RECORD OF SOCIETY OF ACTUARIES
1979 VOL. 5 NO. 4

THE FUTURE OF INDIVIDUAL DEFERRED ANNUITIES

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MR. JOHN K. BOOTH: The discussion will begin with the regulatory and tax problems confronting those who market individual deferred annuities. Last spring, in releases 6050 and 6051, the Securities and Exchange Commission (SEC) set forth a general statement of policy regarding the exemptive provisions of the Securities Act of 1933 relating to annuity and insurance contracts. These releases are ambiguous as to whether an annuity is really the traditional type which always has been exempted under the Securities Act or whether it has some features that would cause the SEC to consider it a security. Furthermore, the SEC has passed the burden of making such a determination to the companies. The general statement of SEC policy is that in order for a contract to qualify as an annuity that is exempt, there must be an assumption by the insurer of both a mortality risk and an investment risk. This leaves companies with quite a bit of uncertainty as to whether some of their products are exempt from registration as securities.

I would like to ask Howard Kayton to comment on what product design features companies are using to avoid SEC registration, what other kinds of actions companies are taking, particularly in the areas of advertising and marketing, and what advice they are receiving from outside counsel to obtain assurance that their products are safe from registration with the SEC.

MR. HOWARD H. KAYTON: If anyone wants further information about the SEC releases and the background leading up to these releases, he can refer to the publication of The Practicing Law Institute entitled Insurance Companies and the Federal Securities Laws. This publication suggests actions which can be taken by companies in order to avoid SEC registration.

At this point, the SEC has refused to describe what can be called a "safe-harbor" policy. Instead, they are leaving individual companies to test the waters on their own. Probably, many otherwise aggressive companies will have to be conservative in designing new annuity products because of the uncertainty of SEC approval. Some of the design features that have become critical in the area of SEC approval are: permanent annuity purchase-rate guarantees, fixed annuity commencement dates and guarantees of interest rates at meaningful levels and for longer than a 30-day period or even a 90-day period. In addition, the SEC will be looking for deterrents from the use of an annuity as an investment vehicle.

Unfortunately, the regulatory climates in the state insurance departments and the Internal Revenue Service seem to conflict with the SEC movement. The state insurance departments impose restrictive reserving requirements for long-term interest guarantees. Consequently, companies that meet the SEC requirement necessarily will experience an excess strain on surplus. Also, by the IRS allowing a deduction for all interest paid in the absence of guarantees, companies are encouraged to exclude long-term annuity guarantees. Furthermore, the IRS recently removed the stepped-up cost basis for annuities issued on or after October 21, 1979. This may cause more companies to switch to life insurance type products instead of issuing deferred annuities. (Life insurance has the equivalent of the stepped-up cost basis.) Despite these conflicting requirements, the SEC requirements associated with registration are far more onerous than some of the other requirements of the state insurance departments or the IRS.

What actions have companies been taking to assure exemptive relief from the SEC requirements of registration? First, it should be noted that a statement by a company counsel that the policy meets the requirements of regulation 6051 is not sufficient. Essentially, what they want is an academic discussion of the reasoning whereby the counsel concludes that the policies are annuities and are not securities. For a long time, the industry has considered that it is competing for investment dollars. Policy design and advertising had begun to look more and more like those of investment securities. Now, however, there is a shift in advertising away from emphasis on investments to emphasis on annuity features. Now, there is less emphasis, for example, on the use of penalty-free return of principal and more emphasis on the use of withdrawals merely to meet emergency needs. Now, there is less emphasis on comparing annuities with other securities. There is a word of caution with respect to advertising: an otherwise exempt annuity can lose its exemption because of advertising, but the advertising cannot turn a product that would otherwise be subject to SEC regulation into one that is exempt.

MR. BOOTH: Recently, the SEC wrote letters to all companies that had previously registered combination contracts which were coming up for their post-effective amendments and asked for a justification as to why the fixed side of the contract should not be considered a registerable security. This leads to the next question. Under what circumstances might a company issuing individual fixed deferred annuities have to register these annuities with the SEC and sell each contract with a prospectus?

MR. HAROLD INGRAHAM, JR.: Annuities might fall under the SEC's regulatory umbrella when the annuities do not contain a permanent annuity purchase-rate guarantee. However, there is some possibility that the SEC may relent and

allow the sale of individual deferred annuities having less than permanent guarantees without registration as long as a "group underwriting commitment" exists. This question has particular impact on the Tax Sheltered Annuity (TSA) area, and it probably will be addressed with a no-action letter request to be filed with the SEC either by the American Council of Life Insurance (ACLI) or by one or two companies in the near future. Even if the annuity contracts do contain such permanent rate guarantees, registration still may be required if they are aggressively marketed by reference to short-term, high interest rate guarantees. This would be particularly true if: (1) they are part of a combination contract involving variable annuities, and (2) they are sold through the investment brokerage community (i.e., a contract may have to be registered when sold through securities brokers but not when sold by a company's career agency force).

The SEC's recent approach has been to request that companies having combination contracts obtain the opinion of counsel that the company's fixed annuity meets the requirements of Release 6051. There appears to be considerable confusion as to what exactly will be acceptable to the SEC in this area. There is some feeling that the SEC's concern may spread from combination contracts to the companion contract situation, where the fixed and variable features are not really part of the single contract but where they are administered essentially as if they were and where no-load, back-and-forth transfers are freely granted.

MR. BOOTH: What are the more significant ramifications of SEC registration of individual deferred annuities?

MR. INGRAHAM: First, registered fixed annuities have to be sold by registered representatives. Accordingly, a number of companies are going to find that the percentage of their field force that can sell individual deferred annuities will be substantially reduced if a registered product is involved. Second, the company must keep the prospectus current. This involves annual updates with additional amendments whenever there are material changes in the product or the issuing company. Third, prospectus disclosures which refer to the methods used for crediting excess interest or dividends on the fixed annuities may be required. Proper disclosure might require the company to state the surplus and profit goals of the registered product. Mutual companies probably will experience difficulty working out the appropriate form of their statutory financial information to include in the prospectus. This is because regulation SX does not apply to mutual companies. Fourth, the directors of the life company issuing the annuities will be subject to liability for material misstatements or omissions in the prospectus. Finally, unless some special dispensation is granted by the SEC, companies registering fixed annuities will be required to file reports periodically with the SEC.

MR. KAYTON: In addition to the ramifications of SEC registration listed by Harold, one should consider the cost of the registration process. Outside counsel fees plus auditing fees are generally incurred. Also, the company must identify its investment objectives; these would be the objectives of the company's general account. The company must describe the investment function. The investment department of the insurance company might be deemed to be an entity which has to be registered under the Investment Advisory Act. The company would have to disclose management compensation

to policyholders. It would have to describe the general account portfolio turnover. It would have to describe the brokerage allocation formula; i.e., how the company decides which brokerage firm it is going to use. The company would have to disclose the basis for the annuity purchase rates. All of this constitutes a massive undertaking.

MR. BOOTH: At this point, I should mention that there is at least one company that is trying to register a fixed annuity contract as a security. Furthermore, within the next six months, there may be a number of other companies that will register either guaranteed interest contracts or fixed deferred annuities.

In view of this activity, what effect might the SEC's statement of policy have on individual deferred annuity sales presentations and advertising?

MR. KAYTON: Probably, there will be a change away from the typical illustrations of the past. Until now, many companies have illustrated the accumulation of an initial amount: (1) the initial amount is accumulated at the current interest rate; (2) each year some percentage is surrendered without tax or penalty; (3) the interest is left with the company on a tax deferred basis until the surrender charge disappears; and (4) the rest of the contract is surrendered. Generally, these illustrations do not mention the payment of the annuity. In fact, the entire illustration gives the appearance of some investment other than an annuity. In the future, however, companies will begin to emphasize in their illustrations the annuity income that is available under these policies. In doing so, there will be more emphasis on the annuity values themselves, i.e., the mortality guarantees and the tax advantage of an annuity income relative to a lump sum payment.

MR. BOOTH: A related issue is that the presence or absence of permanent purchase-rate guarantees in an annuity contract could have a significant effect on its treatment for federal income tax purposes. What is the climate from an insurance regulatory point of view for products with no such guarantees? This question might be answered separately for individual products and for group products which are sold on an individual basis.

MR. INGRAHAM: If an annuity contract contains a permanent rate guarantee, the IRS's position is that the amounts held with respect to the contract constitute life insurance reserves. However, such amounts do not constitute amounts held at interest. For a company seeking Section 805(e) "interest paid" tax treatment, the company might provide only limited annuity purchase-rate guarantees. Based on a number of recent private letter rulings, limited guarantees up to ten years have been permitted. The growing use of the "interest paid" route may have some implications to state insurance departments. These departments may ask whether the issuance of annuities without rate guarantees is really in keeping with an insurance company charter. Insurance companies provide interest bearing accounts in many forms, but until a few years ago, almost all of them had been associated with contracts containing true insurance risks. However, as long as the IRS continues to grant "interest paid" tax treatment to contracts with limited purchase-rate guarantees, and as long as this question is not raised, life insurance companies can enjoy the benefit of both worlds. They obtain the full "interest paid" deduction for federal income tax purposes, and they still maintain the annuity's status as an insurance product for state regulatory purposes.

MR. BOOTH: For a nonqualified product, is it clear whether "interest paid" by the insurer necessarily implies interest received by the owner? If not, what are the distinguishing circumstances?

MR. KAYTON: If an insurance company takes the deduction for "interest paid" under Section 805 (e), should it not be required to send out Form 1099 to the policyholder to report the interest? One might assume that one man's deduction is another man's income. However, to the IRS, this is not necessarily true. At Security First Group, counsel has considered this question and pointed out that the language in Section 805 (e) clearly contemplates a deduction for "interest paid" on annuities. Further, according to Section 72, the individual is allowed to defer tax on interest under all annuities other than those for which there is an agreement to pay interest. This has become more important recently because of interest rates rising to their current levels. Companies are attempting to eliminate annuity guarantees in order to qualify for the "interest paid" deduction rather than risk the excess interest being classified by the IRS as dividends. Many companies could not take advantage of the dividends if they were so classified.

MR. BOOTH: For individual deferred annuities with insurance risks, is it possible to obtain "interest paid" tax treatment? Two possibilities might be suggested. One would be to guarantee interest on some part of the contract which could be said to have an insurance risk. Another possibility would be to treat the interest as "discount on prepaid premiums" under Section 805 (e) (3).

MR. INGRAHAM: Deferred annuities are interest accumulation vehicles also providing mortality risk guarantees. The IRS has ruled that "interest paid" tax treatment is allowed with respect to the interest accumulation period under deposit administration and immediate participation guarantee (IPG) group annuities. However, once the employee has retired and is receiving guaranteed retirement benefits from the insurance company under a permanent guarantee arrangement, "interest paid" treatment is not allowed. Thus, there is a two-part tax treatment of the contract. To answer the question, it might be possible to create a contract with two parts that are contemporaneous. This appears to have been the contention of the Southwestern Life Insurance Company in litigation. This company attempted to deduct as "interest paid" the excess interest on its reserves, using the argument that the insurance risk was covered by the assumed interest rate and the excess was not connected to a life contingency. This argument was rejected by the Fifth Circuit.

With respect to the possibility of treating the interest as "discount on prepaid premiums," it can be said that in a sense the consideration for a deferred annuity is a prepaid premium issued at a discount in recognition of earnings expected before the annuity starting date. Section 805(e) (3) specifically allows an interest deduction for the amount which constitutes discount on prepaid premiums. Admittedly, that section of the code was aimed at the traditional life insurance company account for premiums paid in advance. Moreover, there are several other problems with this approach. For one, a court recently has taken a narrow view of what constitutes a "premium paid in advance" (Liberty Life Insurance Company vs. U.S.: 5th

Circuit 1979). In this case, a 5 percent discount on a premium paid 6 months in advance and a 10 percent discount on premium paid one year in advance were held not to be "discount in the nature of interest." Here, as in so many cases, special facts were present, and this decision does not rule out this approach elsewhere. However, the road is uphill. Another and more serious problem is the treatment of interest accumulated on the account in the income of the contractholder. It would appear that if the annuity is individually owned, any amount deducted by the insurance company would automatically be included in the income of the contractholder. This would not be a problem if the contract were held in a qualified trust, but there would be serious questions as to the treatment of an IRA which had such a feature. Such an annuity might result in a penalty tax for early distribution of benefits.

MR. BOOTH: If the reserves of nonqualified annuities are treated as "life insurance reserves," what is the assumed rate of interest? Is it, for example, the stated valuation rate, the rate currently credited, or the guaranteed rate? If it is the latter, does it matter whether the guarantee was established at the time of issue or at a later time? In addition, does the term of the guarantee matter? Finally, what steps maximize the likelihood that excess interest credits will be treated as "increase in reserves"?

MR. DANIEL J. McCARTHY, JR.: The question concerning the assumed rate of interest is an area in which there seems to be a striking lack of unanimity in practice. The different practices of companies sometimes are the result of their own special circumstances. Some of these practices include: (1) classifying contracts according to the rate of interest used in determining the guaranteed annuity purchase rates, (2) classifying contracts according to the nominal valuation interest rate which is usually, but not necessarily, the highest valuation interest rate allowed for deferred annuities in the given jurisdiction, (3) classifying contracts according to the rate guaranteed at issue, and (4) on the assumption that the current rate is at least guaranteed in advance of the year in which it is applicable, classifying contracts according to the current rate on the argument that it is the guaranteed rate. The latter two approaches create some peculiar anomalies between qualified and nonqualified contracts. For example, one may consider a company with a portfolio rate of 7½ percent and that this rate is also the current earnings rate for federal income tax purposes. Next, one might assume that the contract guarantees for some number of years 8½ percent. Further, one may suppose the company is selling that contract both as a qualified and a nonqualified vehicle. If one reviews the arithmetic, he will find that the interest deduction for the qualified pension plan, which is calculated as the product of the reserve and the current earnings rate, is less than that for the nonqualified pension plan, which is calculated using the higher guaranteed rate. Consequently, in certain tax situations, the company does better with the nonqualified plan than it does with the qualified plan. This seems to be in conflict with the intentions of the framers of the tax law.

With respect to excess interest credits, these might be treated as an increase in the reserve during the year or as a dividend. If such credits are treated as the former, a full deduction would be allowed. However, if such credits are treated as the latter, the deduction will be subject to limitation. Most companies seem to believe that the more that the credit represents an advanced guarantee, the more likely it will be treated as an

increase in the reserve rather than a dividend. However, the approaches used by companies in trying to represent such credits as an advanced guarantee vary widely. There are some companies that reissue riders to contracts every year, every other year or at some other interval. Some companies even reissue the contract itself in order to have a contract with the guaranteed rate. Other companies consider that a resolution passed by the company's board in advance of the year in question will be sufficient. Other companies are seeking "letters of opinion" from the IRS, but nothing conclusive has been obtained. Further, it may be such that a resolution will not be reached by means of a "letter of opinion" just as some of the issues that evolved from the 1959 Act remained unresolved for many years.

MR. BOOTH: As if it were not enough to be concerned about whether annuities might be considered securities, one may ponder the question of whether annuities are bank accounts. The Comptroller of the Currency recently issued notice of a proposed rulemaking which would permit banks to accept annuity premiums for deposit into segregated accounts owned by an insurance company for the funding of annuities. What is the tax status of the interest paid by the bank on these accounts?

MR. INGRAHAM: Under this plan, a bank or savings and loan institution becomes a group contractholder of a contract issued by an insurance company. Individual customers of the bank can enroll in the annuity plan. Payments made by the individuals are directly deposited by the bank into segregated accounts to which the insurance company holds title, and the bank pays the insurance company a fee. The benefits are determined by the amount of money held in the account but are backed by insurance company guarantees. For this type of arrangement, the IRS has ruled that the bank account is a separate account. Thus, under Section 801 (g), it appears that all income of the account, other than amounts drawn off for expenses, would be tax-exempt. This arrangement has limitations. A new money rate applicable to the general investment account could not be applied. Tax benefits would apply only to the extent of the separate account earnings. Also, the IRS has ruled that the plan is an annuity contract and that the individual purchaser is not subject to tax until either the contract is surrendered for benefits or benefits are paid according to the terms of the contract.

In view of the interest paid on bank savings accounts in the past, this plan has not been too great a concern for those in the insurance market. On the other hand, it can be viewed as yet another skirmish in the continuing competitive battle between life insurers and banks; this one involves the extent to which banks can sell individual fixed annuities in competition with insurance companies. This matter also would appear to touch on a number of issues of considerable interest to the insurance industry. Examples are:

(1) federal securities law considerations relating to appropriate marketing practices for traditional annuity contracts and the use of banks in the marketing of insurance and annuity products (i.e., the "group trust/passive bank trustee" area);

(2) the extent to which banks can serve as insurance agents;

(3) the Glass-Steagall Act issues relating to the involvement of banks in the issue and sale of annuities and securities;

(4) the composition of groups to which group annuity products can be sold; and

(5) the extent to which the proposed scheme would involve an unlawful delegation of investment authority by the insurers involved.

MR. KAYTON: In addition to the issues raised by Harold, the following considerations are noteworthy.

(1) The IRS has issued a favorable ruling concerning such a contract between an insurance company and a bank. In addition, three companies actually have filed a policy and had it approved. For these cases, the banks are going to guarantee annuity payments, and it is questionable whether they can do that.

(2) As mentioned, this arrangement involves the use of segregated accounts in the names of the individuals. Further, the IRS has ruled that the earnings of such an account are tax-exempt. In the insurance industry, the term "segregated account" has a very definite meaning, and that is an account where the assets are totally segregated from the general assets of the insurance company. This is not what is meant by the term "segregated account" when used by banks for such annuity plans.

(3) Under such plans, excess interest payments are compared to dividends. However, this is a dangerous comparison because some companies cannot deduct such payments when determining their federal income taxes.

(4) The artificial relationship between the bank and the insurance company is nothing more than a blatant disguise for the purpose of tax avoidance.

MR. BOOTH: Another potential regulatory concern is the Standard Nonforfeiture Law for Individual Deferred Annuities, which is a part of the 1976 package of NAIC Amendments to the Standard Valuation and Nonforfeiture Laws. What states have enacted this law?

MR. INGRAHAM: Forty-two states, the District of Columbia and Puerto Rico have enacted the 1976 NAIC Amendments to the Standard Valuation and Nonforfeiture Laws. It is pending in the legislatures of Michigan, Ohio, and Pennsylvania. The nonadopting states are Delaware, Maryland, Utah, Vermont, and Wyoming. Of the 44 adopting jurisdictions, all but seven also have adopted the new individual deferred annuity nonforfeiture laws. New Jersey and Washington retained without modification their earlier annuity nonforfeiture laws. The other five states are Alabama, Florida, Mississippi, Oklahoma, and Rhode Island.

MR. BOOTH: The Standard Nonforfeiture Law for Individual Deferred Annuities will require some policy form changes. What are these changes?

MR. KAYTON: The law requires some mandatory provisions, but many companies already are including these in their contracts. For example, the contract must state that the company will grant a paid-up annuity benefit upon the cessation of premium payments. Also, if there is a cash value at maturity, the contract must state that cash values will be available prior to maturity as well. The contract must state the mortality basis and interest basis. In addition, the contract must provide the information necessary for the contractholder to calculate the amount of benefits.

MR. BOOTH: What is the impact of this law on initial expense charges, surrender charges, and levels of nonforfeiture values?

MR. KAYTON: There should be very little impact. Since 1974, the traditional form of annuity with no meaningful long-term interest guarantees and significant front-end loads has experienced very low sales volume. Competition has forced companies to improve interest guarantees and reduce the front-end loads. While the nonforfeiture law will affect the maximum loads of the noncompetitive annuities, the only impact on the newer no-load products will be the uncertainty of how the various states will interpret the complexities in the law. For example, according to one interpretation of the law, surrender charges will be eliminated; however, the NAIC Task Force has indicated that this interpretation is incorrect. Another problem is whether minimum guarantees are defined at issue or each year.

MR. BOOTH: How do the annuity nonforfeiture provisions of the New York Insurance Law differ from those of the NAIC Standard Nonforfeiture Law for Individual Deferred Annuities?

MR. McCARTHY: Howard's comment that the loadings in the Standard Nonforfeiture Law will have no impact on competitive products is also true with respect to the New York law. In addition, the New York law is comparable to the Standard Nonforfeiture Law in that it provides for a non-disappearing surrender charge as high as 7 percent. However, there is a problem for certain types of contracts. Some contracts provide for higher values if one elects an annuity pay-out than those under a lump sum surrender. This is accomplished through the use of a higher interest rate which is applied in the calculation of the maturity value. The New York Law specifies that the surrender value must be at least 93 percent of the maturity value which would be applied for an annuity pay-out. This could result in a higher lump sum surrender than might otherwise be contemplated by a company with such a contract.

MR. BOOTH: Have some companies attempted to circumvent the Standard Nonforfeiture Law for Individual Deferred Annuities by designing life insurance policies that have all of the characteristics of annuities but are legally life insurance policies?

MR. McCARTHY: A life insurance policy which has many of the characteristics of an annuity is one in which the death benefit is not much larger than the surrender value. There have been several such products. There seem to be three motives for designing contracts like these. One of them is because of the Standard Nonforfeiture Law. Although depending on the design, there can be instances in which the life nonforfeiture law is actually more restrictive than the annuity law. Second, because of state taxes on death benefits, it can be helpful to have the proceeds classified

as life insurance rather than annuities. Finally, there is a point of view which says that some of the problems with SEC registration may be avoided if the contract is a life insurance contract and if the excess interest mechanism operates in a fashion similar to dividend accumulations.

MR. BOOTH: The next subject for discussion is the prospect for profitability from individual deferred annuities. One factor that could adversely affect profitability is potential disintermediation. Howard Kayton has done a great deal of thinking on this subject and has some prepared remarks on the problem of disintermediation in the sale of annuities.

MR. KAYTON: Disintermediation occurs when an individual can remove funds from one investment medium and transfer them into a second, seemingly more lucrative, investment medium. While disintermediation, per se, does not necessarily produce adverse consequences, it can do so if it causes a need for the sale of the underlying securities in unfavorable markets. Since the largest portion of the recent funds invested in individual fixed dollar annuities are supported by high quality commercial bonds, it is illuminating to look at the effect of disintermediation upon bond portfolios.

The bonds underlying a particular portfolio will have been bought at par, at discount or at premium; the effects of disintermediation vary according to the original purchase situation. In addition, call provisions may convert a long-term bond into a short-term bond. Obviously, from a solvency standpoint, one would be concerned with those situations where the prices of bonds have fallen since the date of the original deposit of funds (i.e., when yields have risen).

For this analysis, one may examine bonds initially bought to yield 8 percent and maturing at par. If prices in the current market (two years after purchase) have dropped to a point where a new purchaser can expect to earn 10 percent on his funds, then a bond with a 7 percent coupon that had originally been bought for $887, would now drop by 19.5 percent of amortized value to $721, whereas a bond that had a coupon of 9 percent would have dropped by 17.9 percent of amortized value . Thus, if a company has a simultaneous substantial increase in terminations, it could suffer a significant capital loss as it disposes of its bonds to meet cash value demands. (In fact, the magnitude of the illustrated drop is greater than any currently used surrender charge.)

It should be noted that the 2 percent rise in interest rates illustrated above is not an unusual situation and is in line with what actually occurred in 1978. The Table below illustrates redemption values under various alternative investment situations.

This large potential loss upon forced sales suggests that the writers of these kinds of policies may want to protect themselves against untimely surrender by using alternative policy designs. The principal concern in such design should be to discourage the wholesale switching of annuity contracts from one company to another during rising interest rates. There should be little or no concern over the occasional switch or the occasional emergency surrender.

Several companies appear to be unconcerned about the wholesale switching problem; instead, they seem to rely on the deterrents to surrender built

BOND PRICES AND VALUES

$100,000 PAR VALUE BOND - 30 YEARS - NO CALL PROVISION

Purchased to Yield 8%	Current Yields Available	Cost	Coupon	Market Value At End Of Year 2	5	10	20
At Par	8.0%	$100,000	$ 8,000				
	9.0			$ 89,884	$ 90,177	$ 90,871	$ 93,582
	10.0			81,387	81,846	82,973	87,711
	11.0			74,195	74,735	76,110	82,332
At a Discount	8.0	88,742	7,000	$ 89,493	$ 90,619	$ 92,495	$ 96,247
	9.0			79,768	80,355	81,743	87,165
	10.0			72,080	72,769	74,459	81,565
	11.0			65,594	66,313	68,147	76,448
		Market Value as a % of Cost					
	9.0			89.9%	90.5%	92.1%	98.2%
	10.0			81.2	82.0	83.9	91.9
	11.0			73.9	74.7	76.8	86.1
		Market Value as a % of Amortized Value					
	9.0			89.1%	88.7%	88.4%	90.6%
	10.0			80.5	80.3	80.5	84.7
	11.0			73.3	73.2	73.7	79.4
At a Premium	8.0	111,258	9,000	$110,507	$109,381	$107,505	$103,753
	9.0			100,000	100,000	100,000	100,000
	10.0			90,693	90,923	91,486	93,855
	11.0			82,797	83,157	84,073	88,222
		Market Value as a % of Cost					
	9.0			89.9%	89.9%	89.9%	89.9%
	10.0			81.5	81.7	82.2	84.4
	11.0			74.4	74.7	75.6	79.3
		Market Value as a % of Amortized Value					
	9.0			90.5%	91.4%	93.0%	96.4%
	10.0			82.1	83.1	85.1	90.5
	11.0			74.9	76.0	78.2	85.0

into their policies. This may be unwarranted security. One may examine each of these so called "built-in" deterrents.

(1) The tax on the gain in value of the annuity upon surrender

It is suggested that the adverse tax consequences of the surrender of an annuity that has been in force for several years will act as a disincentive to surrender. This relies on taxation of the tax-deferred interest built up at the time the policyholder receives the distribution. However, this is not a deterrent because Section 1035 of the Internal Revenue Code permits the exchange of one annuity contract for another annuity contract (in the same or another company) without imposing any tax on the gain that occurs at the time of exchange.

(2) The surrender charge

A surrender charge will act as a disincentive in exchanging annuity contracts only if the surrender charge is substantial and permanent. If the owner of an annuity contract with a 7 percent surrender charge exchanges his contract for another with no front-end sales load, it will take him almost 4 years of 2 percent additional interest (or alternatively, 8 years of 1 percent additional interest) to break even with the original contract.

Companies with substantial, but disappearing, surrender charges do benefit from the surrender charge while it is in effect but lose the advantage as it disappears. There are no companies that have offered a product with a disappearing surrender charge that have any appreciable amount of business in force beyond the period at which the surrender charge disappears. Therefore, there is no guiding experience. Creative alternative options are beginning to be offered to policyowners of such contracts, such as attractive exchanges into policies with permanent surrender charges, but these are not as effective as permanent surrender charges in the original policies.

(3) Front-end load

In the absence of "no-load" annuity contracts, policyowners would be less likely to surrender existing contracts and then immediately incur the load imposed by a new contract. However, as long as there are "no-load" contracts available, the front-end load deterrent offers little protection in terms of discouraging disintermediation. Instead, the owner might reason that since he has already paid the front-end load, he has nothing to lose by exchanging (unless there is also a surrender charge.)

(4) The passage of time

Although it is not a means of avoiding surrender, it is sometimes suggested that it is unnecessary to retain disincentives to surrender after annuities have been in force several years. Those advocating this position note that after many years the investments supporting the block have become short-term securities. This argument is clearly fallacious since companies constantly have to reinvest the interest earnings of existing portfolios in long-term investments to maintain the high yields that are being paid on such contracts. Also, a company may be forced to reinvest long-term after the exercise of call provisions in a period where interest rates decrease. Because of this, it is highly unlikely that a ten-year-old annuity will be

supported completely by investments of a shorter term than those that were made at issue.

(5) The contractual right to defer payments for up to 6 months

This right is contained in most annuity contracts (and required by several states). This will protect the insurance company to some extent. It may permit the insurance company to dispose of its assets in a more orderly manner to meet its surrender requests, and it might be able to weather a "run on the bank." However, such provisions would be exercised only in desperate times and would certainly result in a substantial loss of new business by highlighting the company's financial problems. In fact, the use of this provision could actually increase the demand for additional surrenders particularly when there are no other disincentives to surrender.

In conclusion, it appears that the only real protection that companies may have is the use of substantial and permanent surrender charges. This policy feature has been recognized specifically in the NAIC Model Nonforfeiture Law. Also, at least one other state, namely New York, has enacted a provision allowing a surrender charge of 7 percent.

It is expected that as companies become more sophisticated and gain more experience with annuities there will be a greater reliance upon permanent surrender charges to avoid the potential dangers of disintermediation.

MR. McCARTHY: There have been some indications that the New York Insurance Department would be willing to consider a product which would have a 7 percent non-disappearing maximum surrender charge that is indexed in some way to investment yields. A company with such a product would be able to advertise that they would have the 7 percent permanent surrender charge only in an investment environment in which it is needed. Of course, some lesser surrender charge would be permitted in times of stable credit conditions in order to allow for the amortization of the marketing expenses.

MR. BOOTH: One might consider a company that has been marketing individual deferred annuities for many years. Interest has been credited to these contracts on a portfolio basis. During the past two years, its individual deferred annuity sales have slumped drastically in the face of competition from companies that have only recently emphasized annuity sales. How can such a company possibly redesign its annuity product line on a basis that is both profitable to the company and perceived as competitive in the marketplace?

MR. INGRAHAM: To discuss this problem a few more assumptions are necessary. One might assume that these are periodic-payment contracts with level premium loads and "fronted" first-year commissions (i.e., commissions in excess of the first-year loads). One might also assume that no surrender charges are imposed on policy cash-outs. Finally, one might assume that the company is confronted by the conundrum of marketing an annuity product that is both losing money and yet considered grossly uncompetitive by its career field force. Not surprisingly, this is the description of the current situation faced by a number of large, old-line mutual companies.

Why are these companies losing money on these annuity contracts? First, policy termination rates have been much higher than originally anticipated ten years ago when the product was developed. A study of termination

experience at the New England Mutual Life Insurance Company on tax-qualified flexible retirement annuities (FRA's) showed a level termination rate of about 15 percent per year after the second contract year. Two-thirds of these terminations represented policy cash-outs; the balance represented policies going to a paid-up status. Second, initial expenses, primarily those related to field compensation, have been substantially in excess of the first-year premium loading, and the high termination rates preclude any reasonable possibility of amortizing fully the excess first-year expenses in renewal years. Third, no surrender charges are being imposed on cash-outs. Finally, no specific annual administrative charges are being imposed on the FRA's to cover renewal servicing costs which are nonetheless incurred by companies even on paid-up policies.

Why are these contracts uncompetitive in the marketplace? In recent years, individual deferred annuity price competition has become intense with "annuity-specialty" companies marketing annuity products, often through securities brokers, and emphasizing tax-sheltered investment returns rather than the retirement income traditionally associated with annuities. These products contain features such as (1) no front-end load, (2) guaranteed return of premium payments on surrender, (3) current interest credits as high as 9 percent, (4) surrender charges on pre-retirement cash-outs and (5) lower commissions than payable under the FRA's of the old-line mutual companies.

Perhaps, the mutual companies can learn something from what banks do in the struggle with the problems of high and volatile interest rates and potential future disintermediation. Banks offer either relatively low portfolio rates for freely-withdrawable savings or considerably higher rates on funds left with the bank for a specified period with significant withdrawal penalties for earlier cash-outs, such as the forfeiture of 90 days of interest and interest for the balance of the period at the lower portfolio rates.

Mutual companies have been marketing individual deferred annuities for many years and are holding sizable reserves on in-force contracts. The interest rate properly allocable to this in-force block is far less than the high current interest rates actually being earned on today's annuity premiums. To be more competitive, these companies have to reflect substantially the "new money" rates on a redesigned and repriced FRA product. However, this certainly would result in a mass switch-over of in-force contracts to the new product since there is no deterrent in the form of either surrender charges or market value adjustments of cash values. Therefore, in the absence of these deterrents, these companies essentially are forced to continue using a "portfolio rate" approach to pricing the FRA's. The "annuity-specialty" companies do not have this switchover problem since they are new entrants (within the past few years) in the field.

However, even if a repriced FRA were based on a quasi "new money" rate approach for crediting interest, disintermediation (reflected in continued high premium suspension or cash-out rates) can be expected if interest rates stay high or go higher. This means that there is very little chance of achieving an acceptable level of profitability on these contracts unless initial expenses are almost completely covered by the initial premium loading. In other words, there should be a minimal amount of expense amortization contemplated, and there should be a sufficiently punitive surrender charge over a long period of time to serve as some deterrent to

disintermediation through cash-outs. Under this approach, the suspension of deposits (i.e., cases going to paid-up) only costs the profits on lost future deposits; at least, the "amortization of past expenses" problem is avoided. All of the foregoing suggests that companies consider individual deferred annuity product changes incorporating features such as the following:

(1) A premium loading structure that minimizes the amount of excess initial expenses that must be amortized.

(2) First-year agents' commissions which are not in excess of the premium loads.

(3) The use of surrender charges on cash-outs.

(4) The imposition of annual administrative charges whether or not any premiums are paid during a given policy year.

New money interest credits on these contracts are basically incompatible with guaranteed cash values. Surrender charges are helpful, but they cannot be expected to protect a company fully from losses on disintermediation with respect to contracts at advanced durations during a period of surging interest rates.

It can be argued that perhaps "baby group" contracts are the answer in the tax-qualified markets; these would use market value adjustments on lump-sum cash-outs or impose spread payouts for individuals wishing to obtain their proceeds at book value. However, it is one thing to explain the implications of a market value adjustment to a large sophisticated corporate client and quite another to make this explanation effectively to an individual purchaser of an IRA, TSA, or HR10 annuity.

MR. BOOTH: I would like to ask Harold Ingraham to present some questions and comments on the next subject which is the Portfolio method versus the Investment Year method of crediting interest on individual deferred annuities.

MR. INGRAHAM: The first in the series of questions is: how can the Investment Year method of crediting interest be justified for individual deferred annuity contracts with guaranteed cash values ? Theoretically, it cannot, but as a practical matter, a rate close to that derived from the Investment Year method is needed to attract business in the marketplace. Some companies go part way by choosing a rate that is a blend of the rate earned for the particular annuity line of business and an Investment Year rate. Of course, if the company is a relatively new entrant in the annuity field, the rate earned for the annuity line will be close to the Investment Year rate anyway.

If a company pays an Investment Year rate, how can it protect itself if there is a sudden large upsurge in new money rates? Unless the currently credited rates applicable to the existing annuities are also boosted, significant disintermediation to annuities of other companies or bank-sponsored funding vehicles will take place. This is the time when one wishes that a group annuity product using market value adjustments had been used. Surrender charges are of some help, but they are not enough. For the products of many companies, these changes are principally intended to cover unamortized excess initial expenses rather than to serve as a

market value adjustment alternative. They cannot do double duty effectively.

If the portfolio approach is used, should it be the portfolio rate of the annuity line or the rate of the company as a whole? The rates paid should reflect the rates earned on the particular deferred annuity products separately for tax-qualified and non-qualified products.

If an Investment Year approach is used, should the rate be a "true" Investment Year rate or an approximation? Probably, an approximation should be used. The company may group together a valuation class, a policy series, or simply a number of continuous issue-years. This approach is relatively easy to apply. To develop a "true" investment rate, one would need to study the relative net contributions of one issue-year block made during each calendar year. To do this, the company's accounting system should keep track of the premium and benefit payments made in each calendar year by year of issue. Alternatively, this might be approximated as the annual increase in reserves where the data is split by issue-year. In the extreme, one might keep track of each policy on a seriatim basis if there is computer capability. One would then look at the net contributions to the policy for each calendar year and assign a particular interest rate associated currently with each of these years.

How can a company protect itself from anti-selection when different rates are credited to different generations of policyholders, particularly in periods of rising interest rates? To protect itself, the company should do the following:

(1) It should use high surrender charges (perhaps the highest permitted under the new annuity nonforfeiture law) on cash-outs. This, however, will not protect the company in the later policy years when the surrender charges grade off.

(2) It should try to inhibit older policies from rolling-over their accumulations into new contracts. The intelligent policyholder will switch his accumulated proceeds into another funding vehicle crediting higher interest. He will then either buy a new annuity contract and obtain current rates, or more likely, he will put his future deposits in the same place as his roll-over proceeds.

(3) If the company allows switchovers from old to new policies, it should attempt to minimize them by making the interest rate spread small (e.g., not more than 0.50 percent). Assuming graded surrender charges, the trade-off then becomes higher interest rates in exchange for higher surrender charges. This assumes also that the lump-sum switchover would go into a full-load single premium deferred annuity. This should serve as a deterrent to internal switchovers at least.

(4) A cynic might state that the best protection from anti-selection is the inertia of the policyholder.

MR. BOOTH: Next, to open our discussion of individual deferred annuity marketing, the first question is: "Who buys nonqualified single premium or annual or flexible premium annuity products?"

MR. KAYTON: At Security First Group, the market is comprised basically of affluent people, most of whom are at mid-life. The average size annuity is approximately $22,000. The contractholders may use these annuities to assure retirement income over and above that provided by Social Security and any other retirement plan. Because they have watched their savings disappear due to inflation or have watched their stock market investments disappear to market specialists, they want something with long-term guarantees. Security First Group does offer a seven-year interest guarantee at high rates. People use this product to build an educational fund or nest egg for their children or grandchildren. They do this through annuities instead of life insurance for several reasons: (1) they may not qualify for life insurance; (2) they may not be convinced that they would get good returns on life insurance; or (3) they would not be willing to pay the cost of the insurance. However, like life insurance, annuities avoid probate and allow for a tax deferred build-up. While there are other kinds of investment in competition with nonqualified annuities, these other investments have a higher degree of risk, and many people wish to avoid risk. The buyer of nonqualified deferred annuities is someone who is very concerned about the safety of his principal and wants a return that will enable him to keep up somewhat with inflation.

The strengths of the deferred annuities are (1) the tax deferral feature; (2) the safety of the principal; (3) the investment guarantees; and (4) the mortality guarantees. These guarantees are substantial in that they may span up to two lifetimes. The chief weakness of the deferred annuity is the expenses that might not be associated with bank accounts or other forms of investment.

MR. INGRAHAM. Today's issue of Fortune magazine contains a very interesting article on this subject entitled "Building a Shelter for Dividends." The article begins by pointing out that in the real world, dividends on common stock are taxed at substantially higher rates than are capital gains; in the top bracket, the tax rate on dividends is 70 percent, and the rate on capital gains is 28 percent. Because of this, it would seem strangely perverse for corporations to distribute a sizeable part of their earnings instead of reinvesting the money. However, the thesis of the article is that a lot of shareholders really do not pay taxes on dividends; instead they avoid these taxes legally by using a combination of debt and a tax shelter to cancel most or all of the tax liability associated with the common stock dividends. The simplest way to avoid the tax penalty on dividends is to leverage the stocks by using an essentially riskless tax deferred investment such as a single premium deferred annuity. The article uses a single example to demonstrate the point. An investor with a million dollars of common stock paying $60,000 per year in dividends takes a margin loan of $500,000 from the broker at 12 percent. This loan provides $60,000 of interest deductions to offset the dividend income. The investor then uses the $500,000 loan proceeds to buy a no-load single premium deferred annuity. At current rates, the annuity would yield 9 percent or more; this would provide $45,000 per year. This $45,000 is tax exempt until the investor actually collects it, and this may be many years later. In the meantime, the annuity has a cash value of $500,000 plus accrued earnings, and the investor can borrow against this at any time. So in this example, the annuity device saves $27,000 because instead of paying as much as 70 percent of the $60,000 in dividends and leaving himself with only $18,000, he pays no current taxes at all on the $45,000 earned on the annuity.

This article does refer to one major pitfall in the annuity shelter: the IRS will not allow interest deductions on loans taken out to buy annuities if the taxpayer plans to borrow systematically against the cash value. However, it goes on to suggest a strategy to thwart the IRS. The best strategy is to reverse the order of transactions by first selling some stock and using the proceeds to buy the annuity and then buying back the stock on margin. Finally, the article points out that it may be possible to escape taxes forever by never collecting the annuity.

MR. BOOTH: What is the likely impact of the NAIC Model Annuity and Deposit Fund Disclosure Regulation on future marketing of individual deferred annuities?

MR. INGRAHAM: The short and gloomy answer is that there likely will be no impact for quite a while because to date this Model Regulation, adopted by the NAIC in June 1978, has been adopted only in Nevada (effective January 1, 1980) and in Washington (effective April 1, 1980.) The Model Regulation requires a written contract summary to be provided prior to the acceptance of the initial premium. This summary should include:

(1) the name and address of the home office and the insurance agent;

(2) the amount of guaranteed annuity payments and illustrative annuity payments based on the current excess interest (or dividend) rates and annuity purchase rates; and

(3) if the cash surrender amounts are less than the total considerations paid, a prominent statement that such contracts may result in a loss if held for only a few years.

Also, for the first five contract years and representative years thereafter, the following information must be provided:

(1) the gross annual (or single) premium;

(2) the total guaranteed cash surrender value or guaranteed paid-up annuity; and

(3) illustrative cash values, or paid-up annuity amounts, based on current interest rates and current annuity purchase rates.

There are also several provisions relating to prohibited misrepresentations. Examples of these are:

(1) dividends cannot be represented as guaranteed;

(2) the agent must inform the purchaser he is acting as agent; and

(3) the agent cannot use terms such as financial planner, advisor, etc. unless this is actually the case.

The Model Regulation does not apply to individual annuities sold in corporate plans or IRA's.

MR. BOOTH: Turning to the subject of product design, one might ask how the features of a qualified individual deferred annuity contract differ from those of a nonqualified contract.

MR. KAYTON: First, for the qualified contract, short-term annuity-income rate guarantees are inappropriate because the individual cannot begin to receive the income until retirement. Consequently, the guarantees are not as high as they might otherwise be because of their long-term nature. In addition, penalty-free surrenders are not appropriate because there is little advantage to surrendering a qualified contract because of the tax consequences. For qualified contracts, optional retirement dates are limited; for example, such dates for IRA's and Keough plans are limited to between the ages of 60 and 70. Finally, nonqualified plans must contain annuity purchase-rate guarantees in order to be exempt from SEC registration. However, since qualified plans are exempt automatically from Regulation 6051, there is less need to have such long-term annuity guarantees. In fact, some companies merely guarantee that the annuitant will be entitled to the best annuity purchase rates available at the time of retirement. There is some question as to whether such a contract is really an annuity.

MR. McCARTHY: Of the features just described, those of the qualified product are more restrictive than those of the nonqualified product. Are there any features of the qualified product which are more liberal than those of the nonqualified product?

MR. KAYTON: There is at least one. In many states, a lower premium tax is charged for qualified contracts, and because of this, many companies offer higher interest rate guarantees on qualified contracts. Some companies do not, however, and the reason is that the qualified business is more expensive to market and administer.

MR. BOOTH: Among the various types of products in the qualified market, what are the major differences in design?

MR. INGRAHAM: The different features among these products are the results of marketing considerations and persistency perceptions. For example, in the IRA market, there is intense competition from the banks offering no-load products with high current interest rates. In this market, annuity purchase rates seem less important than loads and interest rates. Since the persistency of IRA annuities has been relatively poor, contracts with low level loads which fully cover level commissions would be the most appropriate. This approach eliminates the need to amortize excess initial expenses.

On the other hand, TSA questionnaires probe all contract facets: guarantees, current interest rates, past years' interest rates, current annuity purchase rates, and loads. In this market, annuity income is important, and consequently, loads can be higher. Persistency probably will be somewhat better because individuals are not always free to switch carriers due to the interposition of the schoolboard or other institutional employer. Of course, school systems can and do switch carriers.

The persistency of HR10's may be better in the future than in the recent past because fewer doctors seem to be incorporating and suspending or

terminating their HR10 plans. One company's approach in the TSA and HR10 markets is to use level loads, which are slightly higher than those applicable to their IRA annuity, and a modestly "fronted" first year commission.

For the small corporate market, the answer depends on whether a prototype plan is used. The prototype plan may specify that the investments be in the sponsor's insurance and annuity policies. However, in split-funded, defined benefit plans involving annuities and an outside auxiliary fund, there may be more likelihood of switching the annuities from one carrier to another to obtain the best yields. Countervailing forces appear to be operating when considering split-funded defined benefit plans involving individual deferred annuities and an auxiliary fund. Agents selling in the pension trust market expect 50 percent first-year commissions on life insurance sold in split-funded plans. Correspondingly, if annuities rather than life insurance are to be used in funding the plan, the agents would prefer "fronted" first-year commissions in the 20-25 percent range. This kind of scale can be supported adequately by an appropriate front-ending of loads, but this results in a product more difficult to justify to sophisticated pension trustees.

MR. BOOTH: What has been the lapse experience of individual deferred annuities?

MR. INGRAHAM: The most recent elaborate persistency study performed by the New England Mutual Life Insurance Company involved annuities issued from 1966 through 1976 and exposed in calendar year 1977. This study measured termination rates both on a policy count basis and also on a reserves basis by relating the reserves of contracts cashing-out or becoming paid-up to the reserves of annuities in force at the beginning of the year. For contracts not cashing-out or becoming paid-up, the relative level of premium payments in 1977 was measured against the corresponding 1976 level.

For all tax-qualified contracts combined, total termination rates based on reserves were 6 percent in the first year, 8 percent in the second year, and about 15 percent each year thereafter. Termination rates by policy count were about 14.5 percent in each of the first two years and about 19 percent each year thereafter. This indicates that the smaller premium policies have higher termination rates than the larger premium policies.

For all issue-years combined, the aggregate termination rates were 13.6 percent by reserves and 16.8 percent by policy count. About two-thirds of the terminations by either reserves or policy count were due to cash-outs as opposed to policies becoming paid-up.

By tax-qualified market for all years combined, the aggregate termination rates based on reserves were 12.2 percent for corporate plans, 13.7 percent for TSA public school cases, 15.6 percent for TSA non-profit organization cases, and 16.0 percent for HR10's. However, based on policy count, TSA public school cases showed a 13.6 percent termination rate while the three other classes clustered at about 20 percent. Eighty-five percent of the corporate plan terminations were due to cash-outs, whereas almost 45 percent of the HR10 plan terminations represented cases going to paid-up.

Because the part of the study dealing with the IRA's only involved 1975 and 1976 issues, the study revealed only that the experience for both years of issue was about average for all tax-qualified business studied on both a count basis and a reserve basis.

With respect to relative premium payment levels for contracts not cashed-out or becoming paid-up, the study revealed a net decrease of 7 percent from 1976 to 1977. This reflected a 9 percent decrease on contracts with decreases and a 2 percent increase on contracts with increases.

The study of non-qualified annuity business revealed a significantly different persistency pattern. For all issue-years combined, the aggregate termination rates were 10.2 percent by reserves and 17.3 percent by policy count. By reserves, the rates were 11 percent in the first year and 9 percent in the second year. By policy count, the rates were 22 percent in the first year and 25 percent in the second year. This indicated that the smaller cases were definitely more surrender prone. Unlike the tax-qualified business, over 90 percent of the terminations represented surrenders.

In a recent LOMA survey, one company reported the following overall termination rates by premium for its tax-qualified flexible premium annuity business: TSA - 10.9 percent, IRA - 17.7 percent, HR10 - 18.0 percent, Corporate - 18.3 percent and overall 15.5 percent.

MR. McCARTHY: With respect to TSA business, the results of studies conducted by Milliman and Robertson are in agreement with some of the results mentioned by Harold. Termination rates by policy counts were higher than those by premium amounts. Also, these studies revealed that the ratio of cash-outs to paid-up was approximately two to one. First-year termination rates were approximately 20 percent and renewal-year termination rates were approximately 10 to 11 percent. Furthermore, experience did not vary greatly by carrier except to the extent that different carriers had different average size cases.

MR. BOOTH: To what extent does lapse experience reflect changes in money market conditions and disintermediation?

MR. McCARTHY: In the most recent Milliman and Robertson study, 20 to 25 percent of TSA terminations were found to be intramural switches among the carriers participating within the same pool.

MR. KAYTON: It may be too early to answer this question in specific terms. This is due to the fact that contracts with disappearing surrender charges have not been in force long enough, and the surrender charges are still in effect.

MR. INGRAHAM: Disintermediation is causing some of the persistency problems. However, there are other reasons. Because of demographic, budgetary and other reasons, the teaching profession has become overcrowded in recent years, and the younger teachers have left the field. The result of this is that many TSA contracts are cashed-out. Another reason is the previously mentioned competition in the IRA market where funds are rolled over into low-load, high-yielding vehicles. Also mentioned was the phenomenon in the HR10 market resulting from the trend in the number of doctors who are

incorporating; when doctors incorporate, HR10 annuities are placed in a paid-up status. Finally, the more liberal eligibility provisions mandated by ERISA have resulted in greater participation in plans by young individuals. However, these individuals tend to be more surrender prone.

MR. BOOTH: A recent innovation in individual deferred annuities is the short-term investment contract. Why has such a contract been introduced?

MR. McCARTHY: The reasons for such contracts are obvious. First, short-term interest rates are higher than long-term rates. Second, a short-term contract minimizes the asset risk because the investments are short-term. Consequently, cash-out problems are much more tolerable. In providing such a product, companies are assuming that an option to convert to a long-term contract would satisfy the SEC requirement for a significant investment risk to be taken by the company.

MR. KAYTON: This is a very dangerous position for companies to take because the SEC is going to look at the contract itself. The option does not involve any interest rate guarantee, and the rates actually used would be those in effect at the time of conversion.

MR. BOOTH: Some companies are offering contracts that provide for waiver of the surrender charge or higher surrender values in certain circumstances. How does this feature work?

MR. KAYTON: This feature is a very effective sales tool and is not very expensive. Instead of guaranteeing an interest rate over some long period of time and establishing reserves for the guaranteed interest, the company agrees to waive the surrender charge if interest rates drop below a certain level. If interest rates do drop, the company would benefit from not having to pay rates which could be higher than it could earn on new investments. However, it would concede the surrender charge if a surrender actually occurs. Such an arrangement is not advantageous to the contractholder because at times when interest rates have fallen, there are few or no satisfactory reinvestment opportunities.

MR. McCARTHY: There is one other aspect to such a feature. The purchaser is relying on the good faith of the company to keep declaring interest rates which presumably are consistent with the company's original pricing expectations,despite the fact that such action is not guaranteed by contract.

Mr. BOOTH: Do companies eliminate the surrender charge at the maturity of the contract or upon death?

MR. McCARTHY: This appears to be the rule rather than the exception. If one presumes that a company will require some minimum period prior to maturity in order to recover initial expenses, then it appears to be a reasonable thing to do. In addition, it would not be difficult to price.

MR. KAYTON: At Security First Group, the surrender charge is permanent and is assessed at death and upon lump sum withdrawls at and prior to maturity. The company plans to make long-term investments, and the surrender charge offers protection against liquidating assets under unfavorable conditions. In addition, the surrender charge is a disincentive to a lump sum surrender and encourages the contractholder to elect an annuity pay-out. (Until recently, the New York Insurance Department required surrender charges not only on lump sum payments but also on annuity pay-outs.)