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CURRENT ANNUITY TOPICS

Moderator: RICHARD A. SWIFT. Panelists: HOWARD H. KAYTON, ELAINE MANDRISH, CHRISTOPHER H. WAIN. Recorder: LYNETTE L. TRYGSTAD

- Trends in annuity product design
- Marketing and agents' compensation
- Competition with other financial institutions, including banks
- Investment strategies
- Establishing separate accounts for annuity lines
- Regulatory issues including TEFRA, state requirements, and the SEC
- Replacement problems/persistency
- Structured settlements/substandard annuities/funding agreements
- Annuitant mortality

MR. RICHARD SWIFT: Welcome to Open Forum #36 on Annuity Topics. Since this is an open forum, we encourage participation in the form of comments and questions from the audience following the presentation by our panelists.

The purpose of Open Forum 36 is to discuss the spectrum of individual annuity products being offered to the public. This includes both deferred annuities and single premium immediate annuities. Tax qualified and nonqualified plans will be discussed. The diverse background of our speakers will illustrate the annuity products and markets that are being served by life insurance companies.

The first speaker is Howard Kayton, Vice President and Chief Actuary of Security First Group. Howard has most recently been involved with a company that markets deferred annuities through stockbrokers and TSA annuities to school districts and municipalities. Howard will discuss product design and marketing of single premium deferred annuity policies. He will also address investment strategy, including asset segmentation, for annuities.

Our second panelist is Elaine Mandrish, Associate Actuary of Crown Life Insurance Company. Elaine will discuss single premium immediate annuities with particular emphasis on the structured settlement annuity market. Elaine will also discuss current developments in the Canadian marketplace.

Elaine's current responsibilities relate to Crown's U.S. subsidiaries. Prior to that she had considerable involvement in individual annuity pricing and product development.

Our third panelist is Christopher Wain, Vice President and Actuary of Prudential Life Insurance Company. Chris will focus on flexible premium annuity products with particular emphasis on the IRA market. Chris has responsibility for most individual life and annuity product development.

Annuities have been a hot topic over the past few years. Recently there has been a growing awareness of the asset risk associated with the sale of annuities. Many companies are recognizing the substantial investment risks and are developing techniques to match annuity assets and liabilities by segmentation. Howard Kayton wrote one of the first papers on disintermediation, and I expect Howard will add to your knowledge base regarding the annuity investment risk. I would now like to introduce Howard Kayton.

MR. HOWARD KAYTON: In June of 1978 at a Society of Actuaries meeting in Portland, I presented a discussion on "The Problems of Disintermediation in the Sale of Annuities." At that time, I began the discussion by explaining what disintermediation is. Now, almost five years later, it is not only unnecessary to explain what disintermediation is, but if I were to believe some of the marketing people I listen to, disintermediation is no longer a problem. I trust that there is no one here who believes that disintermediation is a problem of the past.

The risk of disintermediation and of intermediation, the C-3 risk, has already had a significant impact on life insurance investing. But so far, we have only scratched the surface. During the next 10 years, as actuaries continue to develop the necessary theories, and as investment advisors begin to apply these theories, there will be much more creative investment strategies that will require the joint efforts of actuaries and investment analysts. No longer will the actuary be able to disclaim any knowledge of the content of the asset page, and no longer will the investment advisor ply his course independently, seeking the highest possible quality yield without any concern as to the product-type from which the investable assets arose.

This is already beginning; it has facilitated the sale of the structured settlement annuity, the guaranteed interest contract, the indexed annuity, and the longer guarantees in the single premium annuity. It will continue to develop in the future, requiring much greater investment knowledge on the part of the actuary than has been required in the past. I would now like to discuss some of the investment strategies and some of the product designs used to support innovations developed to meet specific asset strategies. The approach via investment strategies seeks to match assets to liabilities; the approach via product innovation seeks to match liabilities to assets. Either way works, so long as a match can be achieved.

I would also like to call your attention to a soon-to-be accepted paper by Jim Attwood and Carl Ohman of the Equitable of New York which explores portfolio segmentation. It gives a detailed description of the Equitable's recently adopted plan for segmenting their portfolio across major lines of business. This management approach will encourage and facilitate matching strategies for multiline companies.

Specific investment strategy changes that have occurred because of attempts to reduce the risks of disintermediation are:

(1) Hedging via purchase of interest futures -- several companies have been doing this for several years. A spokesman at one of those companies is quite satisfied with their approach, but has indicated it actually works much more to their advantage in a rising interest rate market. Their concerns are obviously more toward the risks in an upward market than in a falling market. There is a difference in opinion as to whether this can be applied in a wholesale fashion to entire portfolios. This controversy will remain largely academic until more companies adopt this more complex strategy.

(2) Shortening the life of the portfolio -- this is largely the barn-door-closing strategy, since the problem of 1979 to 1981 arose from long duration bonds and mortgages. Currently, companies are again investing long term, except that long term has changed from 20-30 years to its current meaning of 6-10 years. Shouts of "Never Again" emanate from the investment departments of those companies that were most embarrassed when the cash flow valve reversed in the late 1970's.

(3) Reduced quality of portfolios -- because of the concern with the C-3 risk and because of the reinversion of the yield curve (i.e., short term investments once again yield less than longer term investments), investment departments have had to reduce quality to maintain yields. Clearly, this is trading some C-3 risks for C-1 risks, a highly questionable strategy. Obviously, the only reason that the yield is higher on lower quality bonds is the greater likelihood of default; but all investment advisors believe they can do better than the standard implies. Such strategies are nearer to gambling than investing.

(4) Changes in private placements -- the innovations here are in shorter maturities and in the development of secondary markets, both of which enable companies to reduce terms on what has been an important means of investment for insurance companies.

(5) Zero coupon bonds -- while the IRS took away much of the appeal to the private investor, zero coupon bonds are still quite viable for the insurance company that expects

to pay little or no taxes. In periods of falling interest rates, this is the best means of removing the reinvestment problem.

(6) Deep discount bonds to gain call protection -- as rates began to fall, the emphasis shifted back to concern over meeting some of the longer guarantees of interest. One clever approach has been to buy deep discount bonds, since these have built-in call protection. However, this strategy, as is true for many of the others, depends on availability of investments in larger numbers.

(7) Expandable bonds -- this is a strategy whereby the lender has an option to either mature the bond, or extend it for a longer period at a predetermined rate. This was mentioned at the meeting in Houston as being available in Canada, and I hope someone in our audience can fill us in on this.

Let us now turn to the other side of the issue and explore some of the product ideas that have arisen both to match liabilities to existing assets and to reduce C-3 risks on new business.

(1) Market value adjusted annuities -- 3 companies now sell nonqualified group single premium deferred annuities that have surrender charges that increase when interest rates rise and decrease when interest rates fall, with the adjustment being a function of years to maturity of the annuity. One version has a 7 year maturity; another is a 15 year maturity. The adjustements are close to what is theoretically required. So far, this cannot be written as an individual annuity in the United States.

(2) "Reverse" bail-out provisions -- one company is issuing an annuity that provides for bail-out if the interest rate in the 6th through 10th year is not at least 1% higher than had been guaranteed for the first 5 years. Many stockbrokers and life agents are now learning the differences between guarantees and bail-outs. Where do the policyholders who had 13% bail-out policies invest the "liberated" funds to achieve a return equal to the initial 14% or even an initial 12%?

(3) Best-of-both-worlds policy -- at least one company is issuing a five year meaningful guarantee policy. It further requires the company to pay a rate equal to the 90 day average T-Bill rate, if higher, for the first 2-1/2 years; 80% of that rate, if higher, for the next 2-1/2 years; and then has a bail-out at the end of 5 years. The investment strategy of this policy, as I understand it, is based on a guarantee of investments results provided by the stockbrokerage firm selling it.

(4) The limited cash value policy -- I have not seen any policies where the issuer has taken advantage of the most liberal provision of our annuity nonforfeiture laws permitting a no-cash-value annuity. But, Capitol Life of Denver has been marketing an annuity which provides only annuity benefits on approximately half of the policy. The product was introducted in late 1980. While Capitol Life does not sell as much of that product as a recently re-introduced "unrestricted-entitlement-to-cash-values" policy (most people call it a deferred annuity), Capitol Life has sold and continues to sell, a respectable amount of business on the limited cash value basis. Clearly, it is easier to invest for a policy with a long term guarantee (presently 7 years) of interest rates if you have eliminated the "call provision" of your liabilities.

(5) Variable annuities -- there is renewed interest in the variable annuity as the ultimate C-3 weapon. However, for the nonqualified annuity we must still overcome the taxation of long term gains. We may also face an added danger if unisex-rating comes to pass, since the guaranteed purchase rates have no margins for feminism. Some other innovations are higher surrender charges and, in at least one product, a real estate fund.

I have tried to describe the products available in the United States market that have been designed to match liabilities to assets and asset strategies to liabilities. These developments have been evolving as a result of "consciousness-raising" on both sides of the balance sheet. It is encouraging to see companies where price setting includes the investment advisors (rather than their memo containing current yields) and where investment committees include actuaries.

MR. SWIFT: The market for structured settlement annuities has increased tremendously in the past year. The advantages of a periodic settlement to both the plaintiff and the company are now recognized by attorneys and claim administrators. Elaine will discuss the growth and products in this market. I would now like to introduce Elaine E. Mandrish.

MS. ELAINE E. MANDRISH: By way of background, I should first explain that Crown Life is a stock company which operates throughout North America as well as the U.K. and parts of the Caribbean. In the U.S. we operate on a brokerage general agency system. In Canada, we distribute our products through career agents.

In January of this year Crown Life Insurance Operations were restructured along geographic lines. My current responsibilities relate to our U.S. subsidiary companies and diversification thrusts within the U.S. individual insurance area. However, prior to January, for several years I was directly involved in individual annuity pricing and product development in both Canada and the United States.

In 1982, individual annuity sales, in terms of premium income, were $30.5 million in Canada and $38 million in the U.S. These compare to 1981 figures of $50 million and $24 million respectively. The bulk of these sales were single premium contracts.

STRUCTURED SETTLEMENTS

A structured settlement annuity is an annuity which is purchased to provide periodic payment of damages for personal injuries.

An example would be where a person is struck by a car and as a result is a paraplegic. A settlement by way of an annuity could provide the necessary living and medical expenses for life. This is the normal meaning of "structured settlement". The term may also be used to refer to annuities purchased to fund attorney's fees resulting from such settlements, as well as to refer to annuities purchased to settle commercial litigation involving damages.

The use of periodic payments in settling large personal injury claims is not a new idea. However, in recent years there has been an increase in the number of large awards and in the amount of these awards. As a result, a structured settlement is becoming a popular alternative to a lump sum settlement.

It is attractive for several reasons:

1) If proper procedures are followed, the annuity payments are completely tax-free to the plaintiff.

2) The payments can be structured to meet the plaintiff's exact needs.

3) It relieves the plaintiff of the need to invest and manage a large lump sum settlement, and it ensures the money is there when needed. This is a particularly important factor in situations where the individual is either mentally or financially incompetent.

4) By structuring the payments to the plaintiff's needs, the defendant may be able to negotiate a smaller settlement than otherwise would be the case.

To date, the majority of structured settlement business has originated in the U.S. -- although the market is beginning to develop in Canada and we are beginning to see some specialized structured settlement annuity brokers. My remarks today pertain to the U.S. market -- and that market has been estimated for 1983 at anywhere from 1.6 to 5 billion dollars!

PRODUCT FORM

The form of settlement may be:

1) a straight life annuity, with or without a guaranteed period, or a cash or installment refund

2) a term certain annuity

3) an annuity with an escalating feature

4) an immediate annuity together with one or more lump sum amounts paid at specified times. These lump sums are frequently used for inflation adjustments or to fund specific contingencies such as college education or projected medical requirements.

QUOTATION & UNDERWRITING RESTRICTIONS

A specialized knowledge and high level of expertise is necessary for both of the above in the Home Office and at the agent/broker level in order to avoid legal and tax problems and to cope with the large amounts involved, the fast turnaround time for quotations, last minute negotiations, etc. For these and other business and legal reasons many companies impose restrictions such as the following:

1. Quotations only to "qualified" agents or brokers -- some companies, ours included, will only deal with brokers who satisfy specific requirements. Our company doesn't have fixed criteria but we do suggest that our general agents deal only with brokers who have either:

    a) placed a large volume of structured settlement business with other companies in the past or,

    b) have placed a large volume of other business with us and can demonstrate that they have developed the necessary expertise for this market.

2. Quotations only to persons representing the defendant's side of the case -- again some companies, including ours, feel that quotations given to the plaintiff's side are non-productive. Also some brokers will not deal with companies who quote to the plaintiff's side. Since it is the defendant who purchases the annuity and chooses the annuity company, it is unlikely he will choose a company which has been providing information to the plaintiff that may have been used to his detriment in negotiations.

3. Limits on the amount of lump sums provided relative to the base annuity -- our company requires that the total premium attributable to the total lump sums provided not exceed 50%. I believe some other companies have similar restrictions. The concern here is with reinvestment problems and also that the contract clearly is an annuity and not an investment.

4. Special disclosure form -- we require the completion of a form disclosing whether the annuity is related to a personal injury suit, commercial settlement or attorney's fees. We rely on this disclosure to make the proper tax reporting.

Structured settlement cases often involve impaired lives. In these cases we follow our normal practice of assigning an age rating based on the most recent medical information supplied. Medical underwriting of these cases is generally a very competitive area.

MARKETING & AGENT'S COMPENSATION

These annuities are marketed principally by specialty brokers who concentrate exclusively on this business. Currently our company deals with these specialty brokers through our general agents. However, a number of companies have set up special Home Office units to deal directly with the brokers. This sort of arrangement facilitates the daily contact and fast turnaround required on quotations in the final stages of negotiation. Compensation on these annuities is typically in the 3½-4% range and does not grade down with size.

COMPETITION

Perhaps the best way to sum up the competition for this business currently is to say "It's fierce!" A concern over the impact of TEFRA on SPDA sales has apparently lead a great number of companies and brokers to enter this market recently. The result is that it has become premium rate sensitive to within 1/2%.

REGULATORY ISSUES

On the regulatory scene, the most significant item is HR5470, the bill to amend the Internal Revenue Code which was passed into law December, 1982. This bill was important because it specifically codified the tax-free treatment of structured settlement annuity payments.

However, it also gives us cause for concern by providing for the tax-free treatment to apply to periodic payments funded by "any annuity contract issued by a company licensed to do business as an insurance company under the laws of any state ...". The issuing company, therefore, doesn't have to be a life company.

This raises the spectre of annuity issuers and assignees becoming insolvent. The plaintiff has no contractual right to the annuity payments. So if the casualty company or assignee who owns the contract becomes insolvent the contract would fall into the assets of the bankrupt.

That the annuity issuer may become insolvent is also a possibility, and these days the pat answer that no company writing structured settlements has failed doesn't count for much! To counter this, brokers often insist on placing the business with an A or A+ Best Rated company. Another method which some casualty companies have begun using is to provide a bond for payment of benefits on annuities purchased from their life company affiliate. There is now at least one company that will offer this service to non-affiliated life companies. One other regulatory problem which we encountered recently was with the New York State Department of Insurance. They are concerned with contracts where the casualty company/owner is a residuary beneficiary. They take the position that this is a straight wagering contract -- the casualty company has everything to gain by the early demise of the payee. They are, therefore, insisting on written assurance from the life insurance company that only the named annuitant or a beneficiary designated by him will receive payments.

ANNUITANT MORTALITY

To conclude the subject of structured settlements, I'll comment briefly on the subject of pricing assumptions. Pricing considerations are similar to those for regular Single Premium Immediate Annuities. However, the presence of lump sums or escalating payments requires careful attention to reinvestment assumptions. Recent declines in interest rates and the longer term of some contracts necessitate careful consideration of the call provisions of the proposed investments. Last year we completely revised our Single Premium Immediate Annuity pricing. The major change was in the mortality basis.

For many years we had assumed a modification of the A-49 table with Projection B. However, industry mortality studies and results in our annuity lines made us increasingly concerned about the appropriateness of our pricing assumptions. A study of our own individual annuitant mortality during the years 1976-1980 showed mortality ratios significantly below 100% for all ages above 70. The results were better at younger ages, but the numbers and amounts of policies exposed were small -- so the results are not significant.

As a result of this analysis we developed a new mortality basis which incorporates a basic table representing 1982 mortality and a progressive projection scale. We relied heavily on the work done in the Exposure Draft of the 1983 Table a and our basis is, in fact, a modificaiton of that table.

CANADIAN ANNUITIES

When I reviewed the outline for this session, I noted the sixth item for discussion was regulatory issues. These days it seems that regulatory issues are the _only_ issues as far as Canadian annuities are concerned.

RRSP's -- the Canadian equivalent of IRA's were born out of Federal legislation introduced in 1957 and they currently constitute the key annuity market in Canada.

Initially, companies sold traditional life insurance plans as RRSP vehicles. When the industry finally awoke to the fact that the public didn't want an insurance policy, didn't want fixed premiums, didn't want high front-end loads and didn't want long term guarantees, the trust companies and banks had taken a large share of our market.

However, in the last 5 years the industry has made great strides. Few companies today offer life insurance policies in RRSP situations, and we've seen some new product innovations.

Most companies that consider themselves active in the Canadian annuity marketplace have contracts which are modelled after Trust Company GIC's. Most contracts have no front-end loads and minimal or no back-end loads. Often the funds are locked in for the term of the interest guarantee. Daily interest contracts are quite common, as are ones with interest guarantees of from 1 to 5 or 10 years.

In the last few years we have seen a continuation of the downward trend in remuneration. Today, it is typically in the 1-2% of premium range. This is necessary to compete with Trust Companies which offer finders fees of 1%. A few companies have adopted a remuneration scale which is a function of the amount of assets accumulated in the contract and this may be the future trend. On this scale the remuneration might be ¼-½% of the accumulated value at the end of each year.

A plan which we developed primarily for the RRSP market at the end of last year has had great success. It's called Retirement Plus, and it encompasses a daily interest option and 3 and 5 year GIC options. Premiums may be paid casually. The minimum casual premium into a GIC option is $1,000 and to the daily plan $500. Premiums into the daily interest fund may also be on a regularly scheduled cheque-o-matic (automatic bank withdrawal) basis. The minimum monthly premium on this basis is $50.

This year was the first year when interest on a loan taken to acquire an RRSP was not allowed as a tax deduction. So, instead of borrowing one lump sum on the last day of February each year and repaying it over the following year, many people will be forced to make small regular contributions to their RRSP.

In view of this we felt our cheque-o-matic feature would be particularly attractive and might give us an edge over Trust Company plans.

Funds in the daily account may be transferred at any time without charge to a GIC account. Funds in a GIC account are locked-in until the end of the GIC term. At that time they can be transferred without charge to one of the other accounts. Premiums may be split amongst the accounts, as long as they meet the minimum.

There are no front-end loads or annual fees. Small charges apply on annuitization within the first 3 policy years or on deregistration and surrender within the first 5 years. A total disability continuance of premium benefit is available which allows a disabled person to complete their retirement program. At issue, the applicant specifies a regular premium on which the waiver is to be based. This regular premium is the amount of benefit which will be paid and on which the benefit premium will be charged.

The disability benefit provides that upon disability before age 65 the company will pay the specified regular premium into the daily interest plan. This premium will continue to be paid throughout disability until age 65.

This form of benefit is unique to life insurance companies and can, therefore, give a competitive edge over Trusts and Banks.

When RRSP's were first introduced the payment had to be in the form of a life annuity. In the late 70's, the rules were liberalized to allow for a term certain to 90 annuity, a Registered Retirement Income Fund, which is essentially an increasing term to 90 annuity, and certain forms of indexed and escalating annuities.

At least one company has introduced an indexed immediate annuity and several offer escalating annuities.

Competition for the annuity at the payout stage has become very strong in recent years. We have seen the growth of specialty annuity brokers and, more recently, the advent of companies offering immediate on-line comparisons of annuity rates available from a number of different companies. The annuity rates can be accessed by terminals located in the agent's or broker's office as well as head offices of issuers.

With the demise of Income Averaging annuities, which represented the bulk of many companies' annuity sales, the RRSP market has taken on greater significance. In the future, it's going to be increasingly important for companies to look for innovative products which will capture the RRSP dollar during both the accumulation and the payout stage.

NON-REGISTERED ANNUITIES

The Federal Budgets which have been brought down in recent years have included devastating proposals concerning non-registered annuities.

Specifically:

1) the inside build-up in non-registered deferred annuities is now taxed annually or triennially and,

2) non-registered immediate annuities and some settlement annuities from life insurance policies which fail to meet certain criteria, are now taxed annually or triennially on the actual interest component of each payment. Some of the criteria are: payments must commence after age 60 (or on prior disability), it must be a life annuity or annuity certain guaranteed up to age 90 and payments must generally be equal and payable in at least annual equal intervals.

The tax deferral of the inside build-up on deferred annuities gave the industry a distinct marketing advantage. Its removal is expected to have a significant impact on sales. The change in immediate annuity taxation also will impact sales -- and even if there is a demand for contracts that don't meet the criteria, the administration complexities will prove insurmountable obstacles to some companies. The future clearly is not bright for non-registered annuities.

INDEXED SECURITY INVESTMENT PLAN

The most recent development of relevance to Canadian annuity markets came in last month's Federal Budget. At that time the Minister of Finance tabled draft legislation to implement a new plan called the Indexed Security Investment Plan (ISIP).

This plan was originally proposed a year ago, and was subsequently referred to an Advisory Committee which recommended that the government proceed to introduce it. The effective date will be October 1, 1983.

It's designed to encourage individual Canadians to make equity investments in Canadian corporations. Recognizing that inflation can lead to significant distortions in the calculation of income tax liabilities, the plan allows capital gains on certain investments to be adjusted for inflation for tax purposes.

The plan will be available to individuals and most trusts residing in Canada.

Most common shares of Canadian corporations listed on a Canadian stock exchange will qualify as investments as will shares of a mutual fund or an interest in a segregated fund of an insurance company.

The mechanics are as follows:

1) The cost of shares owned under the ISIP are adjusted each month for inflation. The adjustment used is the percentage increase in CPI during the previous month.

2) At the end of the year the inflation adjusted cost of these shares is compared to their fair market value to determine the real gain or loss.

3) 25% of any real gain or loss is brought into income each year, one-half of which will be taxable or deductible.

4) The remaining 75% is deferred. This deferred gain or loss is then deducted or added to the year-end market value to arrive at the opening base for the next year.

The plan may be administered by an investment dealer, broker, bank, credit union, trust company, mutual fund or life insurer. There is no limit on the number of plans or amounts invested.

The attractiveness of the plan, and hence sales, will likely vary in direct proportion to changes in the rate of inflation. The rate has moderated recently but is still expected to remain fairly high for some time -- so the plan should prove popular.

It should appeal to a broad sector of the public. Consequently, we can expect that a wide variety of plans will be available. For example, the large investment houses are likely to design plans for the more sophisticated investor -- along the lines of the self-administered RRSP plans which are currently available. Some insurance companies may focus on the same market. Others will likely target to the less sophisticated middle-income investor and design plans that will accomodate small regular deposits as well as larger casual payments.

Many insurance companies already offer segregated fund products -- the flexible premium annuity type being most common. It should be relatively easy for these companies to adapt their existing products and administration system. For others, it will clearly be more difficult -- however, they have had and still have some lead time.

While few insurance companies appear to be gearing up, I expect that several will decide to enter this market, perhaps as a way to partially make up for lost IAA sales and some, I'm sure, will be amongst the frontrunners competing when the doors open on October 1.

MR. SWIFT: 1982 was a tremendous year for the sales of IRA's due to changes in eligibility requirements under TEFRA and the high interest rates offered during the year. Chris Waine will discuss IRA's with particular emphasis on Prudential's success. I would now like to introduce Chris Waine.

MR. CHRISTOPHER WAIN: I will cover the topics of this session as a form of case study by describing the Prudential's experience with its flexible premium, fixed-dollar deferred annuities sold in the qualified markets, principally as IRA's.

With the IRA boom last year, we sold approximately 350,000 of these contracts in 1982, generating about $500 million in premiums.

Description of Our Products

We have had since 1975 a front-loaded flexible premium annuity which we refer to as Flexi. It has been used in all the tax-qualified markets. Until 1972, its sales had been fairly level at approximately 30,000 contracts per year with about two thirds of those being IRA's. Although we had increasing numbers of field requests for a back-loaded product, before ERTA we did not see enough additional sales coming from the development of such a product to warrant the agent and client confusion that would develop. When we concluded that ERTA would probably be enacted, we moved to quickly develop a back-loaded product (called PRUFLEX) to be ready for sale, mainly in the IRA market, at the beginning of 1982. Our development was facilitated by modifying a system offered by an outside vendor. Flexi has also continued to be sold in all markets with a 1% higher interest rate. This keeps the break-even point for the insurer about the same for both products.

Compensation

It's difficult to find the right level of field compensation for these annuities. With their high savings orientation, compensation must be low to permit returns adequately competitive with alternate programs such as those of savings and loan associations. But if the commission scale is too low, there is obviously no point in introducing the product. Flexi commission rates had been higher in the first year than for subsequent ones for most sales. Level compensation is particularly logical for PRUFLEX because of the lack of early-year expense margins, but due to marketing pressure we wound up with a heaped first year commission for the smaller purchases there too. The first year rate together with renewal rates have a present value of less than the level scale we would have been willing to use. As an aside and a confirmation of trends, when we introduced Flexi in 1975, we had compensation on the low side of the industry average. But with PRUFLEX 7 years later, our compensation level is about 30% lower.

With a heaped scale, it's important to keep the contract from being a high compensation way to buy a single payment immediate annuity. So we prohibited PRUFLEX from being settled for an annuity payout on the contractholder before the second anniversary. And when surrender charges eventually disappear, we expect to enforce maximum limits on contract payments strictly.

Investment Philosophy

Before 1982 we were investing assets for this product in our general portfolio, and therefore primarily in long-term bonds. Our experience in 1980 and 1981 with withdrawal rates under our front-loaded product showed that tax penalties alone did not provide adequate control of potential disintermediation by individuals. Our annual withdrawal rates climbed from about 9% of reserves in 1979 to approximately 17% in 1981. As an aside, the withdrawal rate in all years when disintermediation can be profitable is also a function of the sophistication of the market. It's at the highest for split-funded corporate plans and at the lowest for IRA's. Anyway, we changed our dividend scale in 1981 to effectively apply a nominal withdrawal charge in an attempt to stem the flow of dollars. We do not, of course, know what our withdrawal rates would have been in the absence of that change; but we do know that we saw no drop in withdrawal rates during that period. Since the general decline in interest rates last fall, our withdrawal rates on the front-loaded product have declined to an annualized rate of just over 12%.

As part of developing our new product and thereby committing ourselves to increased involvement in the fixed-dollar flexible premium annuity market, we also moved to segmentation of our general portfolio. Since 1982 incoming cash for both our flexible premium products has been invested in a separate portfolio segment.

Our objective with the new segment was to provide an investment return that would permit us to pay returns to our buyers of all calendar years reasonably close to what they could obtain from other savings media available to them.

We settled on investing primarily in marketable fixed-dollar securities with maturities of up to 6 years in the future. Some maturities of the longest durations were desirable to support our interest-crediting guarantees, as well as to get as much of the typical rate advantage available for longer term money as we could handle without serious asset value fluctuation risk. Although we originally targeted a relatively uniform distribution of maturities over the indicated range, including keeping a portion of our investments very short, we also planned on shifting the distribution within that range as market conditions warranted.

We have regular monthly meetings between the Actuarial Department and the Investment area to review the yields actually achieved on the past month's investments and discuss the likely changes, if any, in interest rates for the coming month. At these meetings we also continue to explore what other types of investments might improve our overall yields. We will also have special meetings when changes in market conditions warrant. We have every intention of keeping our annuity products self-supporting. So when interest rates

dropped last Fall, we also dropped our new money rates. (Our field force tells us that it is the first time we have ever been leaders in changing rates!)

Considerations received per week dropped quite sharply when our new money rates changed, but quickly leveled off, reflecting our greater in force base, and then climbed back up, of course, as IRA season approached. Through May of this year, we will have sold about 100,000 flexible premium annuity contracts as opposed to 240,000 sales in the same period in 1982. Although part of this decline is attributable to lower interest rates, that's not the whole story. There are now many other institutions pushing harder to get this IRA money. It's also true that the decline in interest rates plus introduction of some new life insurance products have increased our agents' activity in that more traditional part of our portfolio. The fact that we do still have a fairly strong level of annuity sales and the fact that our total considerations are continuing to come in at a fairly level rate indicates that a consistent profitability objective need not lead to great reductions in the income generated by a product.

The above describes primarily how we responded to the interest rate drop. There has also been a shift in the yield curve, from downward sloping to upward. We have stayed fairly true to our original intentions; that is, both to keep our investments relatively short and also to keep our new money interest-crediting rates at a theoretically correct level. Nevertheless, we do continue to search for better ways to increase yields without sacrificing our investment or profitability objectives. The search is necessary in part because many other institutions are interested in our original maturity groups!

Monitoring Profitability

It's one thing to say that we are attempting to invest our funds and set our interest rates in a manner that will insure that our products are profitable. It's a much bigger job, however, to satisfy ourselves that we are currently meeting those profitability objectives. We have established certain systems and methods and hope to add to these to assure ourselves of those points.

We have some flexible premium annuity models which we use to project income and outgo from issues of a single year or period of years, given certain investment yield and investment-crediting rate assumptions. One of the primary uses of these models is to determine the difference necessary between our investment yield and interest-crediting rates. That difference, which I'll refer to as a "holdback", differs between our front and back-load product. But it is in theory the same for both new and old money within a product, at least for many years. Unless one is greedy, at some time the holdback should be greater for the early contract years than

the later ones! In any event, the holdback levels are set so that we expect to meet our target surplus levels within 10 years after issue.

To set interest rates, however, we need to know not only the necessary holdback, but what we are earning. Even on deposits from prior years, that question is not always easy to answer, given the intricacies of intra-company allocation of investment income, taxes, capital gains and losses, plus the need to have some share of any branch's assets in such things as home office buildings. The fact we are now investing the assets of our flexible premium segment relatively short also means that we need to take signficant amounts of investment rollover into account to estimate future interest rates, even in setting the current interest rates on old money.

Even given certain knowledge of both investment yields and holdbacks, the actual profitability of these products depends signficantly on their persistency experience. There are two distinct types of persistency for flexible premium products: the length of time that prior deposits remain before they're withdrawn and the rate at which additional deposits continue to come in on existing contracts. Changes in either of these persistency-type rates can mean that the originally indicated holdback is no longer sufficient to achieve profitability goals.

We watch Company ledger withdrawals for each flexible premium product month-by-month and compare those figures with estimates of the beginning-of-month reserve. Our experience for several years on the front-loaded product shows that these withdrawal rates are seasonal; they are generally lower in the summer months. So there is some distortion in merely annualizing a monthly rate. Nonetheless, once one has gotten from a monthly to an annual rate, the implications of any difference between the experienced withdrawal rates and those assumed in our models are clear for the front-loaded product. Lower withdrawals mean more profits (assuming we have achieved the desired holdback), and higher withdrawals mean less profit. The effect is not quite so immediate for the back-loaded product. Our surrender charges currently start at 7% and grade down to zero in year 11 (or earlier for issue ages over 50). A withdrawal in the early years of the contract clearly helps one's financial position for the year in which it occurs, since our 7% withdrawal charge is more than the amount we would have held out of investment income for that contract for the year. So withdrawals on a back-loaded product can actually help the current year picture but still reduce ultimate profit levels.

Premium-payment persistency is another concern; a signficant concern for us this year because of our very high sales level last year. I described earlier the present value of our heaped commission scale. That calculation is clearly persistency dependent; and if none of these contracts were to make second-year payments, we would not meet our surplus

objectives as soon as we'd like. However, our initial early indications are that second-year experience will be satisfactory.

MR. DICK SWIFT: Thank you very much Chris. At this point we would like to take comments and questions from the audience.

MS. KAREN LONG: Mr. Kayton, in regards to an individual single premium deferred annuity with a market value adjustment, what are the specific reasons it can be sold through a group contract and not through an individual contract? Also, do you foresee any changes in the near future that would affect the use of the market value adjustment feature?

MR. KAYTON: The only reason market value adjustments are allowed for groups is because the Standard Nonforfeiture Law in the United States for annuities only applies to individual annuities. There are efforts to put them into individual annuities. I think it will be coming but it's not yet there. The current laws are just too rigid.

MR. SWIFT: Howard, do you see any indications that the regulators might want to develop regulations for group annuities that are the same as for individual annuities?

MR. KAYTON: California for example recently came out with a ruling prohibiting the use of group annuities for savings and loans and for the stockbrokerage market. Some of the other states are apparently not as concerned.

MR. ROLAND DIETER: Another reason group isn't regulated as much is that purchasers of group contracts are supposedly more sophisticated and understand more.

MR. KAYTON: Sure, but it's hard to justify if the individual is buying it simply because he is a customer of a broker. The buyer really is the individual and not the group.

MR. DIETER: I think it's another sign that the old laws made sense then (that groups knew more than individuals), but now maybe individuals know as much as groups used to and groups can be called individual.

Chris, in the early part of your talk you said you were selling two types of contracts. What did you mean when you said you had a 1% interest differential to equalize?

MR. WAIN: We have a front-loaded contract and a back-loaded one. Right now the front-loaded contract has a 10% return and the back-loaded 9%.

MR. SWIFT: Chris, what was the mix of the business in 1982 between those two contracts?

MR. WAIN: In 1982 probably about 2/3rds back-loaded. Now it's running about 85% back-loaded.

MR. SWIFT: And what is the difference in compensation between the two products?

MR. WAIN: Fundamentally, the front-loaded contract has a 4% level commission on the first $5,000, grading down for larger amounts, and the back-loaded has 2-1/2%. In practice there are higher first year commissions, but the level rates are what was assumed in pricing.

MR. SWIFT: In spite of the fact that the back-loaded annuity has the lower compensation, it is outselling the front-load product (and even more so currently than when first introduced).

MR. SELIG EHRLICH: I have first some comments on the structured settlement market. You do really have to restrict who you give quotes to in this business. Often you get requests for quotes with several different options (straight life, life with the term certain, cost of living adjustments, etc.) We had agents who constantly called for quotes, and when we saw they weren't bringing us any business, we had to cut it off because of the excessive amount of time being spent.

There is a sort of rule-of-thumb when you have a situation of a life annuity combined with some lump sum payments. The portion of the premium going to the annuity should be at least 50%. That is a rule we do not follow as strictly at Equitable. Our department feels that even with only 25%, you could argue that there's still enough of an interest in the annuity to enable it to be sold as an annuity product.

Another area of concern is in the substandard market. Being a New York company, we currently do not sell any substandard annuities because we are required to hold standard reserves, and we don't want to accept that strain. But we are working on a proposal in New York State to let us hold nonstandard reserves. Elaine, are you not subject to that strain, or do you find it acceptable?

MS. MANDRISH: Yes and no. Our New York company is a very new company. It was formed last year, and was licensed in July of 1982. We are not planning to enter the structured settlement market in New York. But we do encounter the odd case of dealing with a New York resident. So I think we have two or three cases on the books right now. We will not be able to handle very much business because of the surplus strain. So we will have to turn it down or reinsure it.

MR. EHRLICH: Are there any other companies working to relax that strain?

MR. KAYTON: I'm chairman of a subcommittee (for the technical staff group to the NAIC) that is working on a proposal for reserves on substandard annuities. I doubt it would help you though because typically model bills are not adopted by New York anyway. The current proposal is basically to permit nonstandard reserving for substandard annuities. The real problem though is that there is no hope of ever compiling enough data to be very meaningful. You have to be very careful about grading these reserves off. For example, suppose you have someone age 50 and rate him 40 years. Ten years from now he will be 60 years old chronologically, but you are reserving as if he had maybe 10 years remaining in his lifetime. It is a problem and we're not sure the regulators are going to accept our solution. Our solution incorporates the Canadian approach to reserving ("letting the actuaries certify that the reserves are adequate"). The reserves are a combination of interest and mortality. The interest in many of these substandard annuities are as important as the mortality. The second part of our proposal is to disclose the method used.

MS. MANDRISH: I just want to comment that the 50% number was picked quite arbitrarily. There's nothing magic about 50%. We felt we had to have some kind of rule; we may not necessarily stick with it.

MR. KAYTON: That 50% is used not only to help maintain that it's really an annuity, but also to relieve the strain on the company in terms of reinvestment of funds. We have had cases where 75% of the funds are going into a lump sum payout, and then you have reinvestment problems.

MR. SWIFT: One thing I have noticed is that some of these settlements have payments that don't start for several years. For example, the payments may start at age 21 for a child now aged 15. It falls into the category of a deferred annuity, as opposed to an immediate annuity. Elaine, how do you handle those kinds of situations as far as reserving? The interest rates requirements for reserving are very different for deferred and immediate annuities.

MS. MANDRISH: We have not encountered any cases like that to date. The only cases we have had have been true immediate, or a combination of immediate and lump sum settlements. To be honest, we have not decided exactly how we'll handle it.

MR. KAYTON: It does give a reserving problem in the sense that it has more of the characteristics of a deferred annuity. But, there is one important characteristic missing, and that is that it cannot be surrendered. As long as the funds are not commutable, only that individual or the beneficiaries are entitled to that series of payouts. You can invest for it by a combination of zero coupons, for example, and regular kinds of investing. The major point is that you have call protection on your liability.

MR. SWIFT: Are you saying that you think you could use a higher reserve interest rate, as opposed to regular deferred annuities.

MR. KAYTON: I think so.

MR. SWIFT: One of the things Elaine said, talking about the Canadian market, was that there are a lot of similarities between the Canadian and U.S. markets. The U.S. market tends to follow Canada. This is of concern now with regard to the taxation of the buildup on deferred annuities and the problem on taxation of immediate annuities.

MS. MANDRISH: I know that people in the States have been talking to people at our Canadian Life and Health Insurance Association which is the equivalent of ACLI -- Not on the subject of nonregistered deferred annuities, but on life insurance. They are asking what the rules are in Canada now and what is the definition of an exempt policy. Even if you're not in the Canadian market, I think it behooves you to watch what's going on in Canada. Our industry association has not done a very good job in fighting the battle with the bureaucrats. We gave up on the deferred annuities, and we gave up on the immediate annuities because we were far too concerned with life insurance policies. We wanted to be sure we got some life insurance policies still exempt. In restrospect I think that was the wrong thing to do. We bargained from a position of weakness. That is not the way to bargain; you should always start from a position of strength.

MR. KAYTON: I think it's here actually. The Kipplinger Tax Newsletter of last week mentioned that Congress is now considering the taxation of the interest buildup on life insurance and annuities. Apparently they are going to skip the intermediate step and look at the whole question. We were there once also in 1979. Carter's tax proposals were much the same, and the industry came up with annuities as the sacrificial lamb, as long as the proposals kept away from life insurance. Fortunately at the last minute, it was not included. So now we still have that intermediate step.

MS. MANDRISH: In relation to that point, I mentioned the immediate annuity taxation and said that I found it personnally very offensive. The reason the change was made in the law to tax certain immediate annuities on the actual interest and not the level had nothing to do with the equity of the situation. (They didn't make it because the life insurance industry had a competitive advantage.) The only reason was because if they did not do that, imaginative actuaries would design around the immediate annuity restriction. That was the reason, pure and simple. As they normally do, they adopted the sledgehammer approach. So now we have this ridiculous situation where legitamate annuities (people who retire at 55) are going to be hit with tax on the actual interest.

MR. SWIFT: The current interest rates being offered in the single premium deferred annuity market have gone down tremendously the last three or four months. What are you seeing out there now, Howard?

MR. KAYTON: Currently, anywhere from 11.25% or 11.5% down to somewhere around 10% or 10.5%. One company recently announced a 15 year guarantee at 11.25%. (When I mentioned that to our investment people, they said that was where we are going to put all our investments from now on!)

MR. SWIFT: Chris, you mentioned that your back-loaded product uses a current rate of 9%. How does that stack up with competition?

WR. WAINE: Competition is getting closer to us. We were leading at the beginning of the year negatively, but it's getting closer and we may have to reduce rates again.

MR. SWIFT: How does that compare with the rates of interest you are able to earn on the investments you are making?

MR. WAINE: It's pretty close to our desired spread of about 2%.

MR. SWIFT: What about single premium annuities, Howard. What do you think is the desired spread?

MR. KAYTON: As much as you can get. When I was taking my survey some people talked about the concept of negative spread.

MR. SWIFT: What are typical interest rate differentials in the structured settlement market currently, Elaine?

MS. MANDRISH: I think it's about in the 1%-2%, but basically the same thing -- as much as you can get.

MR. CRAIG LIKKEL: Mr. Kayton, are you aware of any specific investment strategies or interest crediting strategies being used with the reverse bailouts you mentioned? Or do you look at that as just a marketing ploy? I would also be interested in hearing any comments in general about the relationship of the bailouts and the investment strategy.

MR. KAYTON: I agree that it is possibly just a marketing ploy. It could be as simple as planning to amortize expenses during the first five years so that the payout could be higher after that. But I really question the levels. These were introducted at a point when interest rates were at an unprecedented high and how anyone could expect they were going to stay at that level, much less go up, was just incredible. Obviously, you have a reinvestment problem. These are deferred annuities. So I really don't think it was a strategy question. I guess it's possible to buy investment interest futures, but I don't think that was what was being done here.

MR. DIETER: We meet once a month on our annuities and we look at our "pure" company competitors (we're on the low end of interest rates right now, just below the range Howard cited). However, a lot of companies outside the industry, like Proctor and Gamble, give free samples away to get into a market. There is something to be said about taking a loss or a breakeven position for a few years to establish yourself in the market. The philosophy of most insurance companies is to make a profit on whatever they sell. If they don't have a market, they'll let someone else have it. I don't know what the answer is.

MR. WAINE: One problem with our type of product is that if you give a free sample and try to make up too much later, they'll run. Our experience so far shows no particular grand loyalty despite the captive type of agency organization we have.

MR: KAYTON: That strategy may work in the flexible market, but when you're dealing with single premium, you have a problem. People will jump for .1%. This will increase as companies get these computer displays of who has the best product on the market. There is no reason to be loyal to one particular company, particularly when the agent gets a second commission out of it.

MR. SWIFT: I think the experiences with term insurance have illustrated that you want to be very careful in giving anything away.

MR. JERRY COLLIS-BIRD: I have been involved in the structured settlement area quite a lot and have been instrumental in arranging a number of these settlements. In recent months I've noticed an increasing resistence in the placement of these settlements for two reasons. First, in the area of a minor, the interest earnings, capital gain, and dividends on a lump sum settlement in Canada do not attract income tax until the minor achieves age 21. Therefore, the advantage of the structure is mitigated considerably. The second area is the concern of what to do about the problem of unknown inflation over 20-30 years time? If he settles for the structure with a fixed escalation rate of, say 3% compounded, is he going to be in a jam 20-30 years down the road? The plaintiff's counsel's argument is that if you retain the lump sum and invest judiciously, perhaps in short term, he may fend off the inflation risk more satisfactorily in the long term. This is becoming a really serious question, and I know of a number of cases which, unfortunately, did not settle through structure but opted to go lump sum instead. I think there is a risk of losing marketshare because of the reasons I mentioned.

MS. MANDRISH: That's an incredibly big IF -- if he can invest it judiciously to be sure to provide income for life. The question is not peculiar to Canada. I assume that kind of thing comes up in the U.S. too. The thing to bear in mind is that structured settlements/annuities are not the be-all and

end-all. It's not going to give the individual an ironclad guarantee that the money will be there when it's needed. All I can tell you really is that, yes indexed escalating annuities at a fixed rate are used to a certain extent. People also use lump sums for inflation purposes. They make estimates or do forecasts as to "what if" inflation did this or did that. They then determine one or more lump sums as a kind of ploy to being an inflation hedge. I don't know whether there are any companies that offer more the "true" indexed annuity. I know Sun Life has a form of indexed annuity which they use in Canada. But I think it was designed primarily for the RRSP market, and I'm not sure they use it in a structured settlement market.

MR. WAINE: As to the plaintiff's attorney suggesting his client might do better personally investing, I wonder if he could meet fiduciary standards in giving such advice. Also, the insurer has access to a lot of investment opportunities that an individual would not. In our flexible annuity operations, we would be at a lower level if we had to rely on the public registered market now. (We have a somewhat different view than Howard does about some of the lower grade bonds. Our models indicate that such a portfolio can make up in yield for the capital losses that are bound to happen with a segment.)

MR. SWIFT: One of the big appeals of the structured settlement is that the plaintiff does not have responsibility for investments. He is guaranteed, even though it might not exactly keep up with inflation, that he will have these payments throughout his lifetime. Whereas if he gets a lump sum, it could be squandered or lost within a few years and then he is a ward of the state. It is a much better situation to have the insurance company guaranteeing the payments than to have the plaintiff trying to do the investments on his own.

MS. MANDRISH: I think there are many actual examples of cases where the money has been, not squandered, but used up due to financial incompetence. The money just wasn't there when the person needed it.