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INDIVIDUAL TAX QUALIFIED PRODUCTS

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1. Regulatory Developments:
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MR. DWIGHT K. BARTLETT: Our panel today will be dealing with the whole gamut of individual policy qualified plan products in the U.S. and Canada. I am not particularly familiar with Registered Retirement Savings Plans and their experience, but I am aware of some of the problems that we and others have had with the IRA market. It is apparent that the IRA is not the bed of roses that perhaps some people have assumed it was or would continue to be. Perhaps some shared experiences will suggest some solutions to the problems that have developed.

We will start by describing various regulatory problems in the U.S.

MR. WILSON H. SCOTT: For the IRA as originally defined the maximum annual contribution was 15% of pay not to exceed $1,500. While the 15% maximum continues to apply, introduction of the Spousal IRA operates to increase the dollar maximum to $1,750 provided:

1. The spouse receives no compensation in the tax year.
2. The contributions on account of each spouse are equal within the tax year.
3. The contributions are made to two separate IRA's or to two distinct accounts in a single IRA.

Since IRA's inception, there has been a 6% penalty tax on any excess contribution and the 6% tax continued each year until the excess was eliminated through under contributions. For tax years after 1976, the penalty tax can be avoided if the excess contribution, with earnings thereon, is returned to the contributor before the due date for filing of his tax return. This liberalization applies in respect of contributions exceeding the 15% limitation but not the dollar limitation. It also applies in both instances if the excess results from an employer contribution to a qualified plan.

A third liberalization effective January 1, 1978 allows the IRA contributor 45 days after the close of the tax year to complete his contribution. This liberalization was for the benefit of persons who need their forms W-2 to identify their eligible earnings.

Another liberalization makes the IRA available to military reservists and voluntary fire fighters even if they are covered by a government plan. Again, there are provisos:

1. If the individual is a reservist, he must be on active duty for no more than 90 days in the year.
2. If he is a volunteer fire fighter, he must have accrued no more than $1,800 of a benefit under a fire fighter's plan.

Our Company entered the IRA market on January 1, 1975, delivering its first disclosure statement with policies at issue. We started using our second disclosure under IRS temporary regulations with policies issued December 1, 1975 and mailed the new disclosure to all existing IRA policyholders. We started using our current disclosure February 15, 1977 and will inevitably mail it to existing policyholders to acquaint them with the liberalizations on refund of excess contributions and the 45 day extension for making contributions. The principal effect of these changing disclosures have been a very significant expense not contemplated in the pricing of the product.

Flooded with individual and corporate requests for exemptions from the prohibited transaction rules, the Department of Labor and the IRS issued a proposed class exemption in 1976. This would have clearly permitted agents and consultants to provide services to a plan and receive sales commissions subject to written disclosure of the commissions and to a requirement that the commissions represent "reasonable compensation." Hearings on the proposed class exemption took place on February 14, 1977 and it is anticipated that the exemption in its final form will be issued before June 30, 1977 when the current grandfather clause expires.

MR. BARTLETT: Following are some random comments on regulatory developments.

With respect to feedback from policyholders on IRS Form 5498, 100 were received--most were complaints about contributions not agreeing with policyholder records or about low cash values. Permitting policyholders 45 days after the end of the year to make contributions and to take deductions in the previous year compounded problems.

The regulations are not clear about the definition of the sales loading for the disclosure forms. Should it be the commission or the difference between the gross and net premiums? We choose the former. Therefore we have to have different forms for each type of agent with differing commission scales.

Maryland recently passed a minimum annuity policy cash value law. The minimum first year cash value is 60% of the first year's premium. Some companies have had to change their policies where the cash value did not meet the minimum.

The Federal Trade Commission expressed concern a year ago about how IRA's were being marketed. They were concerned that companies were stressing the guaranteed interest rate for accumulating net premiums without giving equal stress to the existence of a loading charge. The FTC apparently has not followed up on their expressed concern.

After passage of ERISA the IRS was very slow to act on new HR10 prototypes needed to bring these plans into conformance with ERISA. There appeared to be some uncertainty on their part as to applicability of certain portions of ERISA to HR10 plans with or without common law employees. Apparently, however, prototypes are now being approved.

MR. HAROLD INGRAHAM: I might make a comment to augment what Wilson said on the administrative class exemption. As he pointed out, there was a hearing on February 14. The Labor Department and the IRS allowed industry testimony, and the key points that came out were related to three things: reasonable compensation, suitability and disclosure. On reasonable compensation what the industry is pushing for is, if a company operates in New York, it ought to be deemed a safe-harbor test if a commission scale approved by New York is used for the products involved here. As far as fees are concerned, they are not attempting a quantitative test but something that would be reasonable and customary with similar providers of service in the industry. On the suitability point, the IRS and the Department of Labor are under the delusion that the commission scale and the loads have a one-to-one correspondence and do not seem to understand that excess initial expenses are amortized over periods of time. We presented some examples showing, for five, ten, and fifteen pay life plans with typical fee structures and typical insurance industry pricing, what it would be if three approaches were used: a fully insured plan, a split-funded individual policy pension trust, and some sort of a deposit administration plan. It was indicated (and probably could actually be shown) that, as the plans become smaller, it is cheaper to buy a fully insured plan because there would be no fees for reporting, disclosure, the funding standard account, actuarial certification, etc. The disclosure requirement is also a messy point. As initially promulgated, the administrative class exemption would have required that the commission scales be shown in terms of percentages. Because of some testimony, they are seriously considering asking that dollar commission amounts be shown. Do they mean dollar commission amounts assuming the policies stay on the books until the participant retires, or is it a present value and, if so, how is it valued--the individual company's assumptions or some industry-mandated set of assumptions? This could be a real problem.

MR. J. ROSS HANSON: The final IRA disclosure regulations issued by the IRS in December of last year contain several provisions that can impact on IRA product design. Certainly, the importance of these provisions was substantially diminished by the reinstatement of the broad 7-day revocation provisions in the final regulations. Presumably, all IRA issuers, with the exception of those offering SEC-registered products, will utilize this free look approach, thus placing equity products at an even greater competitive disadvantage than under the proposed regulations.

Apart from the practical effect of the regulations on the buying decision, several provisions should be carefully considered by the product designer. The only guarantee of any significance under the regulations is the interest rate guarantee. The financial disclosure provisions restrict illustrations to withdrawal values, omitting any reference to retirement income values. Thus, the product designer should place a low priority on attractive annuity mortality and annuity interest rate guarantees as well as pre-retirement expense and mortality guarantees. In fact, the designer may wish to shift some of the loading income from the accumulation period to the payout period; this would require consideration of the probable rate of annuitizing.

The interest rate guarantee during the accumulation period should be given careful consideration with respect to both its magnitude and its incidence. The financial disclosure provisions require illustration of withdrawal values for the first five years, at ages 60, 65 and 70 and ". . . at the end of any other year during which the increase of the available amount is less than the increase of the available amount during any preceding year for any reason other than decrease or cessation of contributions. . . ." Illustrations of these last-described values can raise questions which the sales people may wish to avoid. These reduced increases will not generally occur with a level interest rate guarantee but may arise when the guarantees decrease over time, depending in part on the incidence of expense loadings and charges. For example, a level load or no-load product providing interest guarantees of 7% for the first five years, 5% for the next five, and 4% thereafter would have to illustrate values in the 6th, 11th and 12th years where increases in withdrawal values would be smaller than in prior years; a level load or no-load product guaranteeing 5% for ten years and 3% thereafter would have to illustrate values for the 11th, 12th, 13th and 14th years. Relatively simple formulae can be developed to determine the maximum allowable decrease in the guaranteed interest rate as a function of the loading pattern in order to avoid the possibly troublesome illustration of these values.

The required financial illustrations for the guaranteed and reasonably projectable IRA's seem to overlook the impact of application fees or one-time policy fees, and thus the product designer may wish to consider such a fee.

Another factor that should be of concern to the product designer is the use of a $1,000 contribution in the regulations for both periodic IRA's and rollovers. Since the rollover contribution will ordinarily be much greater than $1,000, the rollover IRA should avoid fixed dollar charges, such as policy fees or transaction fees, in favor of percentage of contribution charges. For the periodic payment IRA, the appropriate form of the charges will depend largely on the average contribution that the company expects from its market.

There are two minor advantages given to the equity products by the regulations: (1) the right to describe their charges in terms of a combined rollover and periodic contribution IRA, and (2) the exemption from stating the sales commissions to be charged in each year. Presumably, the IRS felt that this latter exemption was appropriate due to a similar SEC requirement; however, the equity product prospectus shows only the portion of the load allocable to sales expenses or to combined sales and administrative expenses but says nothing about specific sales commissions. The sales commission statement required of guaranteed and reasonably projectable IRA's may influence the product designer to decrease total commissions rather than to adopt a system of chargebacks. If and until the term "sales commission" is defined by the IRS, IRA compensation may tend toward production and persistency bonuses, overwrites, and possibly salary arrangements.

Several other perplexing questions arise from the final regulations. To what extent must a company issuing participating variable annuities reveal its dividend formula under the description of ". . . The method for computing and allocating annual earnings, . . ."? What is to prevent an issuer from ignoring the disclosure regulations completely and passing on the $10 penalty in its pricing structure? How will compliance be policed since no _a priori_ approval of disclosure statements is required? Under what authority can the IRS require return of commissions and administrative expense charges under a revoked IRA, since these disclosure regulations arise from a reports section of the Code? What if advertising materials differ substantially from the disclosure statement?

The answer to this last question may be forthcoming when the Federal Trade Commissions's IRA study is completed around the beginning of July. The other questions await IRS action or possible airing at future hearings of the Ways Means Oversight Subcommittee likely to take place later in the year.

MR. FREDERICK J. THOMPSON: Following is an overview of all topics relating to Canadian RRSP's. The Canadian government decided some time ago to encourage people to save for their retirement. If one starts and registers a savings program for retirement, deposits are not taxed in the year in which they are made. One can save $1,000 and reduce taxable income for the year by $1,000. Not only that, but there is no tax on the investment earnings on these plans. However, as we all know, one cannot avoid tax--only defer it. Thus, whenever the money--principal and interest--is taken out of the registered fund, it is taxed as income when received. If the money is taken as an annuity, the tax accrues over a period of time. Progressive tax rates encourage one to take the money out as an annuity.

These, then, are the ground rules. The amounts involved are set down by law. If not a member of a company pension plan, one can save as much as 20% of income each year--subject to a maximum of $5,500. If one is a member of a company pension plan, the limit, in total, to a personal plan and the pension plan is $3,500. For our American colleagues, I should mention that in Canada employee contributions to a registered pension plan are tax deductible. This tends to encourage contributory pension plans. It also makes the lower limit for pension plan members more reasonable.

Strangely enough, these registered savings plans are referred to as Registered Retirement Savings Plans or RRSP's.

From all of this we can see that any product which conforms to certain rules and can be seen to accumulate a savings fund could be used as an RRSP. In fact, the government requires primarily that there be no cash value payable. If a cash value is paid, then the policy is immediately de-registered and the full cash value is subject to tax as income in the year of de-registration. The exception to this rule is that at retirement (but not after age 71) one can take the fund out as an annuity.

In the beginning, insurance companies had the field to themselves. They offered retirement income plans with which we are all familiar. You remember from Jordan, solving to find "a", the point where the cash value exceeded the death benefit, the death benefit being $1,000 per $10 of monthly income. Of course, there were other plans which were even more savings-oriented, having a death benefit of return of premiums or cash value, if greater.

Because of the mathematics of covering an increasing risk with a level premium, we all know that there is a reserve built up in any level premium life insurance policy. Because this fund or cash value is called a savings element, some people hit on the idea of registering life insurance policies. The government helped by authorizing a "savings portion", which was roughly the premium less the cost of term coverage.

While the insurance industry had the field to itself, these were (and too often are) the traditional products. One can argue that saving for retirement is a long-term thing. In the long term, these plans, with their guarantees, can appear attractive. Dividends will raise the guarantees to a level closer to current rates if interest levels are high. From the point of view of the companies, these plans are good profit makers. Because of the tax implications on de-registration, persistency is enhanced. Agents like the traditional heavy front end commissions and the persistency. This persistency is encouraged from two points of view. If another agent says the client is getting a bad deal and should change, he is guilty of twisting. If the client feels he is getting a bad deal, he is shown the tax problem and encouraged to continue his long-term plan. After all, he is over the first year and has paid the heavy early expenses.

One might have the impression that I am not too enamoured with traditional products. A few years ago trust companies realized that there was a lot of money to be managed in the form of RRSP savings. Not being inclined to take long-term views the way insurers do, trust companies offered products which were quite different from those of insurance companies.

These plans are of three types. First, there are Guaranteed Investment Certificates (GIC). The principal and interest are fully guaranteed over the period chosen. (The period is anywhere from 1 to 10 years, with 5 years being the most common.) There is no cash value (except on death or retirement) until the end of the period. Every year at tax time we are beseiged with trust company advertisements trumpeting their GIC rate. All loadings or expenses are recovered from the spread between the rate on investments and the rate paid. Registered GIC's have a small added charge of about 1/5%.

Another trust company plan is a savings-account type of plan with an interest rate guaranteed for 3 to 6 months and set in advance. These are average interest funds; the return is about ¼% over the savings account rate. Obviously, the money is quite liquid except for the tax penalty at cash-out.

The final plan offered by trust companies is a market value diversified fund. Money is invested in bonds, stocks, etc., and the fund is credited with actual earnings less management charges of from 3/4% to 1½%. On mortgage funds the charges run from 1¼% to 2%.

As actuaries, we all feel comfortable with time-weighted payments, termination rates, and the value of long-term guarantees. Someone off the street who invested $1,000 in a savings plan last year and can only get back $200 one year later does not feel too comfortable. Sad to say, perhaps, but people's plans to save are subject to change. Public awareness of RRSP's brought in many people who changed their minds within a few years of starting the program.

This same increasing awareness meant that there was more and more outcry against the heavy front end charges of the traditional insurance company plans.

To get into the market with plans acceptable to the public, insurers had to be prepared to swallow any losses because of plan terminations. Naturally, their actuaries could not countenance this. An alternative was to drastically reduce front end loads, probably through a severe reduction in commissions. Naturally enough, the field force did not like this. Companies which were more broker-oriented than full-time agent-oriented had more leeway.

One early contract was a plan with commissions of 40%, reducing by 1% for each year of age over 25. We then saw plans with commissions of under 10% at all ages.

At the same time, the idea of contractual premiums was under attack. Some companies responded to all criticism by encouraging the sale of a series of single premium deferred annuities. This put commissions at about 3% and gave the client the option of paying or not paying each year. However, these were not all that attractive either.

Finally, insurance companies responded with plans which can successfully compete with the plans offered by trust companies. A typical plan will have a front end load of 5%. There may or may not be a policy fee. The commission will be in the order of 3% to 4% of each deposit. Although small, the usual sales overrides and bonus will likely apply. Thus a company will have first year sales expenses of 3% to 4%.

There will be no contractual requirement to make deposits. One has the option of choosing a new plan each year or making another deposit to the old plan.

On cash-out the company will pay 95% of deposits plus interest. With minimum interest rates at 4% to 5%, one is virtually assured of getting at least his principal back if he withdraws early.

As one can imagine, the loading of 5% plus a small policy fee hardly leaves enough in the first year to issue the policy and pay the agent. Thus, there is a certain amount of expense carry-forward. However, it is not nearly as concerning as under traditional products.

Setting the interest rate is the most difficult theoretical problem. The competition unabashedly declares a rate. There is little opportunity to disguise low interest with mortality and expense considerations. Theoretically, insurers, having chosen front end loading and commissions paid on sales only, should have interest rates which are compensatingly higher than those of the trust companies.

Actually, although I indicate that, with everything up front, it is hard to avoid direct comparison, there are some considerations which can give one pause when comparing. For instance, insurers will provide some minimum guaranteed rate for the life of the plan; they will also provide some guaranteed purchase rate for income at retirement.

All of our experience has been in setting an interest rate which we expect to be attainable over an indefinite period. But interest rates are seen to be quite volatile. The bank rate has dropped by 2% since November of 1976. Many experts expect it to go back to 1976 levels by year-end. Trust companies are promoting plans which are very sensitive to rate changes. Even a 5-year GIC lets one get on side every five years. Investment departments of insurance companies, perhaps with the experience of investment-only pension products, are eager to obtain money to invest. But everyone is afraid of this thing called "demand money", and savings plans are really closer to demand money than are cash value life insurance policies. This is because of the lack of disincentives, such as cash values well below premiums, and because savings plans are set up in anticipation of an investment return. Cash value life insurance is bought mainly for protection. Here are several solutions to the problem of what interest rate to use.

A relatively low rate of interest is guaranteed, and, if experience warrants, the actual yield is increased by dividends. Of course, this traditional idea, if applied in the usual way, has two problems. With interest rates at 10%, few dividend scales will bring guaranteed yields up to this level. In other words, more of the excess interest must be distributed if one is to compete. Also, competition plans offer interest at today's rate today. Dividends usually are determined after the experience is in. In the case of an RRSP with all the other apportunities available, some feel the dividend approach is like buying a pig in a poke. The answer, as one company found it, is to guarantee dividends for anniversaries in the next year. They set their rate based on a weighted average of the yield on their existing fund and expected yields and expected cash flow. Thus they must project cash in and rates for a year. While they do not actually hold a separate fund for RRSP money, they keep a notional fund. As the fund matures, the weighting for future money becomes less significant.

A second idea is to declare a guaranteed rate every month. All money received in that month would earn that rate for the guaranteed period. This is relatively simple on the surface, but imagine the complexity if rates change every month and contributions have been made monthly.

One company has a plan which is meant to parallel GIC's. The rate is guaranteed for 5 years. Only single premiums are accepted with a minimum of $1,000.

A very innovative approach, with its roots in group deposit administration funds, sets up an account for each year. At the end of the year, 10% of the account plus interest at the guaranteed rate on the reduced balance is transferred to the new account for the year.

There are two questions that come up with any of these funds. While not the type of thing to spark an action-packed TV series, they represent areas where actuaries can get into heated discussions.

On cash-out is book or market paid? In all the sales literature no one ever mentions the concept of book versus market. However, if interest rates change, then in the marketplace the value of the guaranteed fund changes. Most companies have anticipated this. The usual answer is to pay book or depreciated market, whichever is lower. This smacks of a "heads, I win; tails, you lose," situation, or at least "heads, we tie; tails, I win." Other companies pay book no matter what. Others go to market--i.e., they pay appreciation as well as depreciation.

Is the average or fund rate paid, or is a new money rate paid? In periods of falling interest, one is able to keep a competitive edge by using the fund rate. When interest rates are on the rise, one will face certain pressure to go to a new money approach. In theory, one should make a choice and stick to it. No matter what the choice, expect severe pressure from the sales people when the trend in rates changes.

One of the companies cited above uses the portfolio average approach and plans to start a new notional portfolio if rates go down too far. This may be an awkward way of moving to a new money approach. Actually, they had wanted to use the new money idea from the start, but had run into problems.

Throughout I have referred to competition. This is a very real concern because of increased public awareness in the registered savings area. Some of this awareness is a natural concomitant of high interest rates. A large element is simply the times in which we live. Whatever the reason, the life insurance industry has been under severe attack because of the traditional heavy front load products.

The Canadian Life Insurance Association (CLIA) has led the companies toward what could be called more responsible marketing. Nevertheless, in spite of the products available, some agents still sell the old policies. This often leads to some very difficult situations. What can be done when a client realizes his $1,000 has grown to $200 and there is another plan in the portfolio under which it would now be worth $1,050?

We may know in our heart that interest levels are cyclical and current high rates will not persist, but the people with the money have developed a very short time horizon. Further they do not admit that rates will drop.

My opinion is that the insurance industry will continue its trend toward low load, low commission, current rate guaranteed interest. I expect more and more companies will offer plans with investments in unitized market value funds. This will overcome the questions of portfolio rate versus generation rate. It will mean a market value payout whether market is above or below book. It will mean that actuaries will not be involved in setting interest rates.

Some problems with unit value funds are that the insurance element is small. A guaranteed settlement option should be included. This would help separate insurers from trust companies.

Another problem is that RRSP money is demand money. With minimum surrender penalties there is little to discourage moving money around. RRSP money can move from one plan to another with no tax implication. Thus, you could see money constantly moving from one company to another. Practically speaking, this is unlikely to happen, because of the number of individuals involved.

Let me briefly summarize, using Question 4 as a check list.

A) Field force compensation has generally been reduced, on savings plans, to 3% or 4% each year. There are some plans which pay 10% or more, but they also contain charges levied on early surrender.

B) Persistency is generally quite good compared with other products. It will be quite bad on the old plans as people realize there is something else available.

C) Loading levels are generally 5%, but seldom over 10%. A policy fee may be charged as well. Of course, 5% plus a $25 policy fee means a loading of 7½% on a $1,000 deposit. Expense levels are within this range--provided enough business is generated. RRSP contributions can be deducted for a tax year if made before March 1 of the following year. For this reason, a very large proportion of RRSP activity comes in February. It is likely more economical to do it all at once than to have smaller pieces straggle in over the year. Some companies are trying to promote monthly deposits. However, they are, of necessity, small and hence cannot absorb much loading.

D) Administrative problems abound as we move from the old contractual plans to the new unit value plans. As indicated, several companies have used a single premium or portfolio interest approach only because they could not handle the administrative problems of a generation interest method.

Finally, let me touch on Question 6. One can set up an RRSP in one's spouse's name. One receives the deduction, and the spouse receives the income and pays the tax. This is a good income-splitting scheme. However, with so much marriage-splitting, it could be dangerous.

MR. KENNETH T. CLARK: The insured product, as contrasted to a bank or trust product, has gotten itself into a bind in Canada. This bothers me, for I admit to the bias, which I suspect most of us share, in favour of the insured product. Specifically, I mean the insured product marketed by an agency force which is compensated at the point of sale for its efforts.

It seems to me the insured product will stand up in competition against the trust company product only if the product is a relatively long-term product; this is a matter of economics. The acquisition cost of the insured product is necessarily greater than the acquisition cost of the trust company product. The famous "eyeball-to-eyeball" confrontation of the agent and the customer is more expensive than having a pre-educated, pre-motivated customer walk into the trust company office. This higher expense is unavoidable. It is also justifiable because of its service contents; it motivates the customer, educates him, and helps him to match his income to his needs. The acquisition expense is relatively small if it is spread over a lot of dollars (not practical because of the limitations on deductible contributions) or over a long term. When that happens, the insured product stands up very well in competition with the trust company product.

The trust companies are playing the game intelligently. In order to get RRSP money under their management, they had to adapt the RRSP product to their kind of investments. These are substantially mortgage loans, and, in particular, residential mortgage loans. In Canada, residential mortgage loans are, as a practical matter, limited to five years. Hence, the trust companies made the RRSP product a five year product, because it would have been difficult for them to extend meaningful guaranties beyond five years. This was, as I say, intelligent of them, but it is a case of "letting the tail wag the dog." Savings for retirement should be long-term savings.

The five year term is difficult for an insured product. Five years is about the shortest over which acquisition costs can be spread in order to be reasonable. Even so, five years is tight. Somehow or other, the insured product must stop playing the game in the ball park of the trust company product. There are a number of ways of getting out of this ball park, but I single out that of emphasizing the long-term nature of retirement savings. I preach this doctrine with no shame; it is good for the insured product, but, more importantly, it is good for the customer as well.

MR. SCOTT: Our current product in the Corporate and HR-10 markets and our original product for TSA and IRA have a first year load commencing at 36% for plans scheduled to mature in 31 or more years grading to 10% for plans scheduled to mature in 4 years. This product carries first year commissions of 4% less than the loading. The newer product for TSA and IRA with its 10% load for the first 10 years provides 20% first year commission for the longer premium paying periods grading to 4% at the short end.

At the time we designed the revised IRA product, we made the optimistic assumption that IRA's would enjoy essentially the same persistency as TSA's as opposed to the much poorer persistency of Corporate and HR-10. While we think this can be improved, we are not at all sure that it can meet TSA persistency.

As mentioned under disclosure above, we find that IRA's, even with our flexible product, abound with administrative problems and thus far have occasioned very heavy expenses.

MR. BARTLETT: The law permits IRA's to be funded by annuities and endowments. The most commonly used product is the flexible fixed annuity because of the need for flexibility, as each individual's eligibility and maximum legal contribution status changes. Monumental decided against this product, because we concluded that our agents would mostly sell fixed premium annuities and retirement income policies because of the higher commissions. We attempted to allow for the need for flexibility by including, on request, a premium deposit fund (PDF) endorsement with a disability waiver of premium provision and a disability income provision that, in effect, waives the deposits to the PDF during disability. All these combinations have been accepted by the IRS. IRA's accounted for about 12% of our sales in 1975 and 1976 by premium, about 60% on annuities and 40% on retirement income policies. We also offer the same products on HR10 sales which account for about 20% of IRA sales.

Our fixed premium annuity is a traditional annuity with a high first year loading of 40% and a high first year commission. Interest guarantees are 3½%. We are currently crediting 7% on the accumulation of the cash value.

The trend seems to be to lower loading and commission as competition in this IRA market has intensified within the industry, and with banks and savings and loan associations. At least one company is offering a no load annual premium annuity. Another company has a flexible premium annuity product with a $5,000 initial premium minimum, more directed to the rollover situation, no load with 7%, 3-year guarantee for cash value accumulation and 8% for accumulating the gross premium if the policy is eventually annuitized. This product, I am told, has a 7% sales commission. Still another company accumulates the net premiums of the policy, equal to 90% of the gross premiums, at a high rate of interest but makes a surrender charge graded by duration on early surrenders.

Several companies have developed deferred annuity riders which can be added to fixed premium life and annuity products, similar to the PDF endorsements described earlier. These do, however, provide a small loading for payment of a modest commission and are treated for valuation and tax purposes as true annuities.

Apparently, it is permissible to write IRA's on a group policy form. The employer can make payroll deductions, but must not, in any other way, appear to be sponsoring the plan. Few companies, if any, have apparently taken this approach to the IRA market.

I alluded earlier to the concern we had at Monumental that few sales could be made using a low load, low commission flexible premium annuity if we permitted our agents the choice of selling higher commission fixed premium products. Some companies have met this problem head on by accepting IRA applications only on a low commission, flexible premium annuity basis.

I am told that a few stock companies have experimented with paying excess interest credits on retirement income policies used in tax qualified markets to make them more competitive with participating policies but have run into problems with state insurance departments taking the view that these are participating policies.

As mentioned previously, a number of companies have flexible premium or single premium deferred annuity products with little or no loading, interest rate guarantees of 7% or more for the first few policy years and even higher currently credited rates. Obviously, these products reflect a new money interest rate approach, rather than a portfolio interest rate in an effort to be as competitive as possible. The pros and cons of using new money rates on individual policy products have been well discussed elsewhere. These high interest rates do raise a number of practical problems. The first is an apparent concern expressed by the SEC in a letter, dated December 17, 1976, to a number of companies marketing such products, suggesting that the stress on the high interest rates makes these products more in the nature of securities than annuities. The companies receiving this letter have apparently all replied to the letter, so the ball is back in the SEC's court to decide if they wish to press the matter. Secondly, a number of state insurance departments have taken the position that if the annuity policy guarantees an interest rate for the accumulation of the net premiums which is in excess of the maximum valuation rate for deferred annuities, the insurance company must set up an extra reserve equal to the present value of the difference of those two rates. Those states are apparently not consistent on the question of whether this can be offset by the excess of the maximum valuation rate over the ultimate guaranteed rate, if lower. This so-called interest deficiency reserve can by substantial if the maximum valuation rate is 4%, as it still is in some states, and the guaranteed rate is, say, 7% for five or more years. A third problem is determining the proper Phase One deduction in the life companies' Federal Income Tax (FIT) return on those annuity products. It seems clear that the national office of the IRS considers these accumulations during the deferred period as life insurance reserves with a regular pension reserve required interest deduction calculation based on the company's current portfolio interest rate and any interest credited in excess of this rate deductible as a dividend only in Phase Two. Actual practice in the field seems to be quite different, however. Some companies are taking the position that these are not life insurance reserves and they are, therefore, entitled to the full interest paid deduction. Still others are taking the pension reserve deduction plus an interest paid deduction of the difference between the guaranteed rate and the currently credited rate. For some companies with more modest guaranteed rates, the sum of these two pieces can be in excess of the full interest paid deduction. The Southwestern Life has been involved in a tax suit dealing with these issues. These annuity products tend to have small margins to begin with. The reality following an overly optimistic assumption of the FIT treatment of these products may completely wipe out the expected profit margins.

Incidentally, I understand the Washington National has developed a fixed annuity, funded through a fixed income securities separate account, just to avoid any possibility of an adverse FIT effect.

Monumental's commissions on its products used in the IRA and HR10 markets follow the typical non-qualified product patterns. However, as mentioned previously, companies using principally flexible premium annuities have tended to adopt lower commission scales on a more levelized basis, perhaps in the 5-to-10% range.

There is a tendency to reduce the sales commission with increasing issue age, presumably in recognition of the fact that there are fewer years in the deferred period to accumulate a substantial gain over the gross consideration. I understand a few companies are also grading commissions by size of premium. I presume one reason for this is, in effect, to avoid paying an annual premium commission rate on what is intended to be single-premium-type rollover funds.

We have not done a persistency study at Monumental for IRA and/or HR10 business per se, but we do know what the persistency experience of our annual premium deferred annuity policy which is used primarily in IRA sales since January 1, 1975 has been. That experience, regrettably, has been poor. About 65% of the policies persist into the second policy year and 52% into the third year. We are distressed by this fact and the adverse reaction we are getting to the IRS Form 5498. We intend to do a survey of our lapsing policyholders to determine, in greater depth, what their reasons for lapsing are and to re-think our whole IRA marketing program as a result of that feedback.

It seems reasonable to assume that IRA sales particularly cause higher expenses than non-qualified sales of the same or similar products. The preparation of disclosure materials and the IRS Form 5498 has to result in some expense. There may, also, be more frequent requests for changes in fixed premium policies after issue on IRA situations than in non-qualified sales. It is unfortunate that the same type of three year income averaging prior to plan adoption that was written into the HR10 to prevent an excess contribution resulting from a subsequent reduction in income by a holder of a fixed premium product was not also provided for in the IRA law. Perhaps, there was a good reason for this omission, but it is not apparent to me.

Companies using primarily flexible premium annuities may possibly cut their systems development expense by buying one of the many EDP software packages that seem to be in the marketplace.

A practical problem is how to handle the lapse charge to an agent of a policy that has lapsed because the policyholder is no longer eligible for an IRA. We have decided to relieve agents of such lapse charges. Hopefully, this will not be abused.

Another cost to my company on IRA business is the fact that we have been very generous in returning the gross premium to policyholders, perhaps as late as a full year after sale, who have complained that the policy was mis-represented to them. Frequently, we cannot recover the commission because the selling agent is no longer with us.

We recently changed our annuity policy form to provide that on lapse in the first three policy years the automatic nonforfeiture benefit is cash rather than a reduced paid up annuity. We found that our high lapse rates were resulting in a large volume of small paid up annuities that were expensive to maintain in relation to the size of the cash values.

MR. SCOTT: When the IRA was first permitted, our Company was fortunate to have in existence a Tax Qualified Flexible Premium Annuity which allowed variations in premium from 75% of normal on the lower side and to 200% of normal on the upper side. We made an initial decision not to offer any fixed premium products and have stuck with that decision.

By virtue of the disclosure requirements previously discussed, we subsequently introduced a new flexible premium annuity with a level 10% load in the first 10 years (6% thereafter) as apposed to the relatively high front end load of our initial product. This product also increased premium flexibility to 50% on the downwards side and 300% on the upper side. Both products use a portfolio interest rate.

MR. HANSON: The thing that perplexes me in this conversation is that when the Congress in the ERISA legislation added the notion of the concept of IRA, it was clearly one of the best advances in pension activity in the United States that we have had in a very, very long time. We have had it in Canada some time, and the notion is that people put aside a portion of their income today, get tax deferment on account of that, and, later on, take a retirement income. All the problems we hear discussed here today are dealing with the fact that the public apparently has not had it impressed on them that they have been sold savings devices which can be redeemed six months, a year, two years from now. The fault must lie at the company level in not convincing the buying public that this is a tax deferment device to prepare for retirement income. When that is done, and it is a long range venture, then the services that we do provide through our salesmen and through our intellectual capacities in the life insurance companies are valuable.

MR. SCOTT: I gather that Canada has much better persistency on RRSP's than we do in spite of your trust company competition. Is that true, and what do you see that you are doing right that we are doing wrong?

MR. CLARK: There are really two aspects to persistency. There is the classical surrender where the contract is terminated, and the policyholder takes his cash out. That rate is not very high. The problem we have sometimes is that someone commits himself to an annual pay-in and then does not keep it up. He just leaves the money in the plan, and he suspends his payments. The experience there is often not good. The only way that I know which will make it succeed is to insist that money be put in via a pre-authorized check plan. Expecting people to mail in the money each year does not work, and one cannot expect the agent to get it in every year because it is not possible to compensate him highly enough.

MR. BARTLETT: The problem for my company in the persistency area is that the blue collar people to whom we are selling IRA products buy them on the fringe, and as soon as they get into financial problems, the IRA policy is the first thing that goes. They will hang on to their life insurance because they see the value of the death benefits in the life insurance policy, but the IRA policy will be the first to go.

ERISA authorized defined benefit HR10 plans for the first time. Previously only money purchase plans had been available. The law attempts to translate the 15% or $7,500 limitation on contributions in the old law into limitations on benefits which may be paid on a defined benefit plan. The act provides a table of percentages according to entry age into the plan to be multiplied times each year's compensation as the maximum benefit that can be funded for each year of participation. The table grades from 6.00% for each year of service for entry ages of 30 or less to 2.00% for entry ages of 60 or over. Maximum compensation that may be used in the calculation for any year is $50,000. The benefit so computed is on a straight life basis, commencing at the later of age 65 or 5 years from commencement of participation.

Plans which also cover common law employees must be constructed on a non-integrated-with-Social-Security basis.

My own company is not active in this field, so other than this summary of the law, I know little about the subject.

MR. CLARK: Let me report a recent development in spouse RRSP's. One of the major differences between United States and Canadian income taxes is that there is no such thing as a joint return in Canada. However, by means of a spouse RRSP, it was possible to create a sort of do-it-yourself joint return. Say, for example, that the husband is in a higher tax bracket than his wife. The husband can put money into an RRSP for his wife, and he does not pay tax on that money at his high rate. The wife waits a decent interval and draws the money out, paying tax at her low rate.

The Minister of Finance, in his recent budget, has blown the whistle on this lovely little loophole. At least he has blown the whistle a bit. Under the new tax law, money will go back into the husband's income if it is taken out of the wife's RRSP within three years.

I think that this is a good measure because it emphasizes the long-term retirement savings aspects of RRSP's.

MR. JEFFREY J. NOHL: Many explanations have been mentioned to explain the poor persistency on this business. Some people suggest that the products are lousy, that people are getting wise to the companies, that the agents are not selling the product as a long range retirement plan. All these explanations contain a rather negative note. There is another reason for terminations which I think should be mentioned and that is the volatility of the labor force. It is entirely possible that the agent is doing his job and that the policyholder is purchasing the product as a long-range retirement plan. If the policyholder changes employment and subsequently becomes eligible for a pension plan from the new employer, then the need for the insurance company plan will no longer exist, and it will probably be dropped. I mention this only as an additional explanation which does not contain all of the negative tones of the other explanations for the poor persistency.