuitants have the right to surrender at par, the company might wind up in trouble.

Our contract permits one partial withdrawal, at par, from cash value per contract year without our consent. The contract may be surrendered outright at par. For dividend purposes, we assume that partial withdrawals are made on a last-in, first-out basis to minimize the probable discrepancy

between the yield underlying the dividend rate and the yield available on currently available alternative investments.

In our most sophisticated markets, there is some investment selection against us. In fact, some agents sell minimum deposit by illustrating arbitrage. However, the vast bulk of our policyholders do not make the effort, for example, to borrow 5% money and put it in bank certificates of deposit at 7 1/4%.

It was our initial intent to limit the sale of flexible annuities to IRA's, tax deferred annuities, and very simple prototype pension plans whose investments would be entirely in Prudential. Selective withdrawals from qualified products of this type are generally difficult. An IRA annuitant can roll money over, but in practice we do not think very many will do it. It is probably even harder to switch from one tax deferred annuity to another because of the interposition of the school board or other institutional employer. In the small pension market, if the prototype plan specifies that the investments are in the sponsor's insurance policies and annuities, where else is the annuitant going to go?

An entirely different problem arises if the annuity is sold to a pension plan whose trustee is authorized to use an outside side fund. These trustees are generally bankers or other people with a high degree of expertise. ERISA requires them to apply the standards of a prudent professional. Any banker in this position would be almost honor bound to suggest a transfer of flexible annuity assets to something with more yield if the transfer could be made at or close to par. If you want to sell new-money flexible annuities to these plans, you can minimize investment anti-selection by modifying the partial withdrawal provision to permit a withdrawal in any contract year of no more than some percentage of the cash value. This lets the trustee make a gradual transfer of funds from the annuity to his outside investments, while preventing him from moving out money at one fell swoop because he is attracted to higher interest rates somewhere else. To keep him from taking an end run around the partial withdrawal provision, it is important to restrict cash surrenders, too, while the participant remains in the plan.

Finally, we made the judgment that it would not be sound or equitable to continue to offer, in qualified markets, an annuity based on portfolio average earnings as well as our new flexible purchase payment annuity. Accordingly, we withdrew our fixed-purchase-payment retirement annuity from the qualified market. We permit anyone who has such a contract to exchange it for a flexible annuity and transfer the cash value without additional fees or loadings. As a guide for our agents, we have computed the durations of existing annuities, based on current dividend scales, at which such a transfer is expected to be to the annuitant's advantage.

MR. O. DAVID GREEN III: There have been two surveys within the past year concerning products in the IRA market. The first of these was conducted by Mr. John Fritz of Booz, Allen. This review was limited to 70 companies,

60 of which responded. The second survey was conducted by the Life Office Management Association (LOMA) and pertains solely to flexible premium annuities. The LOMA report is dated May, 1977.

IRA's have been with us for just 31 months. The common product vehicles being marketed under this title are not new however. There are four products generally offered: annual premium deferred annuities, retirement income and retirement endowment policies, flexible premium annuities, and variable annuities. Among the 60 respondents in Mr. Fritz's survey, there are a total of 92 different products available. Slightly over one-half (47) are flexible premium annuities and slightly less than another third (27) are of the insurance variety. The remainder are equally distributed between variable annuities and annual premium deferred annuities. The different products seem to reflect the different marketing thrusts of the individual companies.

The annual premium deferred annuity is a holdover from the early days of providing money for retirement without the attendant cost of accompanying life insurance. Its adaptation to the IRA market is quick and easy. However, the annuity nonforfeiture law being adopted by various states will require changes by some companies which provide low early cash values. One company in the survey has a first-year cash value of only 10% of the first-year premium.

Another product that required little change to enable a company to compete in the IRA market is the retirement income or retirement endowment policy. This product has a lower first-year cash value than the annual premium deferred annuity. The first-year commission is higher, of course.

The flexible premium annuity and the variable annuity are products of the late 1960's. Both were made possible by sophisticated computer systems without which the valuation of these forms would be nearly impossible. The inherent disadvantage behind the flexible premium annuity is that a policyholder may slip in funding his own retirement program. That there are many administrative problems associated with this form is well borne out in the LOMA survey.

The appeal of variable annuities should be limited to both the well informed and trained agent and the knowledgeable buyer. Not too surprisingly, of the nine companies offering a variable annuity in the IRA market, eight have other products which are available to IRA prospects.

Virtually all of the annual premium deferred annuities, variable annuities and insurance products have an accompanying waiver of premium disability rider. However, only about one-half of the flexible premium annuities have such a rider. Where a disability rider is available with the flexible premium annuity, most of the companies base the disability benefit on the average annuity premiums received over a finite period prior to disablement. Some other companies limit the disability benefit to the annualized premium at the time the annuity was issued with further provisions concerning continuance of premium payments since the date of issue.

The guaranteed settlement option rates in all of the 92 products fall within a moderate range. For a male age 65 with payments guaranteed for ten years certain and life thereafter, the average settlement option ranges from $6.38 for the insurance products to $6.58 for the annual premium deferred annuity products.

Current settlement option rates paint an entirely different picture. While the average values by product type are very similar, the range of values is extensive. For example, among the 27 insurance products, one can find the current settlement option rate, per $1,000 of proceeds, for a male age 65 - again with 120 payments certain and life thereafter - as low as $6.21 and as high as $9.03. The range is $6.57 to $9.17 for the flexible premium annuities. The rationale behind these low values is hard to say. Perhaps some companies find the profits in their products to be terribly slim and are attempting to generate additional profits at that time in the contract's life when competition plays a less significant role.

Turning to other assumptions within the individual products, we find quite a variety among the 92 different plans. Assumed first-year lapse rates range from something less than 10% to 35% and even higher. Minimum policy sizes range upward from $100 annual premium in the case of the annual premium deferred annuity, upward from $15 per premium payment in the case of the flexible premium annuity and upward from $1,000 face amount in the insurance products.

Thus far, data on lapse experience is sketchy. Among companies with whom I corresponded, first-year lapse rates were as low as 1% for variable annuities and as high as 50% for a retirement endowment policy. First-year lapse rates do decline with advancing age at issue. I concur with one company in the belief that the lapse rate will decrease somewhat after the IRA becomes more familiar to the public, particularly as we wean out persons who are actually ineligible for IRA before their contracts are issued.

Among those companies issuing annual premium deferred annuities, the average premium size ranges from $780 to $1,500. The average premium on the insurance products ranges from $647 to $1,200; a similar range ($687 - $1,200) has been observed in the variable annuity area. For the flexible premium annuities, the average annual premium range is from $610 to $2,300.

The future of IRA sounds like a quotation from the Bible: "The government giveth and the government taketh away". I do not expect the federal government to take any action which will reduce the sale of IRA's. We have already seen several liberalizations in the IRA market: spousal IRA's, and the extension of sales to certain volunteer fire fighters and members of armed forces units who serve 90 days or less on active duty in a given year. Further extension is likely. It should be noted that spousal IRA's are not being met with great success. The primary concern is that the maximum contribution with respect to each spouse is not large enough to either fund a reasonable

retirement program or reward the agent for the added work in completing the sale.

Among likely changes in IRA is an increase in the maximum allowable contribution per year. The increase will be at least enough to offset the value loss of prior contributions due to inflation.

Not all of the changes are beneficial to the insurance industry. Beginning on July 1, 1977, amended Regulation Q of the Federal Reserve Board becomes effective. This establishes a new category of time deposit accounts which will permit banks to pay maximum interest rates up to 7 3/4% for consumer-type time deposits to savers in Individual Retirement Accounts. This is a significant change. Among those companies answering the question on current interest rates about their flexible premium annuities, only 11 rates were in excess of this rate. True, these are the current interest rates of a year ago, but in the ensuing time there has been little or no improvement in new money yields. This higher rate will require the industry to tighten its belt. I do not foresee the agent being willing to take a reduced commission.

Because IRA is relatively new, the introduction of new-money pricing in this area will be accepted without much criticism. One of the strongest arguments offered by the consumerist organizations against this concept in life insurance is that the rules would be changed during the middle of the game. This is not the case with IRA.

Another area of concern is the disclosure requirements. These are most burdensome for agents to complete and certainly troublesome in getting the correct figures. This complicates the administrative handling of the IRA plans. Not to be overlooked is the problem of changing disclosure regulations.

The revised standard nonforfeiture and valuation laws apply to the retirement income and retirement endowment policies being marketed. Certainly unit gross premiums are going to be lowered for these products. But will this be entirely satisfactory? Will we not see a lower aggregate first year cash value because (1) a higher interest rate will be assumed and (2) the products will be priced to include our ever-increasing operating costs?

Several companies feel that they have not really begun to tap the IRA market. We must double our efforts to acquire this business lest we lose it to the continually-increasing force from outside financial organizations including banks, trust companies and mutual funds. IRA's in other financial organizations cannot provide the certainty of a retirement income for life. This and the total service in financial planning must be two of our strong offenses when competing for public's retirement dollars. Unless the industry moves to meet this increased competition, our effective participation in this market will eventually be limited to a few companies that have developed separate

marketing organizations with special products, special marketing techniques and adequate compensation programs.

MR. ROBERT J. INGRAM: For the flexible premium annuities at my company, we measure case persistency and premium-payment persistency. We find a good case persistency of about 94%. But preliminary results indicate that our premium-payment persistency is only 80% to 85%. What are other companies experiencing?

MR. FITZHUGH: We do not know yet. But in the course of determining what experience we will have, there are two considerations. One is that because of our recapture arrangement on our flexible annuities, we can look at the policies as a percentage of the total issued for which contributions decline in the second year. The other is that if we study the profitability of a block of flexible annuity business, we care more about the net of the gains and losses than the rate of decrease of premiums. If one policyholder decreases his flexible annuity contribution by $500, but another increases his contribution by $500, then the block of business has received the same premium it did before.

MR. DONALD W. HAGEN: I have a question concerning the federal income tax implications of companies' methods of paying a higher interest rate. Do you go to a current earnings rate? Do you consider it "interest paid"? I understand some of these tax questions are now up in the air.

MR. FITZHUGH: We currently claim the interest on the reserves under Section 805D just the way we do on a portfolio average product. It is my understanding, though I gather this is in a state of flux right now, that if you have any life contingency guarantees during the accumulation period, you cannot receive the advantage of an interest-paid deduction under Section 805E. The fact that we guarantee a settlement option rate, conservative as it is, precludes it. For a mutual company that pays income tax on the basis of taxable investment income, this puts it at a considerable disadvantage. The interest-paid deduction would give us a considerable tax break and would let us pass on more money to the client. Unfortunately, you must steer between the Scylla of the SEC and the Charybdis of the IRS. The SEC has become very interested in high-yield contracts with little or no annuity guarantees and may decide they are securities that have to be registered and sold through a prospectus.

MR. INGRAM: At our company we feel that we cannot get the interest paid deduction. But I have heard that there are several companies who are going the interest-paid route.

MR. J. ROSS HANSON: Regarding the federal income tax, guaranteed excess interest should be treated as interest because it is not derived from any source involving life contingencies. It is pure investment income which is

distributed to the policyholders. It is not until the money is credited to the reserve accounts that it becomes life insurance reserves.

Regarding IRA lapse rates, some actuaries say that the rates are higher than they expected in their pricing assumptions. One company reported that the lapse rates are more like H.R. 10 rates than they had expected. I think the reason for it is that we are not selling IRA's very well. Many of our competing institutions like savings and loans and banks offer a no-load product and are probably only interested in a short-term product. We are interested in the long-term product because we have acquisition expenses which we must amortize. Therefore, we must make a very special effort at the time of sale to convince the prospect that his IRA is a long-range proposition.

Regarding IRA legislation, congressional activity on IRA's has increased rapidly during the last several months with the introduction of a number of bills dealing with the Limited Employee Retirement Account (LERA). The LERA provides a limited tax deferment for retirement savings of participants in qualified pension and profit-sharing plans. The 1976 Tax Reform Act mandated a study of LERA's by the Congressional Joint Committee on Taxation. To date, the committee staff has taken no action on this study and is not expected to do so in the next few months. There are currently five bills that would amend the tax code to permit LERA's: H.R. 114 which has drawn the largest number of co-sponsors among the LERA bills, H.R. 2123, H.R. 5147, H.R. 5513 which would extend LERA eligibility to employees of private employers and of public employers who elect to comply with ERISA provisions on participation, vesting and funding, and H.R. 7587.

H.R. 4649 would extend the spousal IRA to spouses of workers not eligible for IRA's. It has 55 co-sponsors and much bi-partisan support. H.R. 2123 contains a similar provision on expansion of the spousal IRA. H.R. 1265 and H.R. 3305 are identical bills which would increase the IRA maximum contribution to $5,000. Finally, H.R. 6635 would link the interest rate on Individual Retirement Bonds to that credited under the U.S. Government Series E Bonds.

On the regulatory front, the FTC's inquiry into the adequacy of IRA disclosure is now scheduled to be reported to the Commission in late December. I understand the delay mentioned by Mr. Arends is due to the addition of a consumer survey to the original survey of more than 150 IRA sponsors. The consumer survey was mailed several weeks ago to 30 randomly-selected customers of each sponsor. The survey is intended to elicit responses on the adequacy of disclosure and consumer attitudes toward the IRA in general, and provide some broad demographic information about the IRA customer. I have heard that the early responses indicate there is a great deal of confusion about IRA.

MR. ARENDS: LERA would extend the use of IRA to those who are subject to a qualified plan where small contributions are made for them. An individual would be able to contribute the difference between the employer's contribution for him and the IRA limit. But an insurance company dealing with many small defined-benefit pension plans with unallocated accounts would incur enormous costs responding to participants who ask the amount of employer contribution for them. If LERA is enacted, the bill should include a simple mandatory formula for determining the employer's contribution for an individual in a defined-benefit unallocated plan. The IRS developed such a rule for tax sheltered annuities.

MR. JOHN F. FRITZ: First I want to thank Mr. Green for all the credit he gave me for the survey. Included in my survey were the 20 largest mutual companies, the 20 largest stock companies and 30 other companies with significant annuity business. David mentioned that the average size IRA policy for one company was $2,300. I believe that company was one with considerable rollover business which was not excluded from its statistics. One of the most significant findings in the work done in connection with the survey was that of all IRA's established through the end of March of 1976, only 21 percent in premium volume was with life insurance companies. About 70 percent was with banks and savings and loans. At one time I thought this was because the agents were not totally enamored with the commission levels in the insurance company products. Since then I learned of an agency representative who approached the actuarial department and asked if they could reduce commissions to make their IRA product more competitive. Apparently he believed that his total commission income would not suffer because the larger average premium size would offset the lower commission percentage. This viewpoint is worth considering when justifying the lower commission percentage in an IRA product to our agency force.

MR. INGRAM: We are finding that our IRA business is falling off. One reason is that banks are crediting a higher rate of interest. Another reason, according to our agents, is that we do not offer a waiver of premium feature. What sales results are experienced by companies which sell this feature? Are you experiencing favorable loss ratios or is it following the disability income policy pattern?

MR. ALLEN D. BOOTH: I have several points and I will discuss the waiver of premium feature at the end. Mr. Fitzhugh stated that if you have two flexible premium annuity policies and one increases $500 and the other decreases $500, persistency results are the same. But from a profitability view, that is only true if you do not pay first year commissions on contribution increases.

There was much conjecture at a recent LIMRA meeting that persistency has not been good. In our own company, we now estimate a 20% first-year lapse rate and 8% renewal versus a 10% level annual assumption when we designed our products. Apparently, when insurance company IRA clients

discover the loads in their products, they are freezing their policies and going to other financial institutions.

Mr. Green did not specify that the annuity nonforfeiture law applies to flexible premium deferred annuities. It is my understanding that it does apply.

MR. STEPHEN H. FRANKEL: As a member of Mr. Charles Greeley's committee for annuity cash values, I can confirm that the law does apply to flexible premium annuities.

MR. BOOTH: When we developed new products 12 to 18 months ago, we added to our flexible premium annuity a premium waiver feature for the IRA and H.R. 10 market. Although this was in response to many requests from our field force, utilization has been almost nonexistent. Apparently, agents like to talk about it, but they rarely sell it. The primary problem seems to be that, while virtually no underwriting is required as the result of an annuity application by itself, the inclusion of premium waiver will occasion rather extensive underwriting action.

The waiver feature also raises the following question: Suppose a client has been making a $2,000 H.R. 10 contribution for some years. He has premium waiver on his policy. He becomes disabled and has no income for a full year. Can you make that contribution into the policy that year as the premium waiver benefit promises?

MR. ARENDS: You have not made a contribution to the policy. You are getting a return for a premium payment that was based on compensation earned in the prior year. I would argue that the premium could be waived. No one would be penalized if it was waived. The employer obviously would not claim a deduction that year.

MR. CARL E. MEIER: Our attorneys have taken the position that the waived premium is not a contribution and should be reflected as "earnings" on Form 5498.

MR. BOOTH: Is there then an attendant problem of commingling assets, i.e. tax-deductible contributions under H.R. 10 or IRA versus non-tax-deductible contributions made by the waiver benefit?

MR. FITZHUGH: There is a tax trap here. If you sold a disability income policy for the amount of the IRA premium, you could not, of course, deduct the premium for the disability income policy, but the disability income would be tax-free. But if your IRA grows by means of premium payments made by a waiver feature, then when you finally start to take a distribution of those benefits attributable to those payments, they become fully taxable. By filtering those disability payments through the IRA you have lost the tax-free nature of disability income payments. And apparently all you have gained, based on some private rulings, is deductibility of a waiver premium which amounts to very little.

MR. ARENDS: I have another concern about the likelihood of success for the spousal IRA. To make it work the husband (generally) has to decide that he is going to put half the deductible contribution under the single unilateral control of his wife. Have you seen the latest divorce rate in the United States?

In the financial disclosure required for IRA, most companies show figures based on an assumed $1,000 annual deposit. As we move into the spousal market, should we help the unsophisticated buyer by illustrating financial information for $875 annual deposit? This is the maximum which can be applied to each contract in a spousal arrangement. Many buyers cannot easily figure 87.5% of the numbers we now illustrate.

MR. HANSON: It is a fact that the insurance industry has not obtained its share of this market. To some extent it is due to our product. But the idea which is not being stressed in the marketplace is that other institutions are not selling an IRA which meets the requirements of statute. Their trust or custodial agreements are written so that the account can be distributed as a life annuity. However, no bank or savings and loan IRA can effect a life annuity without purchasing it from a life insurance company at a later time. There will likely be various loadings when the annuity is purchased. That means that there has been a loading in each one of those contributions made to the other institution. This is not disclosed when an IRA is purchased from one of these other institutions, and we have not made an active effort to bring up this point. We could get a much larger share of the market by explaining that our product really is the product for which the law was designed. Re-pricing is not the solution. The pricing allows us to provide services bank tellers cannot.

MR. ARENDS: In 1976 every newspaper in the country contained large IRA advertisements placed by savings and loans or banks. I never saw ads by insurance companies or insurance agents about their IRA products. IRA has had substantial publicity, and the public has been educated about its existence largely through the savings and loans and the banks. The commission on our products is not great enough to interest an agent in pursuing the market. He will sell IRA to a customer who asks about it, but he will not go out to find a market. Our products have advantages. We guarantee an annuity rate today, and we illustrate a current rate which is better. We have to do a better selling job.