RECORD OF SOCIETY OF ACTUARIES
1983 VOL. 9 NO. 1

PENSION PRODUCTS

Moderator: F. ALLEN SPOONER. Panelists: DONALD E. CONOVER, PHILLIP N. MAISANO**, MURRAY L. BECKER, JAMES A. TILLEY. Recorder: GERALD L. KATZ*

o Markets

o Distribution systems

o Products from the buyer's viewpoint

o Products from the seller's viewpoint

MR. F. ALLEN SPOONER: If you look through our program, I think you'll agree that the steps that we are going to follow are those that everyone would like to follow in developing a product: look at the markets, look at the distribution systems that you have available or should make available to get into those markets, look at the kind of products that would seem to satisfy the needs of the markets you are trying to hit, and then actually get into the product development itself, trying to see what kinds of obstacles there are and deciding which you will attempt to overcome and what kinds of compromises you need to make. We have tried to structure the program along those lines and we have a speaker for each of the four topics mentioned.

MR. DONALD E. CONOVER: We are going to focus on the Employee Benefit Fund Market, its size and shape. I am going to break it down by sectors: the corporate sector, the public pension fund sector, the union sector, and endowments and foundations. I will be building primarily off the research that Greenwich Research does annually. We'll compare the difficulties of going after the top of the corporate pension market, which I'll call "Jumbo": $500 million and up in plan assets, versus going after the lower tier of the market, which I'll call "Regional": $10 million or less in plan assets. I'll point out the distinct characteristics of each segment and we'll discuss how you go about delivering services to that segment and how you position your different products.

The total block of money in the four major market sectors is on the order of $850 billion, based on the research we did in the latter part of October. The biggest block of money is the corporate pension sector with about $475 billion. The other major component of the $850 billion is the public pension fund market; states, counties and cities. Obviously, the major component of that would be the large states, primarily the large northern industrial states. Those two pieces of the Employee Benefit Fund Market are not only the largest components, they also happen to be growing at the fastest rate. The corporate pension sector is growing at about 12% a year,

*Mr. Conover, not a member of the Society, is Vice President of Greenwich Research Associates Inc.

**Mr. Maisano, not a member of the Society, is Divisional Vice President of Pension Investment Marketing for Mutual Of New York.

the public pension sector at about 10%. If you run those numbers out, $475 billion in the corporate world will grow dramatically over the course of the next five years to $840 billion. The public pension funds will increase from $250 billion to about $400 billion in five years. The whole $850 billion, the Employee Benefit Fund Market, will grow to something like $1.4 trillion by 1987.

For the corporate pension sector, in particular, I want to define the active players; the ones chasing this huge, growing block of money. We all think in terms of a whole family of investment counselors, insurance companies, banks, real estate counselors, foreign managers coming over here and managers here going overseas. But let's cut away a lot of what we read in the press and look at the really active players.

The number of investment counselors, the truly active investment counselors, is between 75 and 90. I'm excluding, for example, some of the smaller firms here in Philadelphia. They are in the marketplace, they are pursuing it, but they are relatively small. Who are the big players? Alliance, Batterymarch, Jennison and other comparable firms.

Insurance companies - who are the active players and what is the size of that group? We envision it encompassing no more than 25 to 30 carriers. There are certainly more insurance companies than that in the nation, but that's not the point. The point is that there are only 25 to 30 companies really active in the corporate pension business, primarily through the Guaranteed Interest Contract (GIC) side. The top five or six, Equitable, Aetna, Prudential, Metropolitan, Hancock, Travelers, have taken their capabilities in the GIC area and cross-sold their other investment capabilities to broaden their base of business.

Banks: 20 to 25 and declining.

Real estate counselors: a lot of press, a lot of activity. Evaluation Associates for example, through their real estate manager profile services, is now tracking 60 or 70 managers. But of that group, the core real estate counselor group is no bigger than 10 or 12. I'm talking about the real estate counselors who have said, as a business strategy, this is an opportunity for us; we have the real estate investment capability, we are going to pursue it. "Pursue it" means defining the markets, evaluating the opportunities, building the product, figuring out a way to deliver the product, then maintaining and nurturing the client relationships.

Among the international managers who are coming here, coming from Great Britain and the Far East, are names which we research each year as part of our annual evaluation. We track some 70 international managers. But when you go through all the numbers, and take out all the minor market share positions, it reduces to 5 to 10.

Add all those numbers up and it totals no more than 120 to 140 really active players in the corporate pension market.

The segmentation of the market is essential. But, how do we encourage managers to segment the market? Three simple points: think in terms of plan assets, think in terms of whether or not there is a full time pension officer

at the corporation responsible for overseeing the pension activities of the firm, and think about the number of managers. Dissecting the market that way, you are able to segment the market into four tiers.

The top of the market, as I mentioned before, is the Jumbo tier. That is those funds with $500 million and up in plan assets. Full time pension directors, to say the least; a full time pension operation. They each have one person that we think of as the focal point. In some cases they have a whole pension department behind them. At this top tier of the market, pension fund management is a full time operation. These people are clearly the market leaders. The first group of people to move into real estate was the Fortune 200. They did it back in the early 1970's. Back in 1973, 35% of these people were already investing in some kind of diversified equity real estate fund.

In terms of the number of managers that this tier typically uses, it is eight or more. It is two or three stock managers and two or three bond managers. They have at least one real estate manager, if not two or three. Chances are they are in international markets. They have a position in GICs, which we are going to discuss in more detail. They have a master trustee to oversee all the managers. You are dealing with a pension professional; not in the sense that he is an actuary, but he knows the business. His job is to be the subcontractor. He is managing the managers.

The next tier I will describe is the National: $100 to $500 million in plan assets. A full time pension officer, five or more managers. Chances are they are not in international investments unless they are near the top of the spectrum; if they are down at $100 million probably not, if they are up at $400 million or more, probably they are. In this tier you are dealing with an informed professional, perhaps at the assistant treasurer level.

As you segment the market this way, you understand that the jobs are different, the block of money to be managed is different and the problems associated with overseeing that block of money are different. Phil is going to describe the difficulty of delivering investment services to each segment of the market.

The next smaller tier I will call Large: $10 to $100 million in plan assets. Here you are dealing with a member of senior management. You could be dealing with the secretary of the company or a senior vice president. The smaller you are in terms of plan assets, size, Fortune rank, etc., the higher you tend to rise in terms of the audience that you will be visiting. That would hold true for the investment managers and also, I am sure, for those of you who are actively working with your clients on a consulting basis.

The Regional block is $10 million or less in plan assets. You are clearly dealing with a senior officer. You might be dealing with the president of the company. He may oversee his pension plan ten hours a year, three of which are on the golf course with his personal investment broker who also manages the money for the pension plan. Chances are the company is relying heavily on a local bank. I am sure that you have a sense of that market through the actuarial side.

Let me review the shape of the market in terms of the major segments, and the diversity of needs. What is the Jumbo tier looking for in terms of money management, in terms of actuarial services, in terms of legal services? They are expecting to see the absolute best. They are not expecting to see a pension generalist - someone who knows a little bit about pensions. They will listen to a pension generalist and a marketing professional, but they must see the person on the investment side who is moving the money. If they are talking to an economist, they must see the one who is putting his reputation and capability on the line and calling rate moves. Contrast that with the lower end of the market. What the plan sponsors in the Regional tier are most in need of is a firm in which they can have trust and confidence. A local bank will pay the checks. A local bank will produce the 5500 data. An actuary will say how much to deposit each year. They don't want to hear a lot of the details; they certainly can't absorb the complexities. Keep it simple; trust and confidence.

With regard to the overall asset mix, how is that $475 billion being put to work? The major components are common stock, marketable bonds, GICs and real estate. The common stock position, as of the end of 1982, was about $182 billion. In response to the questions: tell me where your fund is now, tell me how it is positioned in terms of asset mix, tell me where you would take that fund mix over the next three years - the response, aggregated across a whole series of interviews, translates into about a 58% increase in the equity position, to $286 billion.

The other equity type product of the four I mentioned, equity real estate, represents some $15 billion. With PRISA, Separate Account #8, the Aetna fund and a number of very aggressive real estate counselors, that $15 billion will rise to $38 billion over the course of the next three years. Primarily fueled by new cash flow. That is a dramatic jump on a percentage basis, going up 150%; the dollars obviously are not quite as dramatic as in the common stock area.

In the marketable bond area, about $91 billion is now at work in the corporate pension world. That $91 billion, the marketplace is telling us, will rise to $124 billion over the course of the next three years, a 36% jump.

The final piece in the fixed income spectrum is the GIC, with some $28 billion now in place, expected to rise to $34 billion over the course of the next three years, a 21% jump.

These numbers are projections, and the market has changed <u>dramatically</u> in the last three to four months. But the general theme that should come through is that the corporate plan sponsors are going to continue to maintain their fixed income positions, whether it's in marketable bonds or GICs. And they are going to beef up the equity side of their positions, whether it is common stock, including the whole different spectrum of common stock types, or on the equity real estate side.

With regard to asset mix, as of the end of 1982 for a typical defined benefit plan, common stocks represented 44% to 48%, marketable bonds 22% to 26%, equity real estate 8% to 9% and GICs 13%. A point to note is that the GIC position is going to be allowed to ride down slightly in terms of the defined benefit plan asset mix to about 11%. But it's still a very healthy business.

If you flip over to the defined contribution area, the common stock percentage is 42%. The bond position is at 8%, contrasted with the defined benefit area where the position was much higher. More than 22%. There is an equity real estate position in defined contribution plans, to our surprise. It is approaching 1%. I am assuming those are profit sharing plans versus savings or thrifts. As you would expect, a substantial portion of the money in the defined contribution plans is in GICs.

There is a lot of difference between what a defined benefit plan is meant to do by design and by strategy versus a defined contribution plan; yet the asset mix is not very different. You would expect a larger appetite for the equities in a defined benefit plan, given their long term nature.

In terms of what the corporate pension sponsor seems to want, there is a series of consistent themes that come through in the research we have done over the course of the last 11 years. A series of themes that are not distinguished by size of firm, location or industry type: "I want to be told clearly, in a straightforward fashion, what is your investment philosophy." It sounds simple but it is not. The marketplace is telling the managers to articulate what it is they do and what their investment objective is. The plan sponsors are telling us, "I'm not quite sure what my money manager's decision-making process is. He must explain the decision-making process and how it will be implemented."

The final theme is consistent performance over time. The typical plan sponsor is looking at five years of performance. Some will look at ten. The plan sponsor is saying that that's the period over which he chooses to measure his managers. Has he been taken in that direction by the performance measurement firms? Probably.

Preferred money management firms: is there a generic preference? Yes there is a generic preference. In the common stock and marketable bond areas, the generic preference is for investment counselors. Given the absolute necessity of choosing between a large and a small investment counselor, a small one is preferred.

With equity real estate, who has the lead? It still is the insurance companies. They have market share. They are still chasing this market very hard. With their solicitation activity, they are everywhere. The message is being better delivered with more and more credibility all the time. The difficulty in the real estate market for the insurance people is that the real estate investment counselors are coming in and setting a new standard. Insurance carriers still have a very strong following and a huge market share. That market share can grow because there is clearly an opportunity for all of the carriers, large or small, that have the real estate capability, to get closer to their clients.

GICs: obviously the insurance companies have a monopoly there. I would only point out that funny things are going on in the financial services industry. True, there are no other financial services firms that are offering a GIC, but again the financial services industry is going through an almost overwhelming topsy-turvy period.

I would like to close with a few comments on the dynamics of the GIC market. 58% of the corporations that we interviewed, and that is the majority in

terms of assets in the marketplace, are now using a GIC. By plan type, roughly 55% are using a GIC for a defined benefit plan. About the same percentage, 55% to 56%, are using a GIC for a defined contribution plan. Seven, eight or nine percent are using a GIC to fund a block of retired life liabilities.

A typical corporate pension fund has two carriers that they are using for their GIC business.

In response to the question, "The last time that you purchased a GIC, did you use a selection advisor?", 28% said "Yes." When you get to the upper tier, $500 million or more, there is not the same tendency to use a selection advisor. I will also make the objective comment that there are only three or four selection advisors that have anything of significance to do with placing business. At the top of the list is Johnson & Higgins. The others include Mercer and Towers, Perrin, Forster & Crosby.

Looking at the demand equation in 1983, 2% of the non-users told us they expected to purchase a GIC in 1983.

In terms of solicitation activity, the five or six top carriers are dominating the market. Aetna, Equitable, and the Met have huge blocks of business. Those three are also leading the market in solicitations. A typical plan sponsor is being solicited, whether he is in the process of buying or not, by four insurance companies. Let's turn it around and ask, "The next time you expect to purchase a GIC in 1983, how many bids do you expect to get?" The answer is five or six. So the plan sponsors will be reaching out. They've got their steady three or four who are calling on them, but they really would like five or six so that they can compare.

The final chapter is relevant GIC product features. I will contrast defined contribution with defined benefit. We presented a list of product features and asked which of them are essential and which are not quite so important. We then ranked them on the basis of descending mean scores. It is not simply a rate game. Having been through a number of competitions, I can tell you that if I had the best rate but not some of the key moving parts, I couldn't place the business.

What are those key moving parts? In the defined contribution area, participant withdrawals allowed at book value is one of the mainstays of product design. Flexibility in the method of handling withdrawals - in terms of how often money can come out or whether there is a size requirement. Are the mechanics of the plan in effect going to be tied up? The ability to move money in and out is key to the GIC.

In terms of the basic structure, the typical GIC has three periods: the open or contribution period, the holding period and the payout period. The preferred contribution period is a year, maybe 18 months. The typical holding period that the majority of those who expect to buy in addition to those who are already in GICs prefer is four to five years. In terms of the payout, the general preference is for a single sum, however this is clearly affected by plan asset size. With the firms that have huge defined contribution plans, the last thing that they want is the responsibility of investing $600 million on December 31 of a given year.

Also, corporate pension sponsors want to hear about expenses. If the rate is net net, that's fine. If it's simply a net rate but there are still administrative expenses to be backed out, either establish an expense guarantee or make sure to explain exactly what's going on.

The preferred structure for defined benefit plans is a total length of five to seven years, and again, a single sum in terms of the payout process.

MR. SPOONER: As Don has indicated to you, we want to get into more detail on the distribution systems, both those that are needed by the marketplace and those that are available to us.

MR. PHILLIP N. MAISANO: The pension marketplace as Don described it is quite diverse, both in terms of buyers and sellers. There are as many providers of our services as there are multiple type buyers. When we compete in the upper end of the market, which Don describes as the Jumbo end (I would even include his next layer, the over $100 million fund) you are, of course, competing against institutions other than insurance companies. Your major competition comes from investment counselors, banking organizations, particularly regional banking organizations where there are some other financial affiliations with the companies, and a variety of other financial enterprises. There are investment consultants emerging everywhere.

It's very critical for us on the market planning side and you on the pricing side (I will drag you into market planning because pricing is part of marketing) to know what the marketplace is for your particular company, and then, how you reach your marketplace. It is essential for all of your planning. The way to do that is to identify your own buyer.

One of the things that Don referred to is whether a head of investment operations or pension operations exists inside a company or whether it's the president or some other officer of the company that actually is making the buy decisions. But I think that you can be even more specific than that. Sometimes, your buyer is the actual participant in the plan. The reason that guaranteed interest contracts are successful in defined contribution plans is because the participants want them. The person who is used to putting $10 a week into a bank account and at the end of the month wants to see that he has $10 plus interest, is the same person who demands that sponsors use interest guarantees inside defined contribution plans. It sounds simple but sometimes we don't quite understand who the end buyer is or we identify the wrong one. Logic told us earlier last year that there would be an enormous emerging IRA market. We thought it would be particularly attractive to offer a product that had a payroll deduction facility. How could anyone pass up the tax deduction? So the insurance industry as well as many others, particularly the mutual fund industry, scurryed about and came up with group IRA products. And we dispatched our group sales people to sell to the corporate buyers, the same people who are managing corporate pension funds. Well what did we find out? Corporate IRA sales came no where near our expectations. The reason was that the corporation had no vested interest in providing the product. We didn't understand that when we offered it. If you think it through, it's a lot of work and certainly not a lot of credit will be given to you. In fact, you probably will be complained to about having provided a poor service. The corporation itself, having no interest in providing this service for their employees, immediately responded by saying, "Well go to the bank, buy

it on your own." So we're sitting around with fancy products, elaborate computer systems, multiple investment options and no buyer. And the individual employee, the participant, walks into the bank, takes some money out of his savings account, establishes an IRA and he stills gets his tax deduction. That's an example of our inability to define the end consumer.

With that backdrop, let me talk about what I see as the three primary distribution channels. Most of us are used to the traditional distribution system; the career or captive agent. Some of us call them career and some call them general agents, but in fact, they are both characterized as having substantial allegiance to the carrier or the provider of the product. That type of distribution system is characterized by a number of elements. It tends to be successful in smaller markets. I would define the small markets as under 50 lives, which is probably applicable to most of us here. The agent distribution system, the one-on-one selling, tends to be successful with individual buyers: Keogh plans, IRAs, tax deferred annuities, etc. It is successful because of the characteristics of the market. You need the personal contact. For those of you who have read Megatrends, you'll recognize "high tech/high touch." High touch has been around for a long time. John Naisbitt did not create it. The high touch has always worked in the smaller group markets and the individual markets. So, for the smaller pension markets, we see an important link in using agents and captive distribution systems. There is a commission orientation. To encourage personal contact, to motivate someone to sit down one on one, you have to pay to create that relationship. Compensation, as well as margins, (expense and profit margins) tend to be higher or should be higher in these products.

This market, because of the distribution system, tends to be less competitive. Let me modify that somewhat. Buyers have become more interest rate sensitive. So you have to display your wares at a fair rate, but you will not find this buyer shopping. He will know that generally rates are 11%, but he's not going to resist buying from you because your rate is 11¼% and someone else's rate is 11½%. So it tends not to be as competitive as your larger markets. The product needs to be simple, both for the benefit of the buyer and the distributor. It needs to be simple because the agent won't understand it if it's complicated. And he won't be able to communicate it to the buyer who may have less sophistication than the agent. So we try to keep the product simple. We tailor the products to the distribution system. Now one of the common complaints about the insurance industry over the years has been that we tailor our products to the distribution system and ignore the end consumer. In this particular market, however, you don't need to be as aggressively price sensitive because the personal selling and the personal service that the agent provides is worth something. There is a perceived value to the buyer in having an informed person sell him something that is good for him. They will pay for this service; the real issue is how much. We certainly haven't figured that out yet, but we're getting closer.

The next level of distribution that I want to look at is the broker agent of another company. Here you start moving up in levels of sophistication; agents of other companies being the first level. People who aren't career oriented towards you as the sole provider of their products, but who will in fact shop. What's the characterization here? You're going to have to be a little more competitive, but you still have to be commission sensitive because it's still a one-on-one sale. This market tends to be the medium size

business, 50 to 500 people. These medium size businesses tend to buy mass merchandised products. The broker or agent has pretty good control, but your end buyer is split. You've got to sell to the broker and the client; you have to be a little more competitive and you have to provide a better product. Some of the larger brokers prefer fees to commissions and they look for multiple product sources; it's not just one supplier. Products can be more complex because you've got a more informed intermediary. You will add the bells and whistles here; some of the bail out provisions and various other investment facilities vis-a-vis the fixed income type accounts.

When you move up in the large corporate market - and here I would characterize that market as the larger case, Fortune 1000 company, assets certainly in excess of 10 and probably in excess of $100 million - that larger market tends to react to direct selling. Now, the direct sale is to someone who will buy for a large group of people; a pension plan administrator, treasurer or whatever the person may be called in a particular firm. As you move up in the pyramid, the buyer tends to be a lot more demanding. The level of sophistication of the seller must be much higher. The ability to marshall resources behind the sale has to be even greater. Don and I both have had the experience of trying to sell equity real estate at that end of the market, but in fact, all we were ever able to do was open the door and explain our general philosophy and hopefully get a next meeting with the people who could explain specific strategies and tactics in the account.

The characteristics of this market: they're looking for the quality in the services you offer. Even in the GIC area, terms are very important. Sometimes as important as rate. If you have a lower rate, the terms are not quite as important. This group makes longer term decisions. They set their asset mix in advance. They talk about what's going to happen two and three years from now. With the smaller markets, the buyers tend to be more oriented toward today. Five years from now is rarely an issue. This market, at the top of the pyramid, is driving the product design for the rest of the market. So, all of this connotes a hyper-sophisticated and hyper-competitive market, which means your distribution channel for that market must be pretty sophisticated. The typical vendor for direct sales uses MBA's with investment backgrounds, not necessarily insurance company backgrounds although they could very well have been raised in insurance companies. There are several other types of distribution systems and I want to just mention these because they have become pretty important for some insurers. First, banks are now a source of distribution for a lot of us, particularly in the GIC business. Banks will, in effect, wholesale your product. Since they can't make five year guarantees, as a defense mechanism the banks are willing to set up master trust contracts and offer their clients five year interest guarantees underwritten by an insurance company. Second, direct mail marketing - IRAs and single premium deferred annuities. I think you're going to see a lot of business written this way. It's in the individual purchase where a client or a prospect can become familiar with what is available or what he needs to buy without your help. You can successfully sell this way and I think it can be a cost effective way to distribute. Third, mass merchandising through retailers. Have you been in a Sears store lately and wondered if you're in a bank? Retailers have the advantage of having people congregate in their stores. If we believe current market research, it tells us that people are not yet ready to make financial decisions in a Sears store. Sears, recognizing that, cordoned off its financial operations and is making

it look an awful lot like a bank where people are willing to make financial decisions. So we've got a lot of competitors looking over our shoulders, ready to compete with us.

In summary, you must match your distribution system to the products that you want to sell. If you want to sell sophisticated investment products, you better have some sophisticated investment people selling them. You also will need a corporate commitment to working in a market which is highly competitive and will be a drain on some of your best manpower. Identify your end consumers. Who are they; who are they really? Is it the corporate buyer? Is it the participant? Gear your distribution around who you identify as that end consumer. If low margin products are the kind of products that we're going to be allowed to sell in the future, well then we ought to try to get efficient and lower cost distribution in place. You can't have group offices in all 50 states if you're selling products that have quarter point margins. Where you can charge a premium for the distribution system because of the personal service, continue to do it because there are some markets that will pay a premium for this service. I think you're going to see the successful companies in the '80s will be those who are driven not by the traditional distribution oriented products, not who are driven by costs, not who are status quo, but those companies who are market driven, who look at the marketplace and say what do people want to buy, how do they want to buy it and can I sell that product.

MR. SPOONER: Our next speaker, Murray Becker, will comment on product needs from the buyer's viewpoint.

MR. MURRAY L. BECKER: My topic for today is Pension Products from the Buyer's Viewpoint. Let me start by saying that I believe that looking at pension product design from the buyer's viewpoint is the logical starting point in any pension product developmental endeavour. Yet this obvious concept is too often ignored. The insurance company decides what it wants to sell and develops the product accordingly, expecting the marketplace to adapt to it.

From the buyer's viewpoint, defined contribution plans and defined benefit plans generate different needs. Consequently, I will address this topic separately for each plan category.

In the area of defined contribution plans, I will concentrate primarily on profit sharing and savings plans with employee investment choices. The use of guaranteed investment contracts has revolutionized the insurance industry's role in these plans. From the viewpoint of a plan participant, there is no substitute for the idea of guaranteed principal and interest in a fixed income type of investment.

Let us now discuss what an employer's investment objectives should be in the use of a GIC in a savings-type plan. Once you know an employer's objectives, you can design products to fulfill these particular needs.

The single most important investment objective in this type of plan is <u>not</u> to obtain the best investment results. Rather, the single most important investment objective is to help meet the plan sponsor's objective in having the plan. And for almost any employer, the plan sponsor's primary objective is to have satisfied employees who appreciate the plan and who do not complain about investment results.

To put it another way, getting good investment results is highly desirable, but not if it exposes the employer to periodic spurts of employee dissatisfaction. To establish the proper investment objective, one must anticipate future problems and strive to minimize them. Problems may arise with either falling or rising interest rates. Let's discuss each in turn.

If interest rates fall, a product with advance guarantees for the future will certainly be helpful. However, it is not clear that this help is necessary. In the absence of guarantees, employees receive a rate of return that depends on the average of old and new interest rates. This "blended rate" will be higher than prevailing interest rates--and be relatively attractive to employees--when interest rates have declined. As long as the plan offers a rate of return that is attractive in current conditions, we anticipate few employee relations problems.

Unfortunately, in a period of rising interest rates, the opposite is true. Advance guarantees are then of no help. Employees may well become concerned because the plan's average rate of return is below those in the current marketplace. Clearly, the principal risk a plan sponsor faces is rising--not falling--interest rates. Therefore, the buyer should appraise each insurance company product and product feature in the light of a potential rise in interest rates. An employer should not worry about falling interest rates because no guaranteed product looks bad under that set of circumstances.

From the buyer's viewpoint, here is what makes sense:

1. Maximum protection in the product against rising interest rates.

2. Complete flexibility in future years, i.e., the ability to invest future cash flows at prevailing interest rates with either the incumbent or an outside carrier.

3. For larger employers, an annual competitive bidding process, using the marketplace as one's best protection.

4. Disbursements from existing contracts for all plan distributions and employee-elected transfers on a pro-rata--not LIFO--basis.

If an insurance company's products are to appeal to a sophisticated buyer who understands his needs, the product should have features corresponding to these needs. In today's marketplace, this results in a guaranteed investment product that:

- takes one year's actual cash flow, whatever that turns out to be;

- matures at a relatively early date, say, three or four years (Our clients are motivated by "shorter is better.");

- provides pro-rata payments for all necessary payouts.

The insurance company is <u>not</u> required to allow transfers to competing fixed income funds, nor can it be expected to deliver a contract that permits an employer to make detrimental plan changes in the future.

Admittedly, this type of product is not so easy for an insurance company to deliver in a competitive manner. With the disappearance of the inverse yield curve, insurance companies can achieve competitive investment returns only by investing in deals with longer durations. The buyer's needs are in the opposite direction; he requires a shorter maturity. The insurance company can readily offer higher rates for longer GIC contracts, but the intelligent buyer with access to a competitive marketplace will be able to get a three or four year contract at an attractive interest rate from someone.

In the end, the buyer selects the best combination of rate and duration. The insurance company must develop its offers accordingly.

So much for defined contribution plans. Let's now talk about defined benefit plans.

I would now like to discuss the emergence of the GIC product in this area as well, plus my prediction of the impending demise of generation interest and traditional IPG-style products.

From the buyer's viewpoint, a GIC product can be an attractive investment opportunity. In today's marketplace, GIC interest guarantees are competitive with other types of investing. The insurance company guarantee converts its lower quality, higher yielding investments into the equivalent of AAA quality. Most important of all, the product matures at some date agreed to in advance.

I believe that actuaries must adapt to the world that now exists. We no longer live in a stable investment climate. We no longer can expect interest rates to remain at a given level and change slowly. Interest rates can go up or down by several percent in a few days. The entire premise of generation interest no longer exists.

Employers must recognize that IPG products have never really been understood by buyers. The emergence of GICs has simply made an IPG contract even more incomprehensible. Given the existence of a GIC concept, the buyer simply does not understand a product that reinvests in itself and never matures.

When interest rates go up, the typical employer fails to understand that book value accounting implies book value interest rates. Having failed to understand what he bought in the first place, he seeks to withdraw his money at book value and then learns about the "fine print" in the contract.

Even given complete understanding, the IPG product is deficient from the buyer's viewpoint. He has absolutely no protection in the calculation of a market value. The insurance company has to estimate the market value and will resolve all uncertainties in its own favor. Whatever investment advantage existed at inception has been totally nullified by the market value determination process at the end.

From the buyer's viewpoint, the GIC product is far superior. The maturity date obviates the market value cash-out. The buyer will be willing to wait until the end when he knows there is an end.

From both the buyer's and seller's viewpoints, the GIC product avoids misunderstandings and ill will when interest rates rise.

Either an interest-paid type of contract or one that reinvests interest at guaranteed rates is acceptable. Presumably, the insurance company can immunize its maturities and adapt to a portfolio of GIC products for its customers.

Operationally, we see a fairly straightforward introduction of GICs as a primary vehicle for accumulating pension assets. Each year, an employer would place a sum of money in a GIC at prevailing rates, with a given maturity date. The process would be repeated annually or at any other interval consistent with an employer's requirements. The insurance company would normally be able to maintain its relationship on an ongoing basis because the maturities would be staggered. It is in the interest of both parties to avoid having the whole plan mature at one date.

Of course, liquidity would have to be arranged. Participants need to be paid plan benefits. The liquidity could come from the interest payments, future cash flows, or be specifically arranged.

I have a few final comments on miscellaneous product needs. The first is bond immunization. The idea of immunization has many applications. Insurance companies could provide this service directly for a given pension fund. Alternatively, a GIC could be used for certain applications, such as the liability for a closed group of retired employees. Compared with conventional immunization, the GIC would tend to offer a higher interest rate. It also can simulate an annuity and create an "actuarial windfall" in the actuarial calculation of that year's plan contribution.

Another specialty market is that of annuity close-outs for terminating plans. One idea worth considering is a technique to reduce the insurance company's risk in order to provide a more attractive annuity purchase rate. We have been able to get our clients to agree to a spot decision in return for a spot interest rate in the annuity calculation.

Finally, I will comment on the use of investment advisory services by insurance companies. Generally speaking, this service deals with recommendations as to how much to allocate to each of the various separate account facilities that an insurance company may be providing. Our experience has been that some clients want this, but most do not. The typical demand is in the intermediate size range, where bank trustees have advised on investment mix. If you are in this particular business, with an array of separate accounts, it would appear to be worthwhile to provide this service.

MR. SPOONER: Many of you may know of Jim Tilley; he has written several papers on annuity pricing and asset liability matching and he has served on the Society's C-3 task force.

MR. JAMES A. TILLEY: From the insurer's viewpoint the pension business has largely turned into one of managing assets--an investment business. There are third party plan administrators, pension consultants and investment consultants who have created special (and often profitable) niches for themselves. Except in the small market segment and in the smaller parts of the medium market segment, the days of a full package of services are long gone.

There are two basic categories of products that pension carriers offer today--risk-based products and pass-through products. In the former category are GICs and nonparticipating annuities and in the latter are conventional participating contracts as well as separate accounts, both pooled and individual client. Pension plans look to insurance companies as the preferred provider of risk-based products--those under which guarantees of investment performance and/or mortality and/or expenses are made. GICs are the primary risk-based pension product offered by insurers today. Nonpar annuities are making a comeback now that plan terminations are on the rise and surplus strain has been alleviated under the dynamic valuation law. As long as interest rates are volatile or threaten to be so, conventional participating products are likely to be only of historical significance. Among other investment pass-through products, open- and closed-end real estate accounts are the only products where the insurance companies are regarded as the provider of preference. Capturing market share of managed bond and stock portfolios has generally been tough going for insurance companies, especially in the large segment of the market. As testimony to that, one very large insurer last year acquired an investment counselor because it had been unable to get where it wanted by itself.

A good starting point in the development of any business strategy is determining appropriate earnings targets. For established product lines, it is useful to set annual earnings goals for a three- to five-year planning period and to determine how much of that goal can be met from business already on the books. The balance must come from new business. The next step is to determine what range of product mixes will deliver that balance of required earnings, and to select from those the ones that will not exceed surplus capacity, that are consistent with the capabilities of the field force, and that result in attainable sales volumes considering the size of the field force and the nature of the competition.

Key to the planning process is an understanding of the source of earnings from each product line: (1) for risk-based products it is the risk margins built into their pricing and those generally have expected values measured in units of 25 basis points or so; (2) for pass-through products it is usually fee less expense margins, generally measurable in units of 5 basis points or so. It is also important to remember that earnings from risk-based products can be highly variable, with standard deviations often equal to or greater than expected earnings.

In situations of intense competitive pressure, it is vital for a company to have in place a system for reporting the "true" earnings of its various lines of business, not just what the statutory statements are showing because that could be different. This is especially true for risk-based businesses where investment guarantees are made by the insurer and there can be profound consequences--good or bad--of asset/liability mismatch that do not show up in the statutory books for many years.

A few examples of such asset/liability mismatch problems may be helpful. Murray Becker has made forceful arguments for using short-term, say three- or four-year, GICs to fund the guaranteed fixed-income investment option of a qualified savings plan. But his clients don't seem to like today's low level of yields at that part of the yield curve. And some insurers come to the rescue by underwriting those shorter contracts and then investing longer, say five to ten years, and passing a part or all of the extra liquidity

premium to the clients in the form of higher guaranteed rates. There is nothing wrong with that practice--it simply involves an interest rate bet; if interest rates come down, the insurer is a big winner, and if they go up, the insurer is a big loser. As long as the insurer has enough surplus to back this interest rate bet, it should be permitted to make it and, in fact, it may even be unwise from a strategic viewpoint not to do so. What worries me is that I don't think the risk/reward tradeoff is very favorable on many such deals--is 50 basis points expected profit worth 100 basis points or more standard deviation?

I can make the same comment about pro rata versus LIFO administration of payments from various GICs in order to fund savings plan benefit distributions. Murray has argued quite convincingly that pro rata administration is highly preferable because it allows the GIC investment option's composite guarantee rate to track market interest rates better. Yet, even though pro rata greatly decreases the predictability of cash flow and shortens the average life of contracts, insurers seldom seem to demand an extra risk premium for it.

I would like to qualify my previous comments slightly to point out that matching of asset and liability cash flows is best carried out for the aggregate portfolio of GICs, and it may be optimal in many circumstances to mismatch the durations of new GICs and new investments in order to bring the entire portfolio into better balance. In such cases acquiring new investments longer or shorter than new liabilities may be a prudent thing to do.

Any insurance company that has been active in the GIC busines for the past several years has realized that competition has intensified and profit margins have been squeezed as a result. Indeed, at times, bidding on new business has amounted to nothing short of a rate war, especially in the upper segment of the market, where visions of sales and marketing glory are tempered only by the fear of the possibilities of very large scale losses when "all the eggs are in one (or a very few) basket(s)."

What strategies can be used in such an environment? Here are a few:

(1) development and implementation of new techniques to control investment risk, such as better hedging of interest rate movements through the use of forward markets, and when legally available for use by insurers, financial futures and options;

(2) diversification across interest rate cycles by trying to write business uniformly throughout the year and by writing many separate pieces of business of more or less uniform size--an extremely difficult thing to accomplish if most of one's efforts are in the large end of the market (because of competitive pressures and potential capacity limitations);

(3) creating incentives for the investment organization to change direction quickly toward areas of current investment opportunities, such as short-term bullet mortgages when the private placement markets dry up;

(4) aggressive use of favorable tax situations to support product pricing, such as the purchase of deeply discounted public bonds to shelter ordinary income from taxation and to generate capital gains taxable at lower rates than ordinary income;

(5) redesign of products to respond better to market need and to differentiate them from those of competitors, as for example, the sharing of cash flow risk between the seller and buyer of savings plan GICs by guaranteeing a higher initial rate than otherwise available, with the right to reduce it in subsequent years if actual cash flow deviates from the client's original estimates; and

(6) repositioning of products to different market segments where there is less competition--this might mean, for example, achieving higher profit margins from smaller customers, although if one moves too far down in size of customer, the distribution costs are likely to become very large.

If all such strategies have been exhausted, it may be time to abandon the product line and move on to some other business--otherwise there is the risk of seriously deteriorating earnings. Of course, many companies fear making such a move because they feel that after many others do so the pendulum will swing back to a "sellers' market" from a "buyers' market," and they don't want to miss the action. I'm sure we've all come across that type of situation before.

Going out of a business or essentially doing so by de-emphasizing it is an extremely difficult, and perhaps unwise, thing to do, especially whan the market demand is high and growing and when the ideal product--a GIC--exists. The only sensible strategy then seems to be to go back to the "fine-tuning" strategies I discussed earlier and make them work very hard for you.

I would like to turn briefly to an aspect of competition that many of us in the insurance industry have not paid sufficient attention to--namely, a massing on the borders of "our" turf of bankers of all kinds--money center bankers, savings and loan associations, and investment bankers. There are a few obvious "pension" examples: (1) in the individual man-on-the-street marketplace, banks have captured a sizeable share of the new IRA market opened up by ERTA in 1981, and (2) in the large defined benefit plan market, banks have successfully written billions of dollars of immunized and dedicated bond portfolios. In the first case, they are providing individual GICs--either fixed-rate or variable-rate certificates of deposit--and in the second case, they are providing a GIC substitute that has the advantage over GICs of almost immediate liquidity. It is not difficult to imagine ways that banks can build on these successes to penetrate our turf further.

With the troubles of the social security system and pressures on defined benefit plans getting more press, it is likely that greater emphasis on <u>individual</u> accumulation of savings for retirement will continue to build. The principal players in this market are mutual fund companies, stock brokers, and banks, all of which, but especially the mutual funds, have recordkeeping systems in place that greatly surpass those of insurers. One strategy, pursued successfully by at least one insurer last year, is the bringing of complementary distribution, product, and administrative skills of two types of organizations together in a partnership to meet the needs of the market-

place better. I believe that there will be many more such joint ventures in years to come. Insurers bring many useful things to that kind of partnership--in most situations it is risk-based product expertise, but in some it can include the agency distribution system.

The examples I have discussed show that one must be nimble in order to be successful. In an arena characterized by many different institutional players all over each other's traditional turf, by volatile financial markets, by shifting regulatory and legislative priorities, by rapid technological advances, and by changing demographic patterns, there tends to be an acceleration of product life cycles. New product development is key to success during such times.

Successful product planning requires pairing what an organization is especially good at relative to its competitors with what the market wants. It is extremely important to understand why the market wants what it claims it wants in order to assess the persistence of the need and how it can be generalized usefully.

It is necessary for actuaries and other product engineers to overcome their reliance on pure "intuitive" feel for what the market wants and to get out to talk directly to customers. And when they return to the ivory tower, it is essential that they find an organizational culture where innovation and flexibility are rewarded, and where product and market planning and allocation of resources are carried out in a careful and thoughtful, but not cumbersome and unduly lengthy, manner. In short, many of us must change our ways or we'll be left behind.

MR. DAVID E. SUNDERLAND: Murray, do you see any move in defined contribution plans to new money rate type or generation type crediting to participants in lieu of blended rates?

MR. BECKER: Yes, I would refer to that as class year accounting. That would be a system in which each participant has an interest in each year's contract. We have about 30 large savings and profit sharing clients that we deal with on an on-going basis and about five or six of them maintain class year accounting. I do see more of that in the future although part of it is for the wrong reason. The employer thinks that the reason that other employers have had problems was because they weren't crediting the current year's interest rate in the plan. The problem was caused by the fact that they had locked their money up at low interest rates with no device to respond to rising rates, so it wasn't the blending that was the problem but that appeared to be the problem. But basically I think that more clients will want class year accounting. I view that as a mixed blessing. There are certain advantages to it; there are also disadvantages and I could give them if we had time.

MR. ROBERT P. CLANCY: If insurance companies suddenly started pricing GICs recognizing the added risks of BAA investments, if they stopped pricing based on the yields of higher yielding long investments rather than the lower yields on short investments with more appropriate maturities for short liabilities, and if they started pricing with larger profit margins consistent with those of banks and others in the financial services industry, would you still advise your clients generally to buy GICs in lieu of IPGs?

MR. BECKER: The answer is, as long as there is a GIC, it seems to meet the need better. The clients will pay a premium in a sense; that is they will accept a lower interest rate to get a reasonable duration, but the marketplace sets that interest rate. If for example, a three year deal was available today, say at 10% interest and a five year deal was available at 11½%, I probably would have a lot of clients who would take the 11½% because they would look at 150 points and they would say to themselves that's a little too much to give away. But you are living in a world where there are now about 10 or 11 companies, and you have different strategies emerging. So, a company says well if the five year rate is 11½% and the three year rate is 10%, we'll win the business if we come in with a three year rate of 11%. We're taking some risk, as Jim Tilley referred to it, and if interest rates are up at maturity, we're going to be sorry we did it. But that company will also try to balance this with other deals. The actuary can develop the risk charge for whatever you do, but in the end you can only charge it if you get the business.

MR. DALE B. WOLF: I have two points that I want to address. First, Jim, I share some of your concerns about profit margins on GICs and so on, particularly in light of potential arbitrary profits on-balance sheet as compared with off-balance sheet which is what the pension business has turned into. I'm wondering about any comments that the panel might have about whether GICs are getting out of control. I think with any product line part of our strategic planning process has to be an evaluation of the product life cycle. What is the next product? Where is the GIC going from here? And then, Murray, a comment on your defined benefit GICs. I think that there are certain rewards for taking risks of possible downward movements of interest rates on defined benefit plans. The investment manager of the defined benefit plan who does not take those risks is probably not going to look too good in downward interest rate paths. And in contrasting this with the IPG for instance, if I'm a defined benefit plan sponsor, and guarantees themselves do not mean that much to me, why should I pay an insurance company for guarantees if I can get the total investment performance assuming that the investment characteristics of the IPG are suitable to my needs in terms of investment timing, duration and so on.

MR. MAISANO: Let me speak up for Murray on the IPG because he and I, even though we come at it from somewhat different perspectives, tend to agree. There are a couple of dynamics working against you in the IPG market. The defined benefit business itself has got some question marks surrounding it right now as a market strategy. Whether or not we offer IPGs to defined benefit plans I think is going to become less of an issue as we move further down the road because we typically get involved when plans are being formed. I don't know of many Fortune 1000 sponsors that have bought IPGs lately, and I rather doubt that they are going to start buying. GICs, as part of the defined contribution package, I think are a permanent part of the landscape. They're very much like 5¼% savings accounts. In spite of the ravages of inflation and interest rates, 50% of the people who had savings accounts still have them at 5¼%. There is a certain comfort level where in employee allocated funds, the GIC does the job better than any other vehicle. Defined benefit GICs; do they make sense? I have trouble with them too. I think an actively managed defined benefit plan will do better. You can use it for immunization techniques but I don't see them having much value as bullet contracts.

MR. BECKER: I think that some of the comments that I made on defined contribution plans got carried over to defined benefits. I believe that if you're talking about using an insurance company fixed income facility for a defined benefit plan, a GIC is a vast improvement over an IPG from everyone's viewpoint when we're living in a world where interest rates can change 2 or 3% in a very short period of time. From the buyer's viewpoint, the buyer wants a known interest rate for an interval. You can evaluate a GIC clearly on that basis. I don't think you need advance guarantees in a GIC. I don't think that makes any sense in a defined benefit plan. I prefer the interest payback. The buyer should know in an IPG product there's a flaw. When you try to get your money out of the contract, the insurance company has to estimate a market value. There's a built in tendency of the insurance company to resolve all the uncertainties in its own favor. So, I'm saying let's replace this business with something that makes more sense. In response to Phil's point, I see merit for GICs in defined benefit plans simply if they have a good rate of return that offsets the illiquidity of them. If the insurance company will offer you a higher interest rate than the bond market is then providing, why can't an employer put a piece of its pension portfolio in that product? It's just a means of diversifying and getting an additional investment mix, but you have to have that premium.

MR. TILLEY: I do think that there is room for a GIC in a defined benefit plan. If you look at all of the investments that are available to an insurer to back a GIC, even extremely illiquid ones, mortgages, private placements when those markets aren't so dry and so on, just being able to choose from all those, to pool those results, pool the default rate and everything else, has to translate into a larger guarantee rate; has to provide a larger guarantee rate than the equivalent target rate by managing a bond portfolio--just because of quality if nothing else. It's just that a defined benefit plan sponsor can't pay too big a price; can't have all his assets in fixed income, can't have all his fixed income assets in GICs. It won't work. But for a small slice like 10%, 15% or 20%, it's hard to make an argument against them. As far as GICs in the defined contribution market, is the landscape going to change? I really find it hard to believe, unless interest rates truly become unglued. And by unglued I don't even mean what's happened over the last three years or so. I mean really unglued; bounding around somewhere between 20% and 200% like in some other countries in the world. If that happened I think you'd have to go to participant level products, and open up buckets if not daily at least weekly and have the administrative support that goes with it. Short of that, it's possible that you can structure a LIFO contract to do much of what a pro-rata contract would. Then a homogeneous, pooled, socialized fund can be made to work very well. There will be leads and lags of the composite rate for the whole plan against where market rates are today, but there needn't be tremendously large discrepancies unless interest rates become really unglued.

MR. SPOONER: I think that the product itself is not the problem; it's the managing of the product, the management of the investments and so forth. Right now there's certainly a big scramble in the industry to establish market share. Everybody who has seen what they could do last year, wants to do better this year by staking out a good position with GIC sales, and as Jim said, maybe making a few bets. Some of the bets won't pay off. There may be some fall out, maybe capacity of the industry might pull back a little bit, but I don't think that necessarily implies a re-structuring of the product as much as it does a re-examination of the process of establishing the

rates, and maybe to some extent the underwriting guidelines. There may be some pull back, but I don't see the need for a whole new generation of products.

MR. TILLEY: There is one evolution that I do expect to see. It is possible to keep all the objectives that a plan sponsor and hence the plan participants have in mind--to keep all of those more or less intact, and still have more sharing of risks, particularly cash flow estimates. I alluded to that when I was saying that you can make the cash flow more meaningful by writing it into the contract and having the interest rate vary with how successful the plan sponsor is in getting it right. Again, without hurting the objectives of the plan.

MR. SPOONER: Thanks very much for your participation as an audience and I would certainly like to thank my panelists.