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THE FUTURE OF SINGLE PREMIUM LIFE INSURANCE AND ANNUITIES

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MR. JOHN F. FRITZ: We are currently caught up in some very out of the ordinary times to say the least. We are in the midst of some of the highest inflation ever for our country -- and interest rates that are going through the roof!

As the title of this session suggests, we on this panel are going to discuss the future of single premium life insurance and annuities. But before we can talk about the future, we must recognize the realities of the present. Some of you may say we are living in the future now!

We, as actuaries, are looked to as futurists by our companies, our clients and the public. Before we can discuss what may happen in the future we have to understand the present. So first, we will set the stage for what we perceive the future to be in the single premium life and annuity area, given the three scenarios presented in yesterday's general session, by discussing the present. And as I'm sure you are all aware, the present, especially in the single premium annuity area, is certainly a hot topic in the life insurance industry these days. So much so, that we'll have to be careful not to fill up all of the time discussing the now but press on and discuss what we perceive the future to be.

Our first panelist will be Bernie Halstead, Chief Actuary of Federal Kemper Life Insurance Company. He will discuss the potential in this market, as well as how government regulation and taxation are affecting and will affect the market.

MR.BURNETT HALSTEAD: My comments cover the potential of single premium insurance and annuities and their regulation. Potential is discussed in terms of sales, replacement and profitability; regulation in terms of nonforfeiture, valuation, taxation, and SEC registration. My comments primarily concern fixed dollar nonqualified products in the United States.

With respect to sales potential, sales of single premium deferred annuities were probably at about 2 billion dollars in 1979. Although this represents a significant increase over 1978 and earlier years, it still represents less than 2% of new personal savings for the year and a drop in the bucket of accumulated personal savings in this country. Sales of single premium life insurance have not been nearly so significant in the U.S. Sales have apparently been more significant in Canada. I understand sales there were about 50 million dollars in 1979. This probably represents 600 or 700 million dollars of volume.

The popularity of single premium annuities is probably traceable to a considerable extent to the appalling economic climate of our country and our times. High apparent tax sheltered yields and a guaranteed principle look very attractive especially with riskier non-tax-deferred or tax-exempt investments as an alternative. There is some question, though, whether their popularity can be sustained in a different economic climate or under more competitive conditions. The high yields, for example, are not keeping up with inflation. As a result these products represent a method of dissaving and it seems difficult to believe they will continue to be popular under the high inflation scenario after 7 more years of double digit inflation. On the other hand if inflation is controlled and investment is encouraged, it is likely people will have enough confidence to return to more traditional investments, especially if other forms of savings offer the same tax advan-

tages. Thus, there is some question whether the Investment scenario holds a great deal of potential for single premium products either. Under the Social Democracy scenario there would not appear to be much incentive to invest in anything. Although these comments are somewhat pessimistic about the continued popularity of single premium annuities, there is a great deal of momentum going for the product and the momentum may well prevail even if the economic reasons for the popularity become somewhat questionable.

To the extent that single premium life policies may be sold in lieu of single premium annuities for regulatory reasons, my comments regarding annuities are equally applicable to life. They can and are being used, though, for insurance purposes as well as for investment purposes. As already mentioned they seem to be rather popular in Canada for this purpose. Properly designed products do seem to have considerable appeal but whether they will be significantly popular under any scenario seems speculative at this point.

These comments on potential sales would not be complete without noting that the federal government seems bent on destroying the product, particularly the single premium annuity. This is covered later under the subject of regulation.

In switching to the replacement potential, under the High Inflation scenario, there is considerable potential for replacement. The replacement can take the form of replacing like products; for example, a new single premium annuity policy for an old single premium annuity policy paying a lower interest rate. Single premium policies, particularly single premium life policies, can also be used to replace annual premium cash value life insurance, especially where cash values have been accumulated. In a rising interest market the modern single premium policy will normally produce more attractive results for the policyholder. While the potential is certainly there and has been there for some time, it would appear, though, that policy owners do not necessarily replace their policies. There is a great deal of inertia even if change is clearly to the policyholders' advantage. This is not to imply that single premium policies are not used in replacement situations. They are. In Canada, for example, I have been told that about one-third of the single premium life sales are replacement sales. In the United States one large national distributor estimates 10% to 15% of single premium annuity sales are replacements of existing single premium annuities. I am surprised, though, that there is not a great deal more replacement activity.

Under the Investment scenario the character of replacement may change somewhat and there might be more replacement of life company products, particularly single premium annuities, by non life company products. Under the Social Democracy scenario there would probably be a gradual erosion of life company business in favor of government programs.

Swinging to potential profit, anticipated annual profits in single premium annuities are probably in the area of 50 to 100 basis points. This works out to $5,000 to $10,000 for each $1,000,000 of annuity assets. Anticipated profits on single premium life are probably considerably higher, at least in current products available. These profits are contingent on (i) being able to earn enough extra basis points on investments to cover both the desired profit margin and overhead expenses not covered by direct loads or other charges, (ii) avoiding capital losses and (iii) avoiding mortality losses.

Capital loss is probably the most serious risk faced by a company writing significant annuity business. Rising interest rates reduce the market value of securities backing the annuities and capital losses can easily occur in the event of any significant withdrawal volume. Interest rates have been rising. The facts on this score are a little chilling. The average prime rate has risen from 1.58% in the 1940's to 3.78% in the 1950's to 5.28% in the 1960's to 7.59% in the first 6 years of the 1970's to over 20% now. Twenty-five and thirty percent interest rates seem unthinkable but so did 10% not too many years ago. Under the High Inflation scenario it could happen and might even be reasonably expected. Under the other scenarios it seems less likely. If an individual can trade in his 10% annuity for one currently paying 20% it seems hard to believe there won't be significant withdrawals, particularly if there is no surrender charge at all, as is the case in many annuity programs.

The mortality risk (in annuity products) is perhaps not receiving as much attention as it deserves, probably because it is not currently being sold for its annuity benefits. It may be that significant potential losses are being ignored, though, particularly under scenarios where interest rates could decline. It is interesting to note that under all scenarios mortality is expected to improve substantially. Betting against people living too long is a little scary with significant medical breakthroughs predicted for the not too distant future.

Turning from the negative to the positive, if you can ignore the mortality risk, it would appear that declining interest rates probably offer the greatest potential for profit, at least to a point. They offer the potential of (i) a larger basis point spread and/or (ii) significant capital gains. If interest rates decline, though, there might well be a movement of assets out of annuities which of course would reduce earnings potential.

Swinging from potential to regulation, these are general comments. Single premium annuities have been designed and become popular in a relatively lax and inconsistent regulatory climate. Since they have become popular there has been an ongoing effort to tighten the regulations and make them more consistent. In some areas, for example nonforfeiture and valuation, this has, in fact, occurred. It seems likely there will continue to be more activity over the next several years.

Regulatory activity is occuring at both the state and federal levels. At the state level a number of areas are important: (i) valuation of liabilities, (ii) valuation of assets, (iii) nonforfeiture laws, (iv) premium taxes and (v) policy forms. At the federal level, tax and securities regulations have been the two most important areas.

With respect to state regulation, valuation and nonforfeiture regulation has been changing and has affected products offered but has not affected their popularity. Nothing currently being considered would seem to alter the situation very drastically.

State regulations allowing bonds to be valued at book instead of market have made it feasible for insurance companies to guarantee the principal sum invested and have helped make single premium products attractive. However, there has been considerable concern expressed about the risk of mass surrenders caused by rising interest rates. If this is translated into regulations that would require insurance companies to use, for example, a market value

approach for valuing securities, it could hurt the attractiveness of the products.

Premium tax regulation has been a significant competitive problem for companies domiciled in states that impose a premium tax on annuities, although a number of states have recently eliminated taxes on annuities.

The various future scenarios, in my opinion, will not have a great deal of effect on state regulation of these products. State regulation moves far too slowly. There is unlikely to be any significant change in valuation or nonforfeiture methods. There will, no doubt, be changes in valuation interest rates and probably mortality standards. Either or both may be on a dynamic basis within a few years. Some consistency will probably be developed between group and individual products. There is unlikely, though, to be much consistency between insurance and annuity products. There will probably be added pressure for all states to eliminate premium taxes on annuities, although this would probably evaporate under scenarios where annuities diminish in popularity. It would appear that all states within a reasonable period of time will approve nonguaranteed or adjustable type products needed to make single premium life viable. One area where state regulatory changes may occur is in the valuation of securities. Single premium policies, as currently designed and sold, as previously noted, contain a significant risk of company insolvency in a rising interest market. Under the High Inflation scenario, for example, continually rising interest rates are a distinct possibility. It would probably take only one insolvency to raise a cry to change the laws.

Turning from state regulation to federal regulation, federal tax regulation has been a very sensitive area. The products are sold as tax shelters and any effort to limit the shelter they currently offer strikes to their heart. There was an attempt in 1978 to tax policyholders on the inside interest build-up of annuities. There is currently an attempt to treat guaranteed excess on interest as dividends for tax purposes and hence limit the deductibility of the excees interest to life insurance companies. SEC regulation has been almost as sensitive. The SEC has made attempts to treat single premium annuities as securities and there is still some question how actively they are pursuing this. SEC activity has affected product design and advertising but so far has had little impact on the popularity of the product.

Future scenarios are likely to have more impact in the area of federal regulations. Current policy in the federal government seems to be against any sort of tax shelter. Single premium annuities are perceived by the federal government as a tax shelter device, and, hence, something to be done in. They are also perceived as unfair competition by other savings institutions who cannot offer the same type of tax sheltering for their clients. It seems unlikely under any scenario that single premium annuity and life products will retain their current advantage over other savings vehicles. Rationally, the government would put them on a more or less even footing, although the government is not noted for its rationality. Under the Investment scenario, it seems reasonable that tax sheltering would probably be permitted and perhaps even encouraged. Under this scenario premiums might even be deductible for non-qualified annuities as they now are for tax sheltered an-

nuities and other qualified annuities. Under the High Inflation scenario it is probably reasonable to expect that current policy would be continued. Under the social democracy scenario tax changes are not clear to me, but it may not make any difference.

Turning from the IRS to the SEC, it would appear the SEC wants to declare single premium annuities as securities and require them to be registered. This may not be likely under the investment scenario but could happen under the other scenarios. I personally regard SEC or some type of regulation as inevitable in the long run for both annuities and life insurance, although the 1980's may be too soon. It should be noted, though, that if the IRS is successful in sustaining its position that excess interest be treated as dividends, companies may be forced to register their products to avoid undesirable tax consequences.

I have a few comments on single premium life versus single premium annuities. There have been some significant regulatory differences between single premium annuities and single premium life insurance. More lax regulatory requirements on annuities have tended to favor them over life policies and have been one important reason why they have been more popular. To some extent this has been changing and in some respects reversing. So far the changes have not been significant enough to change the relative popularity of the products, though. Single premium life, however, can provide most of the benefits of single premium annuities plus the added advantages of (i) receiving benefits on death free of income tax, and (ii) purchasing death benefits with before tax instead of after tax dollars (i.e. compared to a combination program involving an annuity and term insurance). There is some feeling that when the additional tax shelters afforded by single premium life are "discovered" the relative popularity of the two products may change. Life products also have so far been free of recent IRS and SEC attacks on annuities. Since life products can be designed which provide minimal death benefits, just enough to cross the definitional line between annuities and life insurance, they may offer a way around regulations designed to repress annuity sales.

In summary, I am optimistic that the product will survive and probably thrive over the short term. Some companies will probably be bloodied a bit by them and there will no doubt be a good deal of regulatory harrassment. It seems to me there is an element of unsoundness in the product which will probably be corrected in some evolutionary way either by the companies themselves or by the regulators.

Over the longer term I am not comfortable about predicting whether single premium policies will continue to be popular until 1990. A good deal depends on (i) what the federal government does in the tax area, (ii) the state of our economy and (iii) whether other financial institutions can come up with competitive products. It is somewhat faddish at the moment for securities dealers to recommend putting investment money in single premium annuities. Investment fads, however, do not last forever and securities dealers have a reputation for being fickle. The viability of the product may well depend in part on the ability of the life companies to get better control of the sales of the products. As I indicated earlier I am somewhat pessimistic over the long run under all three scenarios, but I would be the first to admit I could be dead wrong.

MR.FRITZ: Our next speaker, Jim Tilley, Assistant Actuary at John Hancock, is the author of the very excellent paper entitled, "The Pricing of Single Premium Immediate Annuities". Jim will discuss the areas of field compensation, competition from other savings media and, very appropriately, the pricing and design of these single premium products.

MR. JAMES A. TILLEY: Some insurers market very competitively priced single premium deferred annuities through brokerage houses. Because of the investment characteristics of the product, its simplicity relative to other insurance products, and the large clientele of retail brokers, this is an effective distribution system. Most life agents do not sell single premium life and annuities as their primary (bread and butter) products. However, the single premium annuity is often a good door opener for other sales opportunities.

Commissions to writing agents are usually less than 3% of the single premium. For annuities, a scale graded down by size of the premium is ofen used. On premiums of $100,000 and larger, the average commission rate is often 2% or less.

The public sector can be expected to grow at the expense of the private sector under both the High Inflation and Social Democracy scenarios. Individuals' savings and hence purchase of single premium products will wane. The decline in the rate of saving will be further exacerbated by rampant inflation in the HIGH INFLATION scenario. I would expect little growth in sales in real dollar terms. Coupled with low commission rates, that will mean agents and brokers will have to sell many other products and services to sustain a living. Under these two scenarios, I would aniticipate a decline in the number of life companies and in the size of agency forces.

Turning to a few comments on competition from other savings media, we note that in today's investment climate, certificates of deposit offered by savings banks provide higher short-term returns to the individual investor than do most single premium deferred annuites. Attractive returns as well as limited check writing services and even credit can be obtained through the variety of cash investment trusts that have mushroomed recently. Competition from other financial institutions would be even more intense under the Incentive and Investment scenario that is found today since regulations would permit these institutions to price and design their own insurance products.

There will be little personal investment in the High Inflation scenario. In that scenario, single premium life and annuity products will not be attractive investment vehicles and insurers will be able to capture individuals' savings only to the extent there is a bona fide insurance need as well as an investment need.

With regard to the pricing and design of the single premium products, the interest rate assumption is crucial in pricing single premium products. How to choose it depends on whether investment earnings are allocated to blocks of business on a portfolio or an investment generation basis. If a portfolio method is used, the interest rate is that for the line of business, not for the entire general account of the insurer. Many companies started offering flexible and related single premium deferred annuities about five years ago. At that point there was no distinction between an investment generation and

a portfolio method because the line of business was new. However, as years have passed and interest rates first dropped and then climbed more or less to their present levels, a gap has developed between the portfolio rate for the entire line and the average new-money rate earned by the most recent issues.

Both the Social Democracy and the Incentive and Investment scenarios set the stage for the long-awaited showdown between the portfolio and investment generation approaches to pricing. Since these two scenarios project much lower inflation and interest rates by 1986, portfolio rates in the mid-1980's will exceed then-prevailing new-money rates. There could be massive lapsation of business from the new-money companies to the portfolio companies unless protective surrender charges are sufficiently high. In any event, new-money companies will find it difficult to attract new business. I suspect that these companies might attempt to let new contracts buy into the general account portfolio at book values. This investment antiselection might well be permitted in the less stringent regulatory environment of the Incentive and Investment scenario, but not in the Social Democracy scenario where there are coalitions of worker-owners and customer-owners of mutual companies and where publicly-owned companies must pay increased attention to policyholder wishes.

A completely different picture emerges from the deteriorating economy in the High Inflation scenario. Owners of deferred annuity products are likely to be interested in declared rates or interest guarantees that move upward frequently. There could be heavy lapsation of business from portfolio companies to new-money companies and from old contracts in new-money companies to new contracts in those same companies. Inadequate surrender charges might put some insurers in the position of large unrecoverable capital losses and unamortized acquisition expenses. Technically safe product design might be uncompetitive and potential deferred annuity business would be lost to cash management trusts, savings bank certificates, and other funds crediting short-term interest rates. If a long-term bond market exists at all in the High Inflation scenario, it is possible that corporations would start to issue indexed bonds in the 1980's. These bonds could be used to back deferred annuity products that provide a six-month interest guarantee which tracks prevailing new-money rates. Such a product design would reduce substantially the possibility of mass lapsation when interest rates rise dramatically.

How should the interest assumption be chosen for investment generation pricing? For single premium immediate annuities issued at high enough ages, it is possible to lock in a desired profitability (apart from the contingency of longevity) by choosing the maturity structure of the assets to match the annuity payout. It is not possible to immunize single premium life insurance and deferred annuities fully against the ravages of interest rate movements, but it is possible to invest funds in such a way that total realized returns over a five to ten year period are close to current yields. This suggests that a two-tiered interest assumption be used: current new-money rates for an initial period and more conservative rates thereafter.

An adjustable single premium whole life product can be based on the above idea. Premium rates are established initially using the current two-tiered interest assumption. After the initial period, the face amount (for a given premium) is adjusted up or down on the basis of a "repricing" at the then appropriate two-tiered interest assumption. The amount of the adjustment is

a function of the difference between the actual new-money rate at the expiration of the initial period and the original second-tier interest rate. Considerations in choosing the second-tier rate are much the same as in choosing the "assumed investment return" for a variable annuity.

The mortality assumptions underlying settlement option rates should be given careful consideration. The possibility of medical breakthroughs that would add considerably to longevity cannot be disregarded. The dawn of the era of very primitive genetic engineering has already occured and practical advances may be made in the forseeable future. One cannot rely on sociological constraints to impede or prevent utilization of such techniques. Single premium annuity contracts with long deferred periods issued during the 1980's may reach payout status at the time these breakthroughs are occuring.

The description of each of the three scenarios refers to an increase in the life expectancy at birth of five years from its value in 1976 to its value in 1980. It is not indicated where in the life table the decrease in mortality rates occurs. If the improvements are concentrated at ages 50 and over (where the single premium deferred annuity market is strong), the effect on payout rates can be dramatic. Whatever static mortality table is used to price annuity or settlement option rates, a conservative projection scale should be applied. Several sets of guaranteed settlement option rates can be used, each one applicable to a different period when the option would be exercised. For example, the first set of rates could be used for settlements in the period 1980-89, a more conservative set for 1990-99, and a very conservative set for 2000 and later.

Mortality improvement is a less troublesome problem in single premium life insurance because increased longevity brings mortality gains that accumulate with interest and help to offset mortality losses on the payout under a beneficiary's settlement option. But if the insurance is participating, at least part of these mortality gains would be passed on to the policyholder.

Surrender charges in single premium deferred annuities protect against two adverse circumstances: (1) unamortized acquisition expenses on early lapse, and (2) the inequity of persisting contracts having to buy depreciated assets from contracts cashing out in periods of rising interest rates. The larger the margin between the load and the commission rate is, the smaller the surrender charge has to be to cover unamortized acquisition expenses, and the sooner these charges can grade down to zero. Thus, such surrender scales tend to be found in very low load or no-load products. An adequate surrender charge scale for the "depreciated asset" contingency depends on the type of interest guarantee, if any, and on how investment income is allocated to the various blocks of business. An analysis of results under several interest scenarios is helpful in designing the scale of surrender charges.

Two types of surrender charges are found in the marketplace: (1) a specific percentage deduction from the contract's cash value, and (2) the difference between the cash value computed at the guaranteed or declared interest rate and the cash value recomputed at a stipulated lower interest rate. The latter type is used by banks on term certificates. This "interest penalty" increases during the period when it is applicable, and is viewed by some consumers only as a reduction in credited interest for early withdrawal, not as a direct liquidation charge.

Products with new-money interest guarantees usually do not credit interest earned in excess of the guarantee and are nonparticipating with respect to interest element during the period of the guarantee. By contrast, participating contracts receive interest at a rate declared on the basis of investment (and other) experience. Even products with a new-money guarantee are not permanently nonparticipating since either a new guarantee is established on expiration of the old one, or interest is credited on a declared basis after the original guarantee expires.

Since the market for single premium products is very competitive, loads and other expense charges are usually established at the lowest level consistent with financial soundness. Adverse expense experience is reflected in participating contracts through the declared interest rate.

To the extent that withdrawing contracts cash out at other than market value - in other words, depending on how the surrender charges, if any, are priced - the gains and losses end up fully as credits or charges to the line's surplus if the product is nonparticipating, or at least partially as intergenerational transfers via subsequent declared interest rates if the product is participating.

Annuities in payout status and other contracts having elected life-contingent settlement options are almost always nonparticipating with respect to the mortality element because of the practical and theoretical difficulties in establishing credible dividends on relatively small blocks of business.

Almost all single premium immediate annuities are nonparticipating. This stems from competitive considerations: prospective buyers can compare products on the basis of a single number - the amount of monthly income purchased by a given amount of single premium. Most sales go to companies quoting the highest amounts of guaranteed monthly income, so participating products generally have difficulty competing effectively in this environment.

MR. FRITZ: The pricing and design of single premium annuities, especially, has seen some innovative changes over the last year.

Because of the crazy economic times in which we now find ourselves, as well as certain potential tax complications that have recently surfaced, we are seeing even more new developments in this area. With the current high interest rates, companies are being forced to stay competitive by offering higher interest guarantees that have been used or even anticipated in the past. This can create statutory surplus strain problems depending on the level of theguarantee and the period of time to which the guarantees apply. In order to minimize this, some companies have gone to a group single premium deferred annuity approach, defining "group" as something like "clients of a certain brokerage firm." This definition of "group" is apparently allowed in most states.

The guaranteed excess interest problem mentioned by Bernie stems from the fact that excess interest may be viewed as a dividend by the IRS, or at least they will attempt to view it as such. A recent development in this area is to tie this interest guarantee to some kind of outside index, such as the current prime interest rate.

This may solve the "dividend question" problem. However it may raise another question. How will State Insurance Departments view this kind of a guarantee for valuation purposes? Also, this may not solve problems in calculating taxable investment income.

Last, but certainly not least, Ted Steven, Individual Product Officer at Great-West Life Assurance Company in Canada, will discuss the Canadian situation in these markets.

MR. DAVID E. STEVEN: I will first address some differences in products, markets and the regulatory environment found in Canada today compared to the situation in the United States, and then discuss some probable effects on the single premium life insurance, deferred annuity and immediate annuity business under each of the scenarios.

Financial reporting is now on a GAAP basis, but without statutory requirements which mandate heavy strain. Nevertheless, the valuation actuary, particularly under current circumstances, will pay great attention to contracts subject to surrender at guaranteed value, and these products will normally strain surplus at issue.

On the income tax front, the gain element under deferred annuities became taxable at death in 1979. This was part of a package which also proposed taxing life insurance proceeds at death, but the latter element was withdrawn for political reasons. As one consequence of this attempt, all life insurance contracts in-force were given a "fresh start" in the sense that any excess of value over premiums paid to 1978 was set to zero for taxation purposes.

From a market perspective the Canadian counterpart to the IRA, the Retirement Savings Plan, is more mature, having existed since 1957. This is a growing significant source of immediate annuity business as well as a large deferred annuity opportunity. An additional immediate annuity opportunity is the Income Averaging Annuity, which allows spreading of taxable capital gains through a term certain or life income contract. Trust companies are currently empowered to issue term certain annuities for this purpose.

The adjustable single premium life policy Mr. Tilley alluded to has been a reality in Canada since 1974. It operates on a 5-year renewal cycle, with the initial cash value growth guaranteed as long as 10 years. Compared to traditional non-par or par contracts, the adjustable plan offers immense value to the owner in terms of protection per premium dollar.

Turning first to the High Inflation scenario, we can try to visualize the impact of entrenched institutionalized heavy inflation on single premium business. We may well encounter a decline in the growth of the market for these products, together with a shift in buyer characteristics. As government and employer group programs become the major source of financial security, the lower and middle income customer potential will diminish and sales will increasingly focus on the high income personal or corporate market segment.

Regulated cost disclosure, high technology consumer information dissemination and the additudinal emphasis on "what's in it <u>today</u> for <u>me</u>" will combine to generate intense price competition. This will, in turn, translate into a significant impact on existing business as replacement will become

increasingly attractive and apparent to owners of traditional life and deferred annuity policies.

A natural consequence of such heavy competition is the narrowing of margins for profit. For both immediate and deferred annuity, margins could approach 50 basis points, particularly if capital requirements cause direct competition and comparison with other savings institutions on a fully-disclosed rate of return basis. Under the FTC approach, single premium life would be analogous to deferred annuity plus decreasing term, and profit margins on the added dimension of insurance could be as thin as 5% of the yearly renewable term cost.

The most hopeful prognosis for profitability would be the continuation of favored status under income tax regulations, deferring tax on growth of insurance and annuity funds until disposition. This could enable more customary margins for non-qualified plans, but would be impossible in the Retirement Savings Plan market where we compete on equal tax terms with banks and trusts for both contributions and accumulations.

The Income Averaging Annuity market should continue as a strong opportunity as inflation will automatically generate more and more taxable gains (artificial though they may be), unless tax indexing includes the cost base of property subject to this tax. In any event, continued competition with trusts for term-certains will keep profit margins thin.

Agents compensation on many deferred annuity products in Canada has reached the 1 to 1½% level already, which is, in my view, about as low as it can go. The same is true for term certain annuities for Income Averaging purposes. Both are a direct reflection of competition with non-industry institutions which incur either no cost in acquiring funds or pay a "finder's fee" of perhaps 1%. If the heavy competition for diminishing markets is realized, the same might ensue for immediate life annuities and single premium life insurance. Either the agent will treat these products as incidental to his livelihood, or seek to handle a great volume of funds - perhaps through accelerated switching from one institution to another for each client as new and better "deals" appear.

Under this scenario, I cannot envisage the survival of portfolio rate products. Significant investment policy changes will be necessary to cope with policyholders' shortened horizons, and products will need to provide either lock-in or capital adjustment protection opposite surrender values if there is any asset/liability mismatch. Even immediate annuities could become subject to periodic readjustment under these conditions if consumerist pressure were directed against current practice of offering non-commutable non-participating plans.

The impact of improved longevity may be offset by low interest assumptions in current settlement options, but competitive pressures will bear on this feature as well. Companies not currently using projected or generation options may well find mortality and expense losses exceeding interest gains.

Significant surplus costs may be incurred defending portfolios against replacement. In addition, life insurance replacements will leave behind a generally impaired policyholder grouping whose experience will be an added burden to surplus, while data restrictions may inhibit what we believe today to be proper underwriting of new risks.

Products could be either par or non-par, although there are current regulatory concerns in Canada suggesting that renewable new money contracts should be classified as participating to ensure fair treatment of policyholders at renewal.

The Incentive and Investment scenario appears to be the most pleasant outlook for this business, yet there are a number of "bad news" items in this "issue". While the general market opportunities are quite buoyant with the high degree of saving, the elimination of corporate income tax will eliminate current tax-oriented corporate sales of single premium life insurance, and the elimination of capital gains taxation will eliminate the Income Averaging Annuity market. Reduced personal income tax levels will reduce the attraction of Retirement Savings Plan business to some extent, although it will remain a primary vehicle for retirement saving.

Not only will some markets evaporate, but we will encounter direct competition from other financial institutions who choose to enter our field. Given the major differentials in investment policy and administrative capability requisite for banking and insurance, the advantage seems, to me, to favor banking's move into long-term saving over our industry moving into short-term fund administration. The power and reputation of Canadian banks represents a formidable picture as a competitor for long-term accumulation plans with the tax deferral advantages enjoyed currently only by our products.

If we assume that these new self-sufficient customers are as intelligent as they are prudent, we must anticipate strong demand for good returns on investments. At lower interest rate levels, small yield differentials between products will have a more significant impact on projected long-term accumulations. Even under much relaxed disclosure regulation, then, I believe we will see strong price competition, particularly if banks and trusts enter our domain.

This competition will tend to squeeze both profit margins and agent's compensation to minimal acceptable levels. We may see a trend toward "consultation fee" compensation for agents establishing themselves as financial counsellors, and the introduction of "over the counter" life company distribution centers to compete with banks and trusts.

Portfolio companies will have the upper hand on price competition, but with any large movement of business, that advantage will wane quickly. In the interest of protecting existing policyholder equity, those companies may even choose such an opportunity to change over to new money. The new money companies may suffer heavy lapsation, but should survive financially if they are properly immunized or mis-matched long and have sufficient expense recapture surrender charges. In fact, they may be relieved of settlement option guarantees which, in view of reduced interest and increased longevity, could produce losses. Banks and trusts will, of course, fall into the new money category even if they select a portfolio approach.

Declining interest rates may tend to make non-participating contracts less attractive as pricing assumptions revert to a pessimistic or conservative character, unless contracts are structured on a periodic renewable basis.

This scenario also suggest the revival of equity-linked products for our industry, much akin to the situation in the early 1960's. The elimination of capital gains tax would enhance considerably the attraction of such products

in a strong private-enterprise oriented economy.

Not surprisingly, the Social Democracy scenario is by far the least attractive picture emerging from our crystal ball. A general decline in the need for these products due to reliance on broader government benefits will force diversion of marketing attention toward the very top end of the socioeconomic market. With extremely high income tax rates, the deferral attributes of single premium life and deferred annuity, if tax authorities do not withdraw this advantage, will hold strong appeal to wealthy individuals and corporations. Under permanent wage controls and high tax rates, alternatives to direct cash compensation will be increasingly attractive. On the immediate annuity side, Income Averaging Annuities could flourish. It is also a remote possibility that our industry may be able to provide, on a pooled basis, the pension payments emerging out of National Pension Corporation, but only with highly efficient administration, extremely thin profit margins and no sales commission.

Development of other than resource industries will require capital from a highly taxed populace, which indicates keen competition for diminished savings by all financial institutions. Coupled with a severly restricted market, our competition would become intense and hence profit and compensation margins again minimized.

Within this scenario, the heightened sense of social equity will, I believe, require all companies to adopt new money interest techniques for these products. Most certainly, today's concern in Canada regarding business classification would manifest itself in mandating full participating status for Single Premium life and deferred annuity plans.

As in the Investment scenario, settlement option deficiencies may emerge as interest rates decline and mortality improves. All companies may experience surrenders beyond those anticipated as increasing government benefits and taxation, together with wage controls, transform the utility of policies held into sources of cash for current needs rather than required saving for future security.

Although distinctly different, these three business environments do suggest certain common effects applicable to single premium life insurance and annuity products in the 1980's which I will briefly summarize. Competition will increase in intensity with attendant narrowing of margins for both profitability and agents' compensation. Companies will eventually adopt new money pricing and investment policy for these plans, and must design products with judicious attention to both replacement and capital value considerations. Finally, we must recognize our dependance on a preferred tax status today and be prepared to compete on equal terms with other institutions should that advantage ever be lost.

MR. FRITZ: Under the Momentum or High Inflation scenario, I see single premium annuities and perhaps even single premium life insurance put on an equal footing with other savings media for tax purposes. This could mean the end of this market as we know it today. That is, it would be sold mainly as an accomodation to clients. Commissions would be low and perhaps even nonexistent.

In the case of the Incentive and Investment scenario, other savings media may very well be broughton an equal footing with life insurance companies. That

is, their vehicles may have the same kind of tax shelter as our Single Premium Deferred Annuities. They may even market their products through some kind of sales force, perhaps the brokerage market.

Finally, under the Social Democracy scenario, I do not see much incentive for savings. As a result, little, if any, Single Premium Deferred Annuity business would be sold. The prevailing attitude of people would be "If what I'm forced to put aside for the future is not enough, the government will provide."

This concludes our prepared remarks and we are open to questions from the floor.

MR. MICHAEL R. TUOHY: The current situation in the U.S. shows certain similarities to that which lead to the income bond crisis in the U.K. in the early 1970's. Income bonds are products similar to single premium deferred annuities. Interest rates had risen rapidly and the market value of bonds had depreciated substantially. In the U.K., assets are held at market value and, although valuation interest assumptions can be moved to a current basis, the reserve held on any policy may not drop below the guaranteed cash value. The application of these rules rendered several companies insolvent even before suffering the effects of disintermediation. Interestingly, the disintermediation problem was solved by the tax man. These products were sold on a favorable tax basis to the policyholder. Legislation was introduced which discontinued this privilege to new business but continued to allow it for old business. Therefore, the twisting that was beginning to happen ground to a halt. Could this be the solution in the U.S. if a compromise is reached with the IRS in respect of only regarding excess interest as dividends on future sales?