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## INDIVIDUAL ANNUITIES

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Recent experience and current events, primarily with regard to Single Premium Deferred Annuities and Flexible Premium Annuities:

1. Marketing issues
  - a. Key sales features
  - b. Markets
  - c. Experience
2. Actuarial matters
  - a. Perceived risks for the insurance company
  - b. Pricing and product design
  - c. GAAP
3. Current issues and outlook regarding
  - a. The SEC study
  - b. Federal income tax issues for the individual and the life insurance company
  - c. Nonforfeiture issues
  - d. Model Disclosure Bill (ACLI)

MR. SAMUEL H. TURNER: The topic of this session - Individual Annuities - provides a timely area for consideration. It represents an area of considerable significance to the life insurance industry and therefore to us as actuaries. Annuities have increased, as measured by premium, at an average annual rate of about 20% over the last five years; a rate of growth more than three times that for life insurance. Annuities now represent something approaching one-third of total life and annuity premium income ... and the vast majority of this growth has been in fixed-dollar, as opposed to variable, annuities. Single premium deferred annuity (SPDA) sales alone last year hit something like \$1 billion.

Annuities are generally high-profile products. The loads are very obvious; the deal to the consumer is very obvious. They are also the focal point of what appears to be a concerted effort by federal regulatory authorities to extend federal regulation and taxation of the life insurance industry. The first manifestation of this was the IRS's move against "investment annuities."

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This was followed up with a move by the SEC on SPDAs some months later, and by the IRS on the deferred tax build-up in traditional annuities and certain individual permanent life insurance plans. Most recently, we have just learned of the SEC's proposed regulation to classify certain life insurance and annuity products as "securities" under the Securities Act of 1933.

While the focus of current events and interests seem clearly to be on annuities, the inherent regulatory issues are much broader. Can we draw the line at annuities, or at certain annuities? Have the IRS, the FTC, and the SEC never read a life insurance textbook? How long will they view annuity policies as something completely different than the savings accumulation within permanent life insurance products? The life insurance industry is in the savings business. It has always been a savings institution. Will it continue to be a savings institution?

Annuities are clearly now of considerable significance to the life industry in terms of the volume sold, as well as in terms of the percentage of product mix they represent. Some forms create unusual actuarial problems in pricing and reserving. And annuities seem to be the focal point of threatened extension of federal regulation and taxation.

MR. JACK P. BARGER: While the SPDA has been available for some years, it was primarily a shelf item until roughly late 1972 and early 1973. At that time, Life Insurance Company of North America contacted several stock brokerage firms, including E.F. Hutton, and attempted to interest them in marketing a SPDA product that they had introduced to their regular brokerage facilities some months before. I was intrigued with the product and we started a small test market in E.F. Hutton on the West Coast with 11 people. This test market exploded within a matter of three months into about 50 people and several million dollars worth of SPDAs. In fact, we had sold so much that by early 1973 we had threatened to push INA's life company into a precarious tax position. This temporarily shut down the sales of SPDAs. We were so intrigued with the idea that this was the right product at the right time that we immediately began contacting other companies. After some searching we were referred to Variable Annuity Life Insurance Company in Houston. We found that they had a product which was quite similar to what we were looking for, and we convinced them that it was a salable item. They made some minor changes in the product and that was really the beginning of the huge marketing effort that has been undertaken now by both life insurance men and brokers. Glen Holden, who was then President of VALIC, resigned and formed his own marketing company, the Security First Group, which became a sister company to Capitol Life. He began to sell SPDAs underwritten by Capitol Life through the New York Stock Exchange community. This was quickly followed by Anchor National Life who brought out a product called "Anplan," who in turn also went after the New York Stock Exchange community to market their product. I think it is safe to say that last year over 50% of the SPDA business sold in the United States was done by Capitol Life and Anchor National. Since then, of course, many other companies have entered into the business and are selling not only through broker dealer firms but through their own agents as well. It took about four years for the typical life insurance salesman in the traditional agency system to take hold of the product, but we see signs today that it is beginning to be marketed more aggressively in this area.

Let's go back now and see why the product became successful. Most of you are familiar with the stock market decline in the late 60s and, of course,

this dramatically affected many people selling securities. The obvious recipient of the stock market's doldrums was the bond market. Many insurance companies and other organizations began to establish bond funds and the stock brokerage industry gladly accepted this as their salvation. They began to market these aggressively as more or less a guaranteed vehicle. While they thought there might be a slight variation in price from time to time it would not be a wide swing and the investor could have a comfortable yield for a reasonable period of time. As we all know, that didn't turn out to be the case. While yield in most cases was somewhat close to what was promised, the actual value of the bond funds fluctuated dramatically and resulted in a lot of unhappy investors and disillusioned stockbrokers. This, of course, happened right on the heels of the Real Estate Investment Trust disappointment and therefore many brokers were quite disillusioned. That sets the stage for the introduction of the SPDA. Along came a vehicle that offered an absolute guarantee of principal backed by a large financial institution representing an industry that had a fine safety track record. It offered a reasonably high current yield, and a tax deferred status that enabled an individual to engineer his taxes so that he could pay them at a time most beneficial to him. While the product was not tax free, it was tax deferred. In many cases the high tax bracket individual could purchase the product, let the funds accumulate during a time of high taxation, and then take a pay-out at a time when his tax bracket had been reduced.

Because of the charges that are generally used (either a front-end sales charge or the more recent development of a "no-load" product with a back-end charge) "hot" money did not flow into this market. As a result, most of the people who were buying SPDAs were putting in their serious dollars; we sometimes refer to this as "mattress" money. While I can't speak for other firms, our lapse ratio has been nothing short of phenomenally good. The last report we had on the original block of business that we sold back in '73 and is now going into its fifth year showed that we have had something around a 1% lapse ratio.

The market for this product is hard to pinpoint, but I think a fair description of the average buyer would be someone between the ages of 50 and 65, in a relatively high tax bracket (that is at least 30%), that has reached his peak earning years, has probably taken a few knocks and lumps in the market, and can no longer afford to take risks with his money. Most likely his tax bracket will drop somewhat at retirement.

One of the difficult problems in selling this product was the educational process for the client. We, of course, had some reluctance from a number of account executives who were doing well selling other products available through our firm, but for the most part we had a readiness to take on a product that offered so much to so many. Clients, however, were reluctant to buy an annuity because they basically had a misconception of an annuity. In brief, I think that an annuity to most clients meant giving your money to an insurance company, receiving an income for a few years, and then dying and letting the insurance company keep all the money. We found that the best way to sell the product was to liken it to something the client already owned, such as a Certificate of Deposit, a bond, or some other fixed income investment. Comparing feature by feature and adding the plus features of the annuity, in many cases, was sufficient to give them a high enough comfort level with the product to make a buying decision. Many early buyers are now on their fourth and fifth individual annuity purchase

since they found that what we originally told them was true. We are also getting referrals from existing annuity clients and this, of course, makes a sale easier to this new prospect. The articles which have appeared in the Wall Street Journal, U.S. News and World Report, Money Magazine and others, have given the product a great deal of credibility.

Finally, a few brief comments on why we started selling SPDAs in the first place. Naturally, there was the obvious hope of earning substantial commissions in marketing the product. After all we are in the commission business; however, we had a much bigger goal in mind. We saw a difficult task of getting stockbrokers into the life insurance sales business, and yet we saw a great potential market there since we had access to so many clients. We as a firm had begun to realize that we were not just in the stock brokerage business, but we were in the money business and financial planning; that is, helping an individual coordinate his overall financial program. We realized that one of the largest assets in any man's estate would be his life insurance and, therefore, we felt that it was imperative that we become acquainted with this valuable feature and also be able to market it, thus filling another vital area in the financial planning field. However, selling life insurance is quite different from selling securities, which are primarily sold over the phone. We realized that annuity sales would have to be made on a face-to-face basis, but felt that SPDAs would be helpful in bridging the gap from telephone selling. We looked upon the annuity as being a stepping stone to get our people into the life insurance business. This has proved to be true and, while we are not setting spectacular sales records in the life insurance business, we are where we wanted to be.

MR. EDWARD H. BAKER: I have adopted a generalized approach to what I will define as the "deferred fixed annuity" product line and will address only the fundamental or essential characteristics.

It will be recognized that each specific product, market and distribution system will result in some differences in approach and emphasis; also that my observations are inherently biased by my experience at Capitol Life. Further, like Jack Barger, I hold the view that this is a "new" (or recent) product line by virtue of the high interest guarantees, the flexible premium concept, and the requirement for lower expenses due to the frequent comparison with pure investment vehicles.

#### Perceived Risks

Perception of "risks" depends very much upon time and circumstances. For example, one risk which few of us contemplated back in the early 70s was that of a major change in the "traditional" approach to statutory reserving requirements attendant upon the market growth of this product line. Today we can simply assume that the CARV Method will apply whether or not it has been adopted in the state of domicile.

The following presumes a company which is contemplating a major sales effort for this product line with very limited or zero sales in the past.

The deferred annuity policyholder or prospect understandably has a very different view than the life policyholder who pays a couple of hundred dollars a year for his insurance coverage. In the latter case, you are

providing insurance coverage; in the former case, you have (or will have) his money and there's a lot of it. One of his major concerns is safety and this leads to:

1. The need for major field support - to answer the many questions arising at the distribution level;
2. A high level of maintenance costs - answering policyholder questions and performing functions relating to special features of the policies;
3. The need for conservative investment strategy - designed to preserve principal to the optimum degree consistent with a reasonable yield.

The risk identified here is one of prohibitive expenses which cannot be recovered by reasonable charges against the policies. Other items having a similar impact are: advertising expense, expense of legal opinions and regulatory product approval, and incidental development expense (e.g., fringe products). The solution to this particular problem is volume, but volume naturally has its own problems.

The most immediate problem associated with volume is statutory surplus drain and attendant NAIC "early warning" consequences, et al. Naturally, surplus drain can and will vary significantly in degree and duration depending upon the particular product design. Nevertheless, if the customary and equitable "money back guarantee" is present, surplus drain cannot be avoided and volume can present a problem.

Assuming you've survived these obstacles and are still in business, the investment considerations, both short-range and long-range, present possibly the most significant risk (although I would definitely not discount the risk of future mortality improvement). The major investment concerns are:

1. Type and quality of assets;
2. Timing of purchases (availability of long term investments, current economic factors, etc.);
3. Fluctuations in available yields (current and future);
4. Liquidity (also callability, especially when purchasing bonds at a premium);
5. Maturity scheduling;
6. Portfolio depreciation as a result of external economic factors.

With proper product design and field practices, persistency (or the lack of it) will not present a very significant problem except in one particular circumstance. The particular circumstance which I refer to is "mass terminations combined with liquidation or effective liquidation of heavily depreciated assets" as when prevailing investment yields skyrocket. This happened in the United Kingdom several years ago. Naturally, if this situation develops, one can employ various strategies to modify the long term consequences but an overall reduction in profitability is a distinct possibility. In anticipation, one can foresee the need for:

1. Good product design such that termination is not an automatic consequence;

2. Consistent level of sales year after year;
3. A satisfactory profit margin exclusive of this factor.

Another factor which must be taken into consideration is the need to avoid frequent product changes to avoid confusing the field force. Also, one cannot switch on and off the sales of this product line.

In concluding my remarks upon "perceived risks" I would be remiss if I failed to expand upon my earlier comment about mortality improvement. Relative to life insurance mortality experience, the data base for annuitants seems scant and lacking homogeneity. Even if this is not so, I believe that the class of individuals who are purchasing this product line exhibit better health and mortality. These three factors, future mortality improvement, data base and better mortality, should be weighed carefully in establishing benefit guarantees.

#### Pricing and Product Design

Possibly it will come as no surprise to you to learn that I regard these two topics as nonseverable; that is to say, pricing assumptions so affect the design and vice versa, that I do not attempt to separate the two. True, in designing a product we must attempt to satisfy the prospect, the field force, the management and the regulators and, for that matter, the actuaries. True, again, that these same statements could be made about a vanilla life product. However, what I seek to establish is that "design" can materially affect the results for the deferred annuity product and, conversely, the choice of assumptions can materially affect the design.

In my view, the major design considerations of the deferred annuity product are:

1. Readily understandable benefits, guarantees and charges;
2. Optimizing benefits and guarantees for the policyholder who ultimately carries out the terms of the contract by taking a periodic payment settlement;
3. In general, optimizing benefits and guarantees for all policyholders in a prudent manner (e.g., a long term guarantee of the accumulation rate for funds received today);
4. Features which tend to modify the impact of, or compensate the company for, adverse developments.

The actual procedure which has evolved at Capitol Life over the past several years is essentially as follows (for a "basic" product design):

1. Test alternative sets of assumptions (rates of termination, rates of transfer to "on-benefit" status), on the basis of a constant investment yield rate, and adopt the set which best typifies the result assuming only modest deviations occur. Both deferred phase and "on-benefit" phase are recognized in developing the income stream. All calculations are oriented to the receipt of one premium;

2. Examine the consequences of variation in the yield rate, and of extreme deviations, for acceptability - without regard to probability of occurrence (particularly since we generally have no idea what these probabilities might be);
3. Laugh off the deviation that says you're dead, on the theory that so is everyone else;
4. Translate all results into the equivalent percentage yield rate (e.g., cost of  $x = .07\%$  per annum) for ease of comparison and discussion;
5. Evaluate product-specific variations in the basic design using the "most reasonable" set of assumptions determined in the first phase and, again, translate the results into a percentage yield rate cost;
6. Finally, in this fashion, we are able to determine the most satisfactory "package" of benefits, doing a little horse-trading among the various options.

There are several features of product design which are independent of the actuarial considerations though they are related to the first major design consideration mentioned earlier. These are:

1. Straightforward contract language is very desirable, more so than in the life area, though this may run counter to traditional terminology;
2. If a product has too many complexities the process of obtaining state insurance department approval will be protracted;
3. Design should reflect the policyholder's desire for security.

#### GAAP

First, it was my understanding some five years ago that the accounting profession took the view that the deferred annuity was merely a "savings" or "investment" account. Perhaps in those specific instances, that was a proper identification and posture; I don't know. I do know, however, that the GAAPing process was substantially restricted to a deferral and amortization of acquisition costs.

At Capitol, we took the opposite view and, incidentally, have sought to progressively strengthen the annuity features of our product line since inception.

As in pricing, our orientation is again "receipt of premium", because of the flexible premium concept, rather than "issue of a policy." Thus, for each premium, we establish a GAAP reserve for benefits and expenses, with suitable provisions for adverse deviation, on the assumption that both the initial yield and the initial interest guarantee will continue throughout the deferred phase.

Some practical features of the process are:

1. Use of same activity rates for both pricing and GAAPing;
2. GAAP factors are developed for each distinct block of business issued in an accounting period and are applied to blocks of business as ratios to the statutory reserve;
3. The investment yield rate employed for developing GAAP factors for any accounting period is determined at the close of such period and thus reflects actual investment experience;
4. The benefits being funded are either the computed lump sum for withdrawals and deaths, or the computed annuity payout, assuming that the current scale of settlement option rates remains in effect;
5. Provisions for adverse deviations thus introduced for withdrawal, death and annuitant experience are of rather minor significance when compared to that for the investment experience.

MR. BRUCE E. NICKERSON: You mentioned the danger of guarantees of principle on an annuity and the possibility that sound long term investments would lose market value due to an increase in interest rates, putting you into a situation where individuals could select against you by withdrawing. Mr. Barger indicated that one disincentive to withdrawal would be taxation of the gain on the product as ordinary income in the year that withdrawal occurred. I know that the surrender charge can be used as a disincentive, although whether it is a front-end or back-end charge is academic. What other disincentives can be used against investment antiselection through withdrawal?

MR. BAKER: I'd like to take one of your last remarks first before I forget it. You said that the surrender charge can be front-end or back-end and the choice is academic. Mathematically you're correct; psychologically you're not correct. There's a vast difference between charging at the front-end and then having an individual say I have X available and I will liquidate it and reinvest it elsewhere; and having Y available at that point in time and saying, "Wait a minute; I am now subject to a surrender charge." Despite all of the proper presentation that you do, or have done ten years prior, and despite his awareness of the surrender charge, he is only confronted with it psychologically when he actually surrenders. So incidence of the surrender charge is important.

As for factors which offset the possibility of terminations when your portfolio is heavily depreciated, the fact that an individual will be subject to taxation on the gain in his contract has to be viewed carefully because, under certain circumstances, he can roll over and avoid that taxation. He cannot jump out of his annuity product into the stock market, but he can jump from you to some other company, or even from you to another one of your current products. So, while the tax penalty helps, it isn't a complete offset. Another factor that you can introduce into a product design is a differentiation between the interest rate that will be credited if he annuitizes his contract (as he is expected to), and the one that he gets if he surrenders. This can effectively increase the surrender charge. These factors, taken together, will not only tend to dissuade an individual from surrendering or transferring to some other vehicle, but would also

diminish the actual cost to the company in the event that the surrender still takes place. I have made a personal computation (which I don't hold as gospel) that the general level of interest rates must rise 2-3% before you really begin to have to take action.

MR. J. ROSS HANSON: Did you say that one should use the CARV Method regardless of state of domicile?

MR. BAKER: It's not quite that simple today. I was suggesting two things. First, it's unlikely that a more onerous reserve standard will develop in the future. The CARV Method seems like a straightforward and equitable standard conceptually. If you base reserve requirements on CARV, it's unlikely that you will find yourself being required to put up additional reserves. Second, one must assume that within several years, it will become the widespread, nationwide standard.

MR. WILLIAM T. GIBB: Non-qualified deferred annuities have not only been moved to the front burner by many insurance companies and, as Mr. Barger was discussing, by stock brokerage firms, but have also been moved up the priority ladder of issues being examined by federal and state governments.

This, of course, is not a coincidence. More aggressive marketing of a product will naturally focus attention on it -- or else the marketing effort will have been a failure. Where the marketing stresses tax benefits, the tax folks become interested; where it stresses investment aspects, the SEC will naturally take a look. And this is what is happening in Washington right now.

#### Tax Reform Activity

The tax treatment -- at the policyholder level -- of non-qualified deferred annuities has raised somewhat of a storm within the life insurance business. I think that a full understanding of the issues requires a little background.

Late in the summer of 1977 -- when President Carter was still planning a wide-sweeping tax reform bill -- word was leaked by the Administration that the program would include a proposal to tax currently the "inside build-up," or interest element, of all life insurance and annuity products sold outside the various qualified plan provisions. We quickly confirmed this fact and, on direction from the Council's Board of Directors, organized an effort to dissuade the Administration from making such a broad proposal.

This effort was successful; however, reports filtered back from those who spoke with the White House, the Treasury Department, and Congressional leaders that there was particular concern with the apparent trend of marketing non-qualified deferred annuities as a tax-sheltered investment. The government folks cited ads by stockbrokers as proof positive that the tax deferral granted the earnings during the accumulation period was being exploited in an investment atmosphere. They pointed out that the insurance features of the annuity -- retirement income for life -- were seldom mentioned.

The message that we repeatedly received from these government sources was that the basic tax treatment of insurance products would remain in the limelight -- and be continually questioned -- unless the perceived misuses

of the tax deferral were eliminated. This is certainly not an unreasonable observation and one which, I think, the life insurance business must carefully consider.

The next chapter arose in the context of the scaled-down tax reform package eventually developed and submitted by the Carter administration. True to its word, the Administration -- in this instance, the Treasury Department -- did not completely drop its interest in insurance products. They singled out non-qualified deferred annuities and recommended that the earnings during the accumulation period be taxed as they accrue, rather than during the annuity payout as presently provided. The only exception would have permitted each individual to continue the present deferred tax treatment for a single annuity contract with up to \$1,000 annual premium.

In support of its proposal the Treasury Department cited stockbroker ads stressing the tax deferral advantages of annuities; and from this, classified all deferred annuities as "tax shelters." Obviously, this is not the case. Our member companies, including those that emphasize the annuity product, report that the great bulk of annuities are purchased and actually used to provide retirement security. All agree that the current tax treatment is clearly appropriate for these annuities, and our discussions with the Treasury Department indicated that it was not seeking to change the historic tax treatment as applied to true insurance and annuity products.

The problem then becomes one of defining the area, if any, where a change in tax treatment may be appropriate on the ground that the product involved is not the type of insurance or annuity contract for which the present tax treatment was designed. Here is where differences of opinion can and did occur within the life insurance business.

Where does this matter now stand with the Congress? The House Ways and Means Committee has in its first round of tentative decisions, taken a more limited approach than that recommended by the Treasury. In its initial series of drafting decisions, the Committee adopted the pro rata tax approach to partial withdrawals. Each partial withdrawal would be allocated between an investment element and a return of capital element with the investment element being taxed. It made no other changes in the existing tax structure for annuities. In this regard, we all applaud the decision of the Committee to scrap the Administration's approach which was a classic case of overkill. In fact, the Ways and Means Committee tended to go the opposite way in that it overruled the IRS on the treatment of "investment annuities." If the Committee's action holds, investment annuities will now come back under the same tax umbrella as the rest of the annuities. Now, let me review what is going on in the SEC side of the business.

#### SEC Activities

Yesterday, in a public meeting under the so-called Sunshine Law, the SEC approved the publication of a proposed rule which will have the effect of defining the term "annuity" for purposes of the exemption from the Federal Securities Laws granted to this product. Section 3(a)(8), as I understand it, exempts from the registration provisions life insurance and annuity products. The proposed rule deals with "what is an annuity product" and more so, "what is not an annuity product," for this purpose. This proposal is a result of a 18-month inquiry by the SEC into the nature of "guaranteed

investment contracts" written on insurance company General Accounts being sold to individuals, rather than Corporation Section 401 plans. The Council and about 60 individual companies filed comments with the Commission during this study; the Commission's proposed rule is a response to those comments and their concerns. After the proposal has been circulated to member companies, which will be very quickly, further comments (I'm sure) will be made by the Council within the comment period.

Let me briefly outline the essence of the proposed rule as I, being a non-SEC expert, understand it from reading it this morning. Basically, it sets forth conditions under which contracts, though called annuities, will not be deemed to be annuities exempt from the registration provisions of the securities laws. (It is made clear, however, that this rule has no effect on the no-action letters that the SEC has recently given with regard to Section 401 plans and some HR10 plans.) The following, under the proposed rule, fall into the "not-an-annuity" category. First, contracts without permanent annuity purchase-rate guarantees. Second, contracts which contain deposit fund riders. (For these first two categories that the SEC release stresses, you can look at the contract and decide whether the contract has to be registered or not.) And, third, contracts which are "primarily investments"; their status as being primarily investments depends upon a number of factors: (a) if it is a short-term contract, that is, there is an investment return guarantee that last 5-8 years, it will not be treated as an annuity contract if it is sold to an individual who, because of his or her age, cannot be expected to annuitize before the term of the contract ends; (b) if the permanent rate guarantees that are in the contract provide significantly lower benefits than are otherwise commercially available, the contract may not be an annuity; (c) if the contract provides for discretionary payment of excess interest, it may not be an annuity (but to finally determine, there has to be some other negative factor, such as that the contract is marketed as an investment); and (d) it's not an annuity if it's marketed as an investment.

#### NAIC Standard Nonforfeiture Law for Individual Deferred Annuities

The Standard Nonforfeiture Law for Individual Deferred Annuities was adopted by the NAIC in December 1976 in response to the rapid rise in sales of individual deferred annuities and the need to provide purchasers of such contracts nonforfeiture protection comparable to that provided by the Standard Nonforfeiture Law to purchasers of life insurance. Prior to the adoption of this model bill, only the states of New York, New Jersey and Washington had nonforfeiture requirements for individual annuities that resembled those for life insurance. The NAIC model bill is intended to provide a uniform basis for computing minimum nonforfeiture benefits under individual deferred annuities.

To date, the NAIC Standard Nonforfeiture Law for Individual Deferred Annuities, which is supported by the American Council of Life Insurance, has been enacted in 18 states. An operative date provision in the NAIC Model Bill allows companies two years to elect to be governed by its provisions.

#### NAIC Model Annuity and Deposit Fund Disclosure Regulation

The NAIC Model Annuity and Deposit Fund Disclosure Regulation is patterned after the NAIC Model Life Insurance Solicitation Regulation and was ini-

tially considered by the NAIC Cost Comparison Task Force in July 1976. After a year of no activity, the NAIC Task Force submitted the proposed regulation as an exposure draft at the December 1977 NAIC meeting.

The Model is intended to cover individually marketed annuities, and deposit funds accepted in conjunction with individual life insurance and annuity products. Pension plans subject to the federal Employee Retirement Income Security Act of 1974 (and most group contracts) would be exempt, as would Individual Retirement Annuities which are already subject to federal disclosure standards. Exemptions would also be provided for immediate annuities and for funds accepted for advance payments of specific discounted premiums or under a premium payment facility where the fund would not exceed twice the sum of the premiums payable in one year. However, tax sheltered annuities funded entirely through an employee's own contributions, or salary reduction arrangements, and HR10 plans for a single owner-employee, would be subject to the Model. As part of the required disclosure of values for representative years under the contract, the regulation would prohibit any display of guaranteed and non-guaranteed benefits as a single sum unless guaranteed benefits are shown separately and with equal prominence in close proximity to them.

On May 1, the NAIC Cost Comparisons Task Force developed the most recent draft of the Model which will be submitted to the NAIC for adoption in June. This draft incorporates a number of suggestions from the Actuarial Committee of the Council and members of the American Council of Life Insurance.

MR. TURNER: I think the SEC proposed rule also had certain implications that could potentially bring a company under the Investment Company Act of 1940. Did you mention that?

MR. GIBB: The basic thing we were discussing relates to when you have to register one of these annuity contracts under the Securities Act of 1933 which involves prospectuses. The proposed rule also has some language that says, if the primary business of the insurance company is selling these types of annuities, they may be considered to be an "investment company" subject to the 1940 Act.

MR. TURNER: You mentioned the proposed pro rata tax on partial withdrawals. Was there any differentiation between withdrawal via policy loan and partial cash withdrawal?

MR. GIBB: No. It's our understanding that the way this will be drafted, it will cover both. It will cover an actual partial withdrawal from the contract, or a loan from the insurance company. The question will be, if you pledge the contract as security with a third party, whether they cover that or not.

MR. TURNER: This has been a hot topic over the last 18 months; since the SEC first started their look at SPDAs. I've been at several meetings in the last few weeks where this came up and speakers talked about federal regulation and the recent moves by the SEC, FTC and IRS. The recently proposed compromise by the ACLI led to an accusation in one instance to cronyism between ACLI lawyers and lawyers in these federal regulatory agencies. Recent moves would also appear to represent a coordinated effort of these

agencies. How would you, or the ACLI, respond to recent moves by several federal regulatory agencies into the life insurance business. Is it all really coincidence that they've moved at the same time?

MR. GIBB: As far as it being a concerted move by the government to grab hold of the life insurance business, I don't think they planned among themselves. I do think it would be fair to say that they didn't have to. The product hit the market in such an explosion that it would be hard for anyone to miss it. If anything, the SEC got started before the Treasury Department, but I don't think there is a sinister move going on by the whole government to get together and do us in. At least we haven't seen it yet.

As to the role of the Council in this whole thing, I would like to talk about the tax issue, and more specifically about the Tax Reform Bill. As Sam eluded to, the Council has an official position that was adopted by the Board of Directors offering an alternative proposal to the one made by the Treasury Department. We agreed completely that the Treasury Department's proposal was just plain wrong. They would go after all deferred annuities, when the problem that they perceive (where the contract is being used as an investment) is limited to a relatively small portion of annuity sales. The basic issue we see here is what is the best way to protect our basic tax treatment in the future? This relates to the deferred tax treatment of annuities during the accumulation period and also relates to the tax treatment for life insurance where, if the proceeds are taken as death benefits, there is no tax on the "inside build-up" of interest earnings. It's our view that the current tax treatment is essentially based on social policy and public policy. The best protection we have is to retain the social policy argument. We think that can only be done if the tax treatment is limited to those products which are, in essence, insurance or annuity products. As long as there are particular products or particular uses of products that are not insurance uses and not annuity uses, we feel that the government is going to keep coming back, and eventually they are going to get what they want. So if it's possible to define areas where people can agree that the current tax treatment is not appropriate, we felt that it was to the life insurance business's long-run advantage if those products are carved out and are treated like the products they compete with -- bank accounts, mutual funds, etc. It's with that background in mind that the Council came up with the proposition that there is no way we can look at an annuity contract at the outset, either in its drafted form or even when it's sold, and tell whether this is an annuity or whether this is being bought as an investment. The only way is to look at what it is used for. Under the proposal the Council made, if in fact the purchaser uses the contract as a retirement security vehicle (the funds are not withdrawn until he or she reaches retirement age), then the tax treatment would stay the same. However, if it's used as an investment vehicle (the money is withdrawn before retirement age) then we suggested that a so-called equalization tax be applied. The purpose of that tax would be to undo the tax deferral, or put the individual in the same situation tax-wise as if he had invested in an investment vehicle and had paid the tax currently. We also feel that if we cannot differentiate in some manner between those cases that are real insurance products and those that aren't, then the Treasury Department would come back with a much broader proposal that would go across to life insurance products. I think that their proposal this year was some indication of that. They were attempting to throw out all non-

qualified deferred annuities in order to get at a little piece. So that's the reason we did what we did. There was no compromise on the part of the Council on the basic proposal. The Treasury came to us and said we're making the proposal with respect to non-qualified deferred annuities. They asked what kind of exceptions should there be? And it was in that context that we came back and said that we think that you should handle it this way.

MR. TURNER: I have one more question of Ed Baker - In the pricing area, how sensitive have you found profit expectations to suspension and withdrawal rates? To clarify terms, take a typical flexible premium retirement annuity with the intention to put in \$1,000 a year. "Suspension" to me is when he quits putting in the \$1,000. "Withdrawal" is, having quit putting new money in, at what rate do they withdraw funds?

MR. BAKER: As I indicated in my presentation, our review is entirely oriented to the receipt of a premium; therefore, the fact that the flexible premium contract does provide for additional premiums isn't really taken into consideration because those premiums will be subject, in general, to the benefit guarantees then being made. So, we don't deal with suspension. As for withdrawal, the rates of withdrawal will effectively influence things like yield on invested surplus and, I suppose if you were dealing with potential large deviations in the rates of withdrawals in your assumptions, you might see some material impact. But at the level of deviation that we address, which seems satisfactory, you don't see a really marked impact. Essentially what you are confronted with is that you will earn a certain rate of return on the business so long as it's there, and when it's not there, you won't earn that rate of return.

MR. TURNER: One point I'll make to supplement his comments. In a lot of the studies that we've seen where the companies take a more traditional pricing view as opposed to the methodology used at Capitol, it is very significant in these sorts of contracts to keep up with inactive accounts. The traditional assumption in pricing life insurance is X% lapse and all take cash. In pricing flexible premium retirement annuities and those sorts of contracts, there is a significant difference in the profitability as to whether they do take cash or leave it in. Experience tends to give you a good feel for suspension rates and withdrawal rates. And it's not unusual to see half of the expected profits coming off inactive accounts -- inactive meaning accounts where there are no payments currently being made into the account.