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## INDIVIDUAL ANNUITY PRODUCT DESIGN UNDER CONDITIONS OF INFLATION

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1. Products and marketing
2. Inflating benefits and their impact on mortality assumptions and the reinvestment problem
3. Asset/liability matching
4. Surplus and valuation consideration (including reinsurance)
5. Managing the potential for capital losses inherent in certain types of product design
6. Expense and tax considerations

MR. JOHN M. LENSER: Our title allows us to talk about nearly anything connected with annuities, and the outline that appears in your program gives us equally great latitude in making our presentations. We have chosen to focus on single premium deferred annuities (fixed) in the presentations themselves; however, this is an Open Forum, and if, in the audience participation phase of this session, some members of the audience would like to generate some discussion concerning those products or other annuity products, we can do so at that time.

The annuity business now produces roughly 30% of the premium income of U.S. life insurance companies, according to preliminary 1981 data recently released by Best's magazine. That percentage is dramatically higher than it was 5 or 10 years ago. During those years of growth in annuity premium volume, inflation has raged, accompanied by extremely high and fluctuating levels of interest rates. This combination of a substantial volume of business and the hazards created by inflated and fluctuating levels of interest rates presents significant problems for insurance companies.

With the changes in IRA eligibility that became effective on January 1, 1982, and large flows of funds already reported moving in to various IRA vehicles, we should expect additional, rapid and dramatic growth in annuity business -- in this case, in flexible premium annuities. The problems related to FPA's are, of course, quite like those arising from SPDA's, but with different emphasis. The administration of the IRA FPA will be more complex and therefore more expensive than that of the SPDA; however, at least for some years, the disintermediation risk associated with the FPA should be smaller than that of the SPDA, given the much smaller amounts invested in each contract.

Annuity product design and testing have been made more complicated by these problems that have accompanied inflation. Different companies have perceived and dealt with the problems in different ways. Regardless of the particular perceptions of specific companies, however, it is clear today,

that the design and testing of annuity products requires more comprehensive analysis and -- in the case of some factors that affect profitability -- a much more detailed analysis than was required in more stable times. Some of the problem areas that must be dealt with in the testing process are the following:

- selection of the type and duration of assets that are suitable investments for the annuity deposits, given the characteristics of the annuity contract and other such factors; this problem has become more complicated, not only because the disintermediation risk has increased, but also because of the wide variety of investment vehicles that has become available to help in dealing with this risk;
- determining the proper degree of involvement of investment people in both the product-design-and-testing stage and the later process of managing the annuity line of business; this has become increasingly important because of the critical need to see to it that the management of the asset portfolio and the management of interest credit guarantees on annuity contracts are consistent with one another;
- deciding on an approach to managing interest credits on annuity products so as to minimize risk and earn a satisfactory profit; this may involve such things as remaining sufficiently competitive as to interest credits on older annuity contracts, controlling lapses, preventing asset liquidation losses, etc.;
- preparing to be able to respond to changes in the competitive environment ... changes in products, marketing methods and marketing forces, annuity interest crediting levels, fluctuations in investment market yields, variations in the yield curve between normal, flat and inverted, etc.
- preparing to cope with some of the possible actions of the IRS, SEC, SID's and other regulatory bodies as those actions affect such things as surplus requirements, ability to pass through increased investment yields, permitted growth in new business and even the overall viability of some products.

As we struggle with these problems related to annuity product design and the profitability of annuity operations, it is worth noting that the problems we are being forced to come to grips with today in annuity operations may well be the forerunners of problems that we will face tomorrow in life insurance operations generally. And when we focus on such things as asset management, management of interest credits and competition with rapidly changing products and marketing forces, it may be worthwhile to view our efforts in these areas not only as part of the annuity design process, but also as a process that is preparing us to cope with a broader range of problems associated with managing insurance company products and operations in the near future.

On that note, let us turn to our panel to see how they have gone about dealing with the problems that they have encountered in designing annuity products under conditions of inflation.

MR. GREGORY J. CARNEY:

Product Design

As a general comment, annuity products have changed drastically over the last five years. The traditional product now consists of a no front-end load feature and has interest rates higher than the industry traditionally has paid. New product designs, such as group or individual contracts, interest rates tied to an outside index over which the company has no control, interest rates credited on an investment year method, a "window" rate, which would allow surrender without penalty if the interest rate credited was below the "window" rate, and unusual death benefit guarantees, are some of the current innovations in the annuity field.

With the elimination of front-end load products, back-end surrender charges have been introduced. There are basically two types of products:

1. Disappearing surrender charge -- the concept here is to charge the client for expenses which have not been recovered at time of surrender. For most contracts, the surrender charge will wear off in the fifth through tenth year. The surrender charge may be a level percentage of the premium, a level percentage of the accumulated value or a declining percentage of either.
2. Permanent surrender charge. The concept is similar to the above but additionally it is hoped that the permanent penalty will be a deterrent surrender.

Normally, the surrender charge, whether permanent or disappearing, would be waived on annuitization.

In the design of the annuity products there are four general concerns that must be considered: distribution system; statutory and GAAP reserves; interest crediting methodologies; assumable risks.

Distribution System

In the case of Anchor National, we were originally founded as a subsidiary of Anchor Mutual Funds. Therefore, we have always had strong ties to the Wall Street Brokerage firms. Our life insurance agents are of the PPGA type. We are in the brokerage business and we do not have a captive agency force.

Given our characteristics, it was natural for us, in 1974 and 1975, to utilize the strong relationships we had built up with the stock brokerage community for the sale of the new SPDA. Since many of the member firms were already licensed with Anchor National Financial Services, a sub of Anchor National Life, we used ANFS as an annuity wholesaler. Our reason was primarily one of licensing, but our marketing expenses were all paid by ANFS in return for an override commission on business produced through it. I should note that our usage of the wholesaler technique was through a wholly owned subsidiary and really was for licensing convenience only. However, the final result was that ANFS became extremely profitable because of the commission earnings. We have subsequently eliminated the override commissions to ANFS and pay the marketing expense through Anchor National at this point. ANFS does, however, still exist.

The move to the securities firms by Anchor was an interesting decision. We felt there would be resistance to the new SPDA's from traditional life agents because of the low commissions; i.e., at the 4% level. We also felt that recent stock and mutual fund performance created a good timing for introduction of this type of product in the member firm community.

We, of course, had concerns. Would the stock brokerage firms sell insurance products? Since they are used to making money by churning stocks, would that happen to annuity sales? If the member firm got a better deal from another company selling annuities, would there be wholesale replacements to the new product? Could an insurance company understand the needs of the member firms and vice versa?

At Anchor, our decision was relatively easy. We felt we had to capitalize on our strength and that was in the member firm community. We tried to address the concerns by product design and specific characteristics of our marketing agreements. I think it is more important to mention things we did not do. We did not design specific products for specific member firms. We did not develop "sweetheart" deals; we did not provide policyholder lists; we did not develop group annuities. While the above may not be bad or hurt a company, it is our feeling that it increases the risk of the annuity product.

Originally our sales were approximately 60% from the member firms and 40% from the life insurance broker. Today, those numbers are reversed.

#### Reserves

The Commissioners Annuity Reserve Valuation Method (CARVM) is now effective in all states. The 1980 amendments, with dynamic interest are effective in perhaps 20 states today and will be available in 35 - 40 states by year-end. Utilizing the principles of CARVM, significant surplus strains can be generated by minor modifications to the interest guarantee period, the surrender charge, or other provisions of the contract. Similarly, those changes may impact the maximum interest rate available for discounting future values under the dynamic interest provisions of the 1980 amendments. Extreme care should be taken in the design aspects of the SPDA product to insure that a minor change does not have a significant surplus impact.

Unfortunately, some current design characteristics do not fit easily into statutory valuations, even under CARVM. Consider, for example, an interest rate guarantee that states that the minimum interest rate will never be less than 3/4 of prime. Since prime in the future is indeterminate, what rate do you use for future credits to calculate the cash values that should be discounted using CARVM? Or, consider a "fixed window" contract. By "fixed window," I mean a rate specified in the contract that if the interest credit ever goes below that rate the surrender charge will be waived. Suppose the contract had a 15 1/4% guarantee for one year, a window of 14% and a minimum of 4%. Could it use the surrender charge to calculate the second year value to be discounted under CARVM if it assumed credit at the 4% minimum? How would the valuation be done if the window rate was tied to an outside index and was indeterminate at the valuation date for future years?

Before leaving the topic of statutory reserves, I should point out that prior to the 1980 Amendments, group annuities received a higher discount rate for CARVM than individual contracts. This created an advantage for the group design with regard to surplus strain and gave rise to many "loose

group" type contracts. The 1980 Amendments remove that distinction and it will be interesting to see if some companies come back to the individual product design.

GAAP for these annuities can pose additional problems. The traditional method may create a significant front-ending of profits unless care is taken in the generation of assumptions. It is my view, for example, that interest income should be viewed as revenue in future years and that a deferred acquisition asset should be established even for single premium products. It is my belief that this method would provide the best approach for a no-load SPDA with regard to matching of revenues and expenses and shows investment profit as it actually emerges. This method assumes that the GAAP Benefit Reserve established would equal the statutory reserve.

#### Interest Crediting Methodologies

I am not really talking about simple interest or compound interest under this topic, but I should note that we use both methodologies at Anchor. On contracts where our interest guarantee is less than one year, we use a simple interest approach for crediting that interest. If the guarantee is one year or longer, we use a compound approach.

The product design characteristic I am referring to is the decision to use a portfolio or an investment year crediting approach to the excess interest. In other words, will the company tier the rates they credit to the contract holders? This decision should be made in the design process and communicated to the sales force and the clients. Surprises in the future have a tendency to come back and haunt you.

In today's economic environment, I would imagine that most people would utilize an investment year methodology, although it may be difficult to detect since investments are now very short. The advantages of the investment year scenario are that during periods of rising interest rates you will attract new business. The major problem is that if your new rate is significantly higher than your old rate, you could disintermediate yourself into oblivion. In a declining interest scenario, the problems with an investment year allocation are self-evident.

A portfolio method isn't much comfort either in a period of rising interest rates, since new business could dry up and cash flows could then become a problem. The extent of the problem depends, of course, on the portfolio design. If the portfolio is all short; i.e., one year or less, you have really moved to an investment year method. If the portfolio is all 30-year bonds and private placements, you could have a serious liquidity problem.

At this time, we are all preoccupied with increasing interest scenarios, perhaps because they have the most apparent risk. However, as interest rates decrease, the spread on new investments versus the credited rate decreases until the company recognizes the decrease and reacts accordingly. Depending on the initial margins, the length of the interest guarantee and the reaction time of the company, this can have a significant impact on profitability. It is critical when investments are shorter than the guarantee period.

One other comment on the tier approach; sales literature and disclosure for the SPDA's utilize the current rate projected out for 20, 30, 40, or more years. As actuaries, do we have problems making those projections for that

length of time, when the current rate is based on an average investment of, say, a thirty-day duration?

#### Assumable Risk

Certain risk characteristics are inherent in any SPDA design. Some design characteristics may encourage one action or another by the contractholder at an adverse time. It is these alternatives in design under an inflationary scenario that I want to discuss.

The design of the surrender charge can have a significant impact on terminations as interest rates increase. For example, with a contract that has a disappearing surrender charge, the removal of the surrender charge in a two-to-three-year period is an extremely important "carrot" which may tend to decrease surrenders. Similarly, a contract which provided for a retroactive decrease in interest rates if surrender occurred before a fixed number of years, would also provide a significant "carrot" to the policyholder to continue.

It is my belief that a permanent surrender charge will not act as a deterrent to disintermediation because there is no reason for the policyholder to remain in the contract, i.e., he has to pay his charge no matter when the termination. The most positive aspect is that the company can collect a charge to offset the portfolio loss. It is, however, slightly less than comforting to realize that the product may encourage surrenders and allow the company to collect a 10% charge when the portfolio is selling at a 25% loss.

It is impossible to overemphasize the importance of the investment decisions associated with the SPDA product. However, design characteristic could make the proper investment decision almost impossible to determine. Assume the contract has a long term (5 - 10 year) current interest guarantee, a high window for the subsequent period and a permanent surrender charge. Do you invest to cover the current interest guarantee or the longer window period? Regardless of the investment strategy thus decided, how do you invest to cover the liquidity needs for early surrenders yet still cover yourself for the 10-year guarantee? A related question arises in indexed products. Do you invest in the index which provides 100% safety, but no profit, or do you try to anticipate and beat the index?

Indexed policies raise substantial design problems in the choice of an index. If you can't invest in the index, you should give very serious thought before you tie a rate guarantee to it. Prime, of course, is a good example. The major consideration in an index is that it not only gives the right results today, but that it will retain that position in the future. If the index becomes out of touch with reality, so will the business associated with that guarantee.

As you can probably tell, I have serious reservations regarding indexed policies. Companies advance two reasons for indexing. First, it is a marketing plus, assuming the index is perceived by the client as one that will allow his values to grow at an acceptable rate. Second, it removes management discretion from excess interest and eliminates the dividend question. My comments to those reasons are: 1) the index and the client's perception of the index can change dramatically in our current economic environment; and 2) while the excess interest-dividend question is removed, SEC questions could be raised.

While I have tried to talk about the general design concerns, I would like to briefly mention some other topics. First, what do you do if your design creates surplus strain and that design characteristic is important? The answer, of course, is surplus relief reinsurance. The reinsurance would normally be mod-co without an 820 election. The cost can vary dramatically, depending on the situation of the reinsuring company. If you can find the right company, they may even pay you to provide you with the surplus relief.

Second, how do you handle premium tax? In the case of Anchor National, the choice was easy since we are a California domiciled company and since California has one of the highest annuity premium taxes, the California code and the retaliatory tax provisions of most other states come into play. However, the California code allows an election to "back-end" the premium tax; i.e., pay it at annuitization. We have made that election, and for the most part, pay the premium tax only upon the contract annuitization.

MR. RICHARD W. KLING: Individual annuity product design continues to represent a significant challenge. The two major challenges that I see are:

- Designing a product (or products) appropriate for a fluctuating economic climate. This means that the product must meet customer's expectations as well as allowing the company to survive violent economic fluctuations. This is particularly difficult to accomplish when the "old" economic theories continually break down. As an example, I recall reading that interest rates would drop if we could get inflation down. The rate of inflation has dropped substantially. Look at interest rates. They remain extremely high.
- Reacting quickly to remain competitive. We not only need to be prepared to compete with rapidly changing deferred annuity products, but we also must be able to compete with other types of financial services, e.g., the variety of products being offered in the IRA market.

This morning I will focus my comments on five specific considerations in the annuity product design process: the marketplace; risks; pricing considerations; managing interest credits; and the future.

#### I. Marketplace

The distribution system is a key in looking at the marketplace. Our sales representative focuses on balanced financial planning and is licensed for both insurance and securities. In addition to the traditional insurance products, our agent also markets investment products such as mutual funds and face amount certificates. Deferred annuities seemed like an ideal product addition. First, they appeared to be well suited to the financial planning process. Second, commissions were quite similar to the commission paid on the investment products that our sales force had been selling successfully for many years.

Over the years we have developed two target markets for deferred annuities:

- The man-on-the-street market. This is the market for our nonqualified single premium deferred annuity. Almost all of

this business is what we call fixed, i.e., the principal is guaranteed.

- The individual tax-qualified market. This is primarily the TSA, IRA and Keogh market. Our primary product for this market is a combination (fixed and variable) flexible premium annuity.

We emphasize the annuity features of our products as might be evidenced by the fact that we have permanent surrender charges for the fixed portion of all of our current annuity products. In addition, we have a \$100,000 maximum on our single premium contract.

Our annuities are marketed solely through a captive sales force. At least a sales force that is probably as captive as any of your sales forces. We believe this distribution system has been a key factor in retaining existing deferred annuity business as interest rates continue to fluctuate and as more companies enter the marketplace with exotic new products.

## II. Risks

Far and away, the major risk that I see is an asset/liability mismatch for contracts with a guarantee of principal, i.e., the C3 risk. We've done several studies, some on our own, some in connection with the C3 task force, in an attempt to quantify this risk. Our studies have assumed a variety of future economic scenarios, including the conditions of the past 2-3 years, i.e., volatile interest rates, inverted yield curves, etc. We have drawn several preliminary conclusions:

- On some older blocks of business backed by relatively long assets invested at relatively low rates, there's no way we can maintain enough surplus to provide for the C3 risk.
- We're reasonably well matched on business written in the last three years. This is the majority of our business.
- In aggregate, we are reasonably matched if we continue to hold a relatively high level of cash. We are currently holding about \$200 million in cash.

This question of asset/liability matching raises the question of the investment department's role in the product design process. Involvement of the investment department is critical in assessing this risk as well as designing products to match the investments (or vice versa) is extremely important. Today our actuaries converse in a language that includes terms such as futures, basis points, deep discount, repos, par equivalent, average life, etc. This is the result of having developed a close working relationship with our investment staff. In addition to this day-to-day working relationship, I am involved in the policy setting process as a member of our Investment Committee.

Another major risk is the mortality risk. We recently reviewed our annuity mortality assumptions and concluded that our mortality guarantees were inadequate. This was particularly true for the



settlement option guarantees in our variable annuity contracts where the investment margin (or spread) is limited. Consequently, we have recently adopted a new set of settlement option tables for all of our deferred annuities. These guarantees are based on the proposed 1983 Table A with projection.

A third major risk is what I would call the regulatory risk. The primary risk seems to be that of uncertainty. The price attached to uncertainty has the potential to be enormous.

Let's look at some examples:

- I'm sure you're all familiar with the so-called excess interest issue. We have been crediting our annuity contracts with excess interest, on a prospective basis, for almost twenty years. Now the tax treatment is being challenged.
- The wraparound annuity is another situation. While Revenue Ruling 81-225 clarified certain points, it left us confused. We offer a variable annuity funded by mutual funds that we manage and that can be used only for these annuities. While 81-225 did not appear to affect these annuities, we decided to suspend the transfer provision until we could get the situation clarified. Several months later Revenue Ruling 82-54 answered our questions and we reinstated the transfer provision. In the meantime, we had people upset and confused, probably lost substantial sales, consumed a lot of management time and spent a fair amount of money.
- Interpretation of reserves. What is the appropriate reserve for a SPDA when the surrender charge is waived if the credited interest rate drops below a specified level? I am aware of at least two interpretations. With the volume of business that is currently being written, the dollar difference between these two interpretations is extremely significant.

### III. Pricing Consideration

In pricing, our target is a minimum return on capital invested of 15%. Capital invested includes acquisition costs, any reserve strain and risk surplus allocated to the annuity product. On an annual basis, this translates to about a 100-200 basis point spread, depending on the type of annuity product.

In order to have a competitive product and get a reasonable return on investment, we need to hold our reserve strain to a minimum. This means we need the dynamic valuation system, particularly if relatively long interest rate guarantees are made.

We also strive to minimize reserve strain in the design process. This means we do not offer a bailout provision. I'm also uncomfortable with the bailout provision from a risk viewpoint. As I understand it, a bailout provision is based on the theory that capital gains will be available to recover acquisition costs, etc., if the interest credit rate is reduced below the bailout floor. My concern is that investments that can generate any reasonable amount of capital gains will result in a mismatch if interest rates rise.

#### IV. Managing Interest Credits

We have a variety of annuity contracts on our books. Some of our older business was written with a front-end load, no rear-end surrender charge, guarantee of principal, and portfolio interest credits. At the same time assets were invested relatively long. We currently write business with no front-end load, rear-end surrender charge, guarantee of principal and new money interest credits.

Obviously this situation presents us with some interesting problems. We have not accepted negative spreads on this older business, nor, for that matter, on any block of business. In fact, we are maintaining our target spreads on all of our annuity business. However, we do have a problem with the high level of surrenders (or rollovers) on some of our older blocks of business. The assets backing these blocks of business are not producing enough cash flow to cover surrender benefits. What we actually do is recognize that we are investing some of the new money coming in the front door in older assets when we set the interest rate for new business. So far we have been able to do this without materially affecting our competitive position.

Our commission policy is a major factor in limiting internal annuity rollovers. We don't pay any commissions on internal replacement. No matter what kind of annuity rolls to what kind of annuity, we take the position that we are only going to pay compensation the first time that money comes in the door. We do however pay a \$50 service fee if a significant amount of money, \$5,000 or more, is transferred from one annuity to another annuity.

I'm sure we'll be looking at other approaches to managing interest credits in the future. The key is to remain flexible.

#### V. The Future

What does the future hold? We're looking at shifting some of the investment risk inherent in fixed annuity products to the customer. By this I mean we're making more of an effort to market variable annuity, which gives the customer flexibility to fund his annuity in a variety of ways, e.g., common stocks, bonds, money market instruments, etc.

Obviously, this is easier said than done. Fixed annuities with guarantee of principal and high interest rates are extremely popular vehicles.

I believe we will continue to offer both a fixed and variable annuity. This will give us flexibility -- flexibility to balance the investment risk yet generate significant cash flow for the general account.

MR. MICHAEL R. WINTERFIELD:

In my comments I will attempt to provide support for the six following personal viewpoints.

1. it is important to articulate the basic annuity product design and investment policy approach to the agents who are selling the product. On what basis do we wish to compete ? -- Is it the highest current interest rate and inflation adaptation or something else?

2. Fixed account interest guarantee periods and investments should be limited to the short-to-intermediate range for both financial and marketing reasons. Alternatively longer term instruments with floating rate features can be used.
3. We must be able to change interest rates as quickly as other financial institutions. Most importantly, we must be able to decrease rates as quickly as we can raise them.
4. In designing our new products (especially the SPDA) we have to recognize the unavoidable internal replacement problems that will result. The more attractive our new product is to draw in new funds, the more attractive it will be for existing life insurance and annuity policyholders to transfer funds to the new product.
5. The time is right from a financial, marketing and regulatory standpoint to expand the use of separate account funding vehicles.
6. In the periodic payment market, product design must focus on the ability of the products we sell today to attract new funds year after year in the face of mushrooming competition from other financial services institutions. Our challenge is two-fold -- first to maximize the probability that we will be able to attract new customers and maintain renewal premiums for old customers just two to three years from now, and second, to provide financial safeguards in the event our renewal premium objectives aren't realized.

In accordance with these concerns I emphasize the need for further marketing cost reductions and as much leveling of the commission as possible. Reduced marketing costs are the critical factor in improving our competitiveness.

Before I develop these theses, let me briefly describe our current products and sales activity. We essentially work with just two products:

1. EVLIPLAN: Our single premium deferred annuity which is offered by the Equitable Variable Life Insurance Company. This product is primarily designed for the non-qualified market, but is also available in certain tax-qualified situations. EVLIPLAN guarantees an interest rate for one policy year at a time and has a ten-year graded termination charge. We provide a 10% annual free withdrawal corridor, a money back guarantee and a reasonably conservative bail out rate.
2. EQUI-VEST: Our periodic payment deferred annuity which is offered by Equitable Life. This product is used in all tax-qualified markets other than the corporate IRA and pension markets. This product will also accommodate single premium transfers.

EQUI-VEST provides multiple funding options. We currently offer a Fixed Account with interest rates that are adjusted each quarter and a Common Stock Account. Later this month we are scheduled to add a Money Market Account. We will allow our certificateholders to change their future payment allocations at any time. We currently allow unlimited transfers between the Fixed and Stock Accounts. After the Money Market Account is introduced, we will allow for unlimited transfers from the Money Market Account to the other accounts, but will preclude transfers

into the Money Market Account in order to limit investment anti-selection.

EQUI-VEST has an annual administrative charge and a graded termination charge which runs to the later of age 59½ or five years. We also provide a 10% free corridor after five years participation.

Career agents are responsible for virtually all EVLIPLAN and EQUI-VEST sales. Our 1982 sales goals call for approximately \$250 million new single premium and \$125 million new annualized periodic premium. Due to a tremendous early response to our Every Person IRA offering, we are currently running well ahead of the annualized premium goals.

Let me now turn to my six theses.

1. The need to articulate the basic product design and investment philosophies has been emphasized to me by just about every agent I am in close contact with. The reasons are simple. The good agent wants to know what our strengths and weaknesses are. The agent wants to know how the game is being played and what unique Equitable strengths can be discussed with his or her client.

As an example, let me cite our termination charges, which run for a longer period than the industry average. Our agents would certainly prefer a shorter termination charge period, but they can at least reasonably deal with a client concern when they know that our deliberate emphasis is on providing the best value to persisting policyholders.

The Fixed Account investment policy is an even more striking example. The agent wants to know whether the investment policy will allow the renewal year SPDA interest rate to track changes in new money rates or whether the interest rate should be regarded as a long term lock-in.

I would like to draw an analogy here to disclosure of our separate account investment policies. We see the value of prospectus disclosure of our Stock Account and Money Market Account investment policies. Why then shouldn't we provide some rudimentary information about our Fixed Interest Accounts?

2. In the fixed interest area our current formal investment policy limits our new investment maturities to the short-to-intermediate range for the following reasons:
  - a. We are unwilling to accept the investment anti-selection risk with maturities beyond prescribed limits.
  - b. We find that short-to-medium term investments are more satisfactory from an agent and client standpoint. There are many potential anti-selection scenarios under which interest rates moderately rise and our termination charge provides adequate protection against excessive cash withdrawals. However, we find these situations totally unsatisfying. Over the long haul, discontented policyholders can be as much of a business problem as direct financial losses.

With these thoughts in mind we prefer a small giveup of initial interest rate in order to increase our ability to keep our renewal year rates as close as possible to new money rates. As a result of this policy we have been able to set the second year rate for all SPDA's we have sold since September, 1980 at the new money rate then offered to new issues.

3. The need for immediate responses to interest rate changes was brought home to the Equitable last October and November when marketplace rates were regularly dropping by 100 points or more per week. As a result of our experiences during that period we instituted our present SPDA rate setting practices. We now have a meeting every Tuesday morning to set the new sales interest rate for Thursday of the same week through Wednesday of the following week.
4. Our tabulations of 1981 SPDA sales indicate that a moderate portion of the 1981 premium arose from Equitable life insurance cash surrenders and policy loans. The simple reality is that SPDA replacements at 13% or 14% interest can in fact economically benefit both the knowledgeable agent and the knowledgeable policyholder.

Our response to the life insurance replacements is twofold:

- a. We allow agent compensation, but only at a reduced rate on admitted replacements which the agency manager considers necessary to conserve business, and,
- b. We look for some additional profit margin in our SPDA pricing to partially cover the internal replacement losses.

I would note here the obvious parallels between our annuity internal replacement problems and the banking industry's problems with their high interest CD's. These CD's have brought in new money, but they have also caused tremendous switches from old passbook savings accounts to the higher interest vehicles.

5. I am now more bullish than ever on the value of Money Market, Stock and other separate accounts for both periodic and single payment contracts. I offer the following reasons:
  - a. Money market funds continue to show dynamic growth both in inverted and traditional yield markets. As of March 24, 1982, the Investment Company Institute reported \$192 billion of money market fund assets.
  - b. Especially in the HR-10 and IRA markets it takes more than a fixed account to adequately compete against the banks and against the families of mutual funds. The banks will probably dominate the new Every Person IRA market if we offer just a fixed account against the new 18-month fixed-and-variable-rate certificates and the older style 30-month fixed certificates.
  - c. Despite the current stock market woes under Reaganomics, most

long term measures of stock market performance are still highly favorable.

- d. Separate accounts involve no reserve strains.
  - e. Separate accounts eliminate the investment anti-selection concern that is always present under our fixed account guarantees.
  - f. Under present tax law there is a full federal income tax deduction for all separate account interest and dividend income credited to the policyholder.
  - g. IRS Revenue Ruling 82-54 has clarified the tax treatment of variable annuity contracts with more than one funding option. This ruling holds that the ability to choose among broad, general investment strategies such as stocks, bonds or money market instruments will not adversely affect the treatment of the contract as an annuity.
  - h. The SEC is becoming more comfortable with back-end-loaded separate account contracts. Procedures have been developed to allow companies to use a portion of the asset charge to cover distribution expenses.
6. The ability of our period payment contracts to adapt to accelerating competitive improvements has always been of substantial concern to me. My contention is that the life insurance industry has concentrated too much on enabling the agent to make a high commission sale today and too little on encouraging the client who buys today to give us additional premiums after year one.

We must be aware of these realities:

- a. that bank deregulation has enabled the banks to offer highly competitive rates in almost all maturity ranges;
- b. that Dreyfus, Fidelity, T. Rowe Price and other mutual fund groups are beginning to aggressively market no front-end load/no back-end load families of funds in the various tax-qualified markets;
- c. that we are rapidly approaching the end of the traditional concept of agent loyalty. An agent can only keep business with us as long as our product remains superior. In this environment, as far as many of our clients are concerned, we are only as good as our last quarterly interest rate.

I contend that the insurance industry's present products and commission structures generally do not satisfactorily address these realities. Our marketing costs are the major problem. My rough analyses indicate that the commission and other marketing expenses of most major no-front-end-load annuity writers require an interest or asset margin holdback of 100-200 points plus a long duration termination charge in order to recover just these expenses at an acceptable rate of return. By comparison the

distribution costs of the banks and the families of funds are miniscule.

My proposed responses are threefold:

- a. Marketing expense must be sufficiently reduced to lower the interest or asset margin holdback to not more than 100 points.
- b. Agent commission must be leveled out both to encourage renewal premium persistency and to provide financial safeguards when renewal premiums fall below plan.
- c. Investment flexibility through a combination of fixed and separate account options must be offered.

My belief is that the life insurance industry can attain a much larger share of the various tax qualified markets with such a program. The combination of a well designed annuity program with substantial investment flexibility and a professional agent is unbeatable as long as we keep our charges to a reasonable level. As Jerry Hoff, the President of Sun Life of America indicated in a recent interview for the National Underwriter, "the life industry has an advantage over its financial services competition because of its agent system. It has actual sales people going out face-to-face to talk to customers. We are the only remaining financial industry that I know of with this approach to marketing its products."

It is clear to me that our clients will pay a premium for these services, but it has to be a reasonable premium!

MR. LENSER: The annuity deposits that have come into these companies writing large amounts of SPDA premium have grown rapidly over the past five or six years and the amounts coming in now are enormous. I'd like to ask each of the panelists whether he thinks that there can continue to be either growth of this sort or even leveling-off of premium income, at these levels, and if so, what does he believe the sources of these annuity premiums will be?

MR. KLING: I don't know where the money comes from. It continually amazes me to see the dollars that are turning up. Total sales with the IDS Corporation were up 40% last year and are up about 50% already this year. I don't know where that money is coming from, but it's there, and as long as we can offer the service and a competitive product, it looks like it will continue to be there.

MR. CARNEY: I would probably agree with Dick. I remember back in about 1975-76, Howard Kayton, myself and one of Dick's associates were at a meeting and we were comparing some notes on volumes, etc. We figured that between the three of us we had written about 90% of the single premium deferred annuity volume at that time -- that was about a billion dollars of premium. In 1981, I can think of at least two companies that wrote more than a billion dollars of single premium business, as well as a large number of other companies in the product area that wrote one hundred million, two hundred million, three hundred million, etc. There is a significant volume

of business coming in today. I have no idea where it's coming from but I would think that if trends continue as they are, the volume will continue to be there.

MR. WINTERFIELD: I don't think that we've reached the peak yet as far as money coming in from the outside. Public awareness has increased but it hasn't reached everybody yet. I think the biggest concern with the SPDA in the immediate future is whether Assistant Treasury Secretary Chappoton is going to be able to live with the present "inside buildup" under the SPDA. ACLI has been speaking with the Treasury this week about some possible proposals to allow for the continuation of the SPDA but on a somewhat more restrictive basis, with changes in the tax free recovery of the initial principal amount.

MR. LENSER: Let me add a piece of the answer to my own question before I get the first question from the audience. My own experience with the product arises heavily from work that I have done with various of the Wall Street securities firms. Their belief, back in the late and middle seventies when this product was beginning to take off, was that annuity premiums were not what they referred to as "hot money." The money was not going to move into annuities this year and into something else two years later; and that seemed like a reasonable belief, given the nature of the annuity contract. I think it is probably less true today that it is not "hot money" -- probably more of it is moving around; and there is some part of the new deposits that is simply rolling out of old contracts. It's hard to say how high that goes, but it would not surprise me if it were -- say in a year like 1981 -- if 10%-15% of that enormous amount of sales was turnover of old annuity money.

MR. HENRY RAMSEY: I would like to compliment the panel. I think this was an unusually informative presentation -- you did a terrific job. I have questions for a couple of you. Mr. Kling, in talking about your older annuity portfolio I think you said you have more money going out than you have maturities in your investment portfolio. Then, in essence, you have -- in calculating your portfolio rate on a new money basis a negative current year fund, is that correct?

MR. KLING: It's correct, the cash flow is negative on the assets backing that block.

MR. RAMSEY: So you take that into account in getting your portfolio rate when you say you're still "above water" there.

MR. KLING: Our portfolio rate for that older business is a relatively uncompetitive rate these days, since we do recognize what's happening with the investment posture on new dollars coming in. What we have done is not move that rate to any extent here as interest rates have risen over the years.

MR. RAMSEY: Mr. Winterfield, you said, that you plan to restrict transfers into the money market fund to reduce anti-selection. Why do you have anti-selection in moving into a money market fund?

MR. WINTERFIELD: This is a result of the order in which we developed our options. We have been offering our EQU-IVEST product for a couple of years now with the fixed account and the stock account together, and we allow people to transfer between fixed and stock, if they want to, 365 times a



year. In coming out with the money market account, we decided that we did not want to tamper with what we were already doing with the fixed and stock accounts, so the money market account addition had to coordinate with what we already have with the fixed and stock account. We are obviously concerned about movement of money from the fixed account into the money market account at the wrong time, and we have to preclude transfers from the stock account because we could get movements from the fixed to the stock to the money market account.

MR. RAMSEY: You mean your fixed account is not a market-value-adjusted account?

MR. WINTERFIELD: No, it isn't.

MR. RAMSEY: Let me suggest that you may want to restrict the right to go the other way too. If interest rates swing around the other way, you get hit the other way as money moves back to the fixed account and drives your interest rate down.

MR. WINTERFIELD: That's one of the reasons we have been working with the three-month guarantee.

MR. KLING: In our situation where we were starting from scratch and we didn't have to add the money market account later, we did something else. We have three market value accounts plus one general account option. What we have done is not allow transfers out of the general account option -- you can go in but you can't go out. You can move among the other accounts pretty much at will.

MR. RICHARD FISHER: This is a question for Mike Winterfield, in regard to EQUI-VEST. You mentioned that commission costs amount to about 100-200 basis points in interest spread, and that EQUI-VEST is sold by Equitable, the parent company. Is that interest spread taxable income for Equitable, and, do you therefore have to really charge almost double that spread to cover the expenses?

MR. WINTERFIELD: Right now we're hopeful that the interest spread in Equitable is not taxable.

MR. LEW NATHAN (CNA): I have two questions about FPA product design. First, for any of your products, do you use a type of waiver of contribution feature? Second, do you provide for any type of reminder notice that goes out suggesting that a contribution come in for future quarters to keep the cash flow in the FPA positive?

MR. WINTERFIELD: As to the waiver of premium issue, we had a moderate number of agents asking for waiver. I think that the substantial majority of the agents felt that the waiver feature would really "clutter up" the flexible annuity. I think the consensus was that a \$2,000 per year type waiver was too little to work with. A good agent wants to sell a substantial disability income policy. As to reminder notices, we do use them. I don't know whether they do all that much good, but we do give it a try.

MR. KLING: We do send out premium notices on our flexible annuity contracts and so far we have a positive impact from that. As to waiver, we have offered a completion option which is a life insurance policy with a monthly

income benefit is which allows you to complete the IRA plan in the event of, say, death or disability; but we've found that just offering a pure waiver benefit relatively expensive for the value that you get on the small account, and we've not gone with a pure waiver benefit.

MR. LENSER: Let me add a personal reaction to that. When I saw the first big New York Life advertisement in the Wall Street Journal, earlier this year, one of things that struck me about it -- as providing something that the securities firms couldn't provide -- was the fact that they were offering a waiver option there. In addition, I think that in the securities firms, some years ago when mutual funds sold more heavily on a periodic payment basis, they had something in the way of a completion option. I would think that that would be something you might see on IRA products as they are offered by securities firms in the future.

DANIEL ANDERSON: On the SPDA's marketed out of the general account -- first of all, do you earmark assets, specifically to back up the SPDA's? Secondly, what procedures do you use to monitor the asset and the liability matching over time? And third, if you do earmark assets, do you restrict your investment operation, in any way, from selling those assets in anticipation of interest rates movements?

MR. KLING: I wish I knew the answers to all of those questions. We don't earmark assets; we don't specifically earmark or segregate assets. We do -- by almost a type of memo accounting -- allocate assets, so we know which assets were bought in what period of time. We don't restrict our investment department, but being a member of the investment committee I know what's going on and I am aware of any changes in philosophy. In terms of asset-liability matching, we are still grappling with that problem, and we have been working with the C-3 task force. We don't have a procedure in place, as we would like to have someday when we know both our asset and liability durations, the theory in place. We are working on that now, but have a way to go.

MR. LENSER: Let me add a response to that, and then if Mike and Greg want to respond for their companies they can. I would say that what you are describing is probably in an initial developmental stage at some of the larger SPDA writers now. I suspect, though from the contact that I have had with them, that it is generally not very far along. Obviously, everyone in those companies is very much aware at this point of the asset liability matching problem because of the problems they have had in past two years with disintermediation.

MR. WINTERFIELD: We've been fortunate with both of our products in designing the investment policy. In the case of the SPDA, which is offered by EVLICO the entire general account is, for all practical purposes, the SPDA. Variable life is a separate account. In the case of Equitable, where we are offering the EQUI-VEST contract, the company has moved through segmentation of the general account. We now have the general account subdivided into six segments for different ALB's (accountable lines of business) and each ALB is able to set up its own investment policy.

MR. JAYMES HUBBLE: About three or four times a year, we have a request to bid on a single premium annuity contract, that is not your typical annuity contract. The premium will be anywhere from \$500,000 to as high as \$1 billion. We don't bid on those annuities and obviously, when we get one of these bids, it is a broker who is calling every insurance

company in the country. I am just wondering if anybody ever pursues these things to find out whether there is any merit in them. I presume they are being done for tax reasons or some gimmick and more than likely I would think any insurance company that gets into this is bound to get burned.

MR. LENSER: Are you describing a situation here where the company is selling its standard single premium deferred annuity product ?

MR. HUBBLE: Oh no! They are looking for a deal.

MR. LENSER: I would say that I have heard of some situations in past years where a company was selling its standard single premium deferred annuity contract at its current interest guarantee of 14½% or 15%, or whatever was being offered at that particular time.

MR. HUBBLE: I think Dick said he had a \$100,000 limit on single premiums. We have perhaps a \$200,000 limit so what they are asking is a special request. Generally we don't even touch them and I wonder if anybody does.

MR. LENSER: The largest number I have heard is \$10,000,000, several years ago, coming through one of the securities firms. I don't know whether the contract was ultimately written or not.

MR. CARNEY: We have seen a lot of these coming in. I think that the brokers that have been approaching us think a little bit higher. The largest case we have had a request on was \$2.7 billion. I don't know of any company, in the last five years, that has placed any of these cases. Somebody has got a good deal in terms of getting free lunch from some agent some place and the companies are spending a lot of time and effort making some quotations and nothing ever comes through. We have had a policy for a few years where we just ignore them entirely and we've gone back to look at some -- early this year -- because they have come to us from people that we have good working relationships with. Again, nothing has been placed, and we've just made a decision that we are not even going to waste our time any more with regard to any of the quotes. I don't know of anybody who has ever placed any of them, and if there is somebody in this room who has, I would like to hear about it. One of our competitor companies made a comment that their approach is that when the broker calls with this \$100,000,000 case -- they want a special rate, a special deal, a 20-year arrangement with no surrender privileges, etc. -- the company president just says, "that's fine", we'll take it on whatever basis you want, send the check."

MR. KLING: Just a brief comment, the first one or two of those requests seem to be interesting and we all have these tales to tell about where the money was coming from, but it is a complete waste of time. I refer them to Greg probably or somebody else.

MS. MARY JO NAPOLI: I would also like to compliment the panel on its fine presentation. A couple of questions -- first, just a kind of funny philosophical question. Yesterday morning in the keynote presentation, I was all of a sudden awakened when I saw that variable annuity was one the four dismal causes of inflation. I would like the panel's thoughts on that one. A more practical question here -- looking at the marketplace right now, there seem to be some hybrids developing between the portfolio method of crediting interest and the traditional investment year method that we are all familiar with from textbooks. I would like some comments on your feelings on these.

MR. WINTERFIELD: I think that we do use a little bit of the hybrid with our EQUI-VEST contract. I had mentioned in the case of the SPDA world, we were fortunate enough to work everything out investment-policy-wise, so that we could give everybody a new money rate when they renew. We hadn't been so fortunate in the case of the EQUI-VEST. We use an IYM method, for each calendar year's issues, but after we come up with the first cut at rates, we find that we do have to do a little bit of adjusting and we wind up with somewhat of a blend between pure IYM and a portfolio rate. I think this has mainly come into play because of the very large amount of business that we do with tax-sheltered annuities. We find that it is a really horrendous problem to have one teacher who signed up in 1980 working with a substantially lower rate than one who signed up a couple months later in 1981.

MR. CARNEY: We utilize a portfolio approach, but I think one of the things you have to keep in mind is that when you start getting these large amounts of premium for the SPDA's it distorts portfolio or investment year methods. I remember that in one year, we went through asset increases that hit a \$100,000,000, \$200,000,000 and \$300,000,000 in a twelve-month period. Although we were saying our rate crediting was based on the portfolio, there was a significant new money flavor to that portfolio, because we were taking in so much premium at that point in time. It is kind of a blend; we do not tier our rates, and so we are on a portfolio basis, but because of the function of the size of the premium dollars coming in it does have a mixture of impact.

MR. KLING: I have a quick comment on your question regarding the variable annuities. I believe those comments were made on what has happened historically with variable annuities. As we knew them in the past, they had the heavy front-end loads and one common stock investment option and they have not been very attractive. I guess I believe that the equity market and the other alternatives -- bonds money market instruments, the ability to transfer -- make the variable annuity a lot more attractive, particularly when you combine it with a product that doesn't take anything off the front-end. I think we are seeing a new type of variable annuity contract these days relative to what we have seen over the past ten to fifteen years.

MR. DIETER GANBATZ : With respect to large annuity quotations, what we have done just recently is start to ask people to put a little money up front to show us that there really is some there. I have a question for Mr. Winterfield. You said that you needed to be able to bring rates down as quickly as up. You mentioned that you have weekly rate-setting meetings and that two days after the meeting the rate goes into effect and runs for a week. Is that good enough? How much of a lag can your agents have in sending you a contract? If your rates are effective on Thursday does that apply to anything that the agent writes on Wednesday or does it mean anything that's in your branch office by the Wednesday?

MR. WINTERFIELD: When the rate changes on the Thursday, we will use the old rate on anything that's in the shop through Wednesday. If a rate goes up rather than going down, and we have something in the shop that hasn't been issued yet, and we will automatically issue it at the high rate; but if the rate is going down then we do have the hard line now that it simply has to be in the shop by Wednesday. We went through a lot anguish with this; agents were telling us that they needed a month or two months to really land their cases sometimes. We found that the losses we took under the old procedures were just more than we could sustain. I think the main thing

that allows this to work is that this is the way the banks do it. The rate is good for a week and you have to live with it.

MR. GANBATZ: What do you do about sales that you might want to make on Wednesday night, or do they just stop making sales on Wednesday nights?

MR. WINTERFIELD: Sometimes they do.

MR. GANBATZ: So if they make one on Wednesday night they don't know what the rate will be the next day?

MR. WINTERFIELD: When we set our rates on Tuesday -- we do that Tuesday morning. By 12:00 o'clock that day we send the wire out to all of the agency managers, so any agent who is in the business can find out Tuesday at noon what the rate is going to be on Thursday.

MR. MARTIN GOLDMAN: My question is for Mr. Carney. You mentioned that you thought that the movement from group to individual contracts was because of the new valuation law, but it seems that group contracts still give you some freedom from the individual standard nonforfeiture law in that you have more freedom in setting your surrender charge. The nonforfeiture law prevents you from doing some fairly normal things.

MR. CARNEY: That's probably true. The main reason though for the group products -- as applied to the semi-group or loose group or whatever you want to call it is the 7½% valuation interest rate versus the 5½% valuation interest rate. Some types are very risky; when you have a group annuity for the XYZ brokerage firm and another group annuity for the ABC stock brokerage firm, you are putting the control of that product and its sales and its eventual replacement with that member firm and that's an area that I'm a little concerned about. I think that there may be some companies going to an individual product. There may not be, but there is no valuation reason anymore, and that was the only point I was making.

STEPHEN PATZMAN: My question has to do with the investments that you use and the investment rates. Our marketing department shows us the competition's SPDA's and some companies are crediting 14%. We look at that, add 100-200 basis points, and that comes out to be a 15%-16% gross investment income rate. Our investment department says the best we can do out there is a 14%-15% yield, buying short term. How are companies doing this? What investment vehicles are they using? Are they going very long to get the high rates that they are crediting?

MR. CARNEY: I think that the majority of the investments being made right now are short, and hopefully, at most, maybe five to seven years. Some of the high interest rates may arise because people are trying to get money in today and are willing -- in the short run -- to sacrifice the 150-200 basis points spread that they really need. They plan on being able to increase that spread if interest rates do turn down. I think there may be some of that going on.

MR. KLING: Let me make a quick comment on that as well. I think Greg is right as to long being anything over five years -- five years is a long investment. Three to five years is a range that we tend to invest in more than anything else, but we also tend to buy deep discount bonds. Tax treatment of the capital gain does generate a tax-adjusted yield that allows

a company to credit higher levels of rates. If we are crediting 13% we are certainly looking for a gross tax adjusted yield rate in excess of 15%, there is no question about that. We don't play games -- if it is not there, we don't credit it.

MR. LENSER: Dick, with respect to the use of deep discount bonds, since there is a somewhat reduced cash flow with those bonds, do you tend to go fairly short term with them or would you go to a longer term?

MR. KLING: Short term and sinking fund build-up as well. This means the cash flow position is usual pretty good. It's getting a lot harder to find the right sort of investment, though. Many people are going after the same types of investments.

MR. LENSER: Let me add one more comment to what was said. From what I have seen of the way companies are investing, I think some portion of the annuity money is still being invested fairly long term, although it is a small portion -- maybe less than 25%. By long term I mean ten years or more. Little is as short term as a year or less, but much is being invested at durations from two years to five or six or seven years. Of course with the yield curve the way that it is now, and has been in the last several months, you can go to durations of five six, seven years and not sacrifice much yield in relation to much longer term investments.

MR. DONALD SONDERGELD: A question that was presented earlier raised a question in my mind regarding hybrid methods of allocation. I think many of us are familiar with the practice by companies selling GIC's or "bullets" of putting the money in a separate account, not necessarily to make a market value adjustment but just to insulate the effect of that investment on the new money method. That raises the question, of whether any companies are using an investment generation method where the generations are not calendar years, but rather half-years, quarter-years, months or other periods. I don't know of any, but that is a refinement that could be developed.

MR. WINTERFIELD: That particular method is being developed by the Equitable for corporate IRA cases, which are geared toward the market of employers with 10,000 or more eligibles. We are looking at a product that would open up a new account every three months with a three-year type guarantee after three years. There would be twelve accounts. We felt that for the individual market that was too complicated, but that for the bigger corporate IRA cases, it seems to be a good strategy.