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**STRATEGIES FOR THE
NON-TAX-QUALIFIED ANNUITY MARKET**

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Marketing

- Much of the current SPDA business is sold by specialty companies to clients of stock brokerage firms. What other markets are available? Payroll deduction? S&Ls?
- What impact have the TEFRA penalties had?
- Is there a market for non-tax qualified annuities for the nonspecialty company?
- Can annuities be sold on a direct mail basis?

Investment related

- What changes in investment strategy and investment alternatives have taken place in 1983?
- How are companies investing in order to achieve higher and more competitive yields?
- Are companies better protected against disintermediation now than they were before the 1980/1981/1982 surge in interest rates? What happens if rates return to 1981/1982 levels next year?
- How can the product be managed in a rising interest rate environment?
- Is hedging (futures, options) a practical solution?

Product design and cost considerations

- What are the current trends in product design? What is the role of the investment manager in design and cost considerations?
- Group versus individual policy forms.
- What is the status of the SEC review?
- Can a market value adjustment product be sold and meet nonforfeiture requirements? Is it saleable?
- How can the SPDA product line be managed over time as spreads and competition change?
- Is the spread required to meet commissions, policy issue, and maintenance costs changing as we gain more experience? Have TEFRA administration requirements, particularly for FPAs, resulted in the need for higher spreads?

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OPEN FORUM

MR. ALLAN D. AFFLECK: I am a consulting actuary with Milliman & Robertson in Seattle, and I'll be your moderator for this afternoon's session.

We have three panelists this afternoon, and together they have a substantial amount of experience in the annuity field. Pat Maher is president of MSM Marketing Corporation, who are marketers and administrators for two of the major single premium deferred annuity writers who market through stock-brokers. Pat, who is a CLU, formed his own company in 1979, after leaving his position as Vice President and National Sales Manager of Merrill Lynch's insurance marketing department. Sam Weinhoff obtained his MBA from the Wharton Graduate School and is currently Assistant Vice President of Investments for Reliance Insurance Company. He is responsible for their annuities and other tax-deferred products that his company and their affiliated life insurance companies write. In addition to his investment responsibilities, he is a merger and acquisition analyst and equity analyst for financial services stocks for the Reliance Insurance Group. Cal Winter is Vice President and Chief Actuary for John Alden Life Insurance Company and is responsible for the pricing and design of their annuity and insurance products. He coordinates the investment, marketing, compensation, and actuarial aspects for their single premium deferred annuities. He is also responsible for their financial reporting, so he sees how things turn out. I'd like to ask Pat Maher to speak first about the marketing related issues.

MR. PATRICK F. MAHER: I would like to comment on current aspects of the non-qualified annuity market. First is the kind of life insurance companies entering the business. Another aspect of the market is the impact of Baldwin-United. Also, TEFRA's effect, and certain aspects of the coming TEFRA-II are critically important. Variable annuities are enjoying a renewal with the revival of the equity markets. My firm is a wholesaler of deferred annuities. We basically position ourselves between the issuing company and the retail agent. We work for the issuing company because we're paid by the issuing company, but we have to fulfill the needs of both the issuing company and the retail agent. We are fully dedicated wholesalers whose job is to service the retail agent face to face in representing the issuing company. The companies we represent include John Alden and Executive Life Insurance Company. We are also administrators of annuity products. We perform administrative functions from licensing to the issuance of the contract. There are two other main forms of marketing strategy in vogue. First, the issuing company may deal directly with retailers, paying them both the retailer's and the wholesaler's commission. The second form is where the issuer markets more directly to the consumer, as Fidelity is doing with Capitol Life and when savings and loans act as distributors. These marketing approaches deserve our attention. My comments about them are in no way negative; all forms can work, at least for the time being.

Let us start with the kind of life insurance companies entering the business. Traditionally, it's been a specialty company's business. Lately, more life insurance companies are entering the business, and at least one company, Manufacturer's Life Insurance Company of Canada, is not a specialty company and has entered the business with a highly competitive, fixed deferred annuity. Why are more companies looking at the annuity market? I can think of two possible reasons. One, the life insurance product may no longer be a source of investable assets. Life insurance cash values are being borrowed to pay future premiums. It is estimated that

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various forms of low cost term insurance and minimum deposit amounted to over 87% of life insurance sales in 1981. Second, TEFRA-I may be giving some issuers the attitude that annuity premium is less subject to the forces of disintermediation.

Baldwin United has shaken the annuity market because it has gone to the heart of the product - the safety of the consumer's money. Baldwin-United, to any thoughtful person, is symptomatic of our times. If the same investment mistakes are made in any financial institution's asset management, it's the depositors', the policyholders', the lenders' money that is lost. Baldwin-United is actually a small part of our tumultuous financial world, which includes WPPSS in the municipal bond business, and includes Poland, Mexico and Argentina in the banking business, etc. It is a simple fact, however, that a bond issued by a well-managed municipality can be a good instrument to the right lender. An account at a well-managed bank can be a valuable service. An annuity sold by a well-managed life insurance company can be a good consumer product. The public every once in a while gets sadder, but wiser.

The variable annuity and variable life insurance products are escaping the Baldwin-United problem because the consumer in those products assumes the investment risk. The only point I would like to make about these variable products is that as a long term capital growth entity, variable products really are bad consumer products. For example, if you were to buy a mutual fund for \$10 outside a variable annuity, and you realized a \$1.00 long-term gain, you would keep \$.80 under the current law after taxes. You pay a 20% capital gains tax. On the other hand, if you bought the same mutual fund in a variable annuity, you would have an unrealized \$1.00 long-term gain in your account which would be charged the corporate life insurance company's capital gains tax rate. Let's assume, for the sake of arithmetic, the tax rate is 30%. Therefore, \$.30 is taken out of the account, and \$.70 is left. If you sold the value of your unit for \$10.70, \$.70 would be ordinary income and in the 50% tax bracket, \$.35 would be paid to Uncle Sam. That's a horrendous form of triple taxation. In a variable annuity product, a qualified dividends equity investment portfolio does make sense.

A life insurance company wanting to get its share of the deferred annuity business has several marketing approaches to choose from. It could look for the cheapest, but the most effective, of course, is the cheapest that works best. If more life insurance companies are entering the market, this subject will become more critical. The retailers of annuity products remain the same, and the consumers remain the same, but the products proliferate.

I'd like to discuss three distribution systems presently in use. The first is a dedicated wholesale organization. Dedicated means that it is a group of people or sales force who are basically working for one or more life insurance companies issuing a deferred annuity product. They are paid the wholesaler's commission to bring that product face to face professionally to the retail sales agents. This group could either be exclusive with one issuer, perhaps covering just a segment of the market, or it could be non-exclusive, working for several issuers at one time. It could be a wholesale organization that actually wholesales. Or alternatively, it could be a wholesale organization that actually retails. The second distribution system is when the life insurance company goes directly to the retailer, paying the retailer both the retailer's and the wholesaler's commissions.

This second system is eventually less dedicated, in my opinion, because the life insurance company stands a good chance of becoming one of a multitude of direct to retailer products. The third system is also a dedicated but more direct to consumers approach as Capitol Life is using with Fidelity. I think that any one of these strategies can work, at least for a while.

The traditional annuity wholesaler is contracted to represent specific annuity products. His job may include printing sales literature and also administrative responsibilities. He has a middle-man position, servicing both issuer and retailer, but since he is paid by the issuer, he really works for the issuer. He, of course, wholesales far fewer products than the retailer retails since the retailer can sell any and all annuities. Because the wholesaler works for the life company and wholesales relatively fewer products, the wholesaler can concentrate his professionalism and energy on knowing those fewer products and marketing their features, advantages, benefits, and applications. My firm's 40 wholesalers bring the product face to face to the retail community. We are not exclusive. We are non-exclusive. We represent two companies at this moment - John Alden and Executive Life. Our job is to perform for both companies. If we do not perform, we'll be fired. We wholesale as wholesalers. We try to avoid actually retailing the product. We will, in fact, retail it if we have to, but our method and strategy is based on bringing an evidently consumer-oriented product to the retail community, having the retail community perceive it fairly quickly and retail it on their own. There is another possible strategy. We could take a less consumer-oriented product, possibly a higher margin product, and retail it, using the retailer himself more as a bird dog to prospect for us. That is an effective strategy, particularly in bad times, when the retailer is busy with an active stock market, when Baldwin-United has him down because he sold a ton of National Investors, when the last thing he wants to do is mention a deferred annuity to his customers. If you are represented by a highly trained group of people, wholesalers, who are actually retailers, you can continue to do good business. Maybe in good times you do not write \$2 billion a year, you do \$200 million, but you do \$200 million every year, and maybe that better for the company.

The more direct consumer approach that Fidelity and Capitol Life are using is dedicated, as long as Fidelity does not start advertising several deferred annuities in their ads in The Wall Street Journal. I think this approach can be effective, although it must be costly in the heavy amount of advertising and high-grade sales literature needed to make the sales presentation. It is built, I think, on selling to an already sold market, just as the no-load mutual fund industry has been built. For example, if a consumer bought a deferred annuity from a retailer, then reads that ad in The Wall Street Journal, he might well send in the coupon, read the booklet, complete the application, and send a check back with the application. I believe that's point by point a less effective sale than a face to face presentation, but the law of large numbers is on their side. I am not privy to what Fidelity's experience has been to date, but they are still doing it. In a sense, this approach does to the retailer what no-load mutual funds did to him, except that in this case the cost to the consumer is reduced only by a slightly lower surrender charge schedule.

The savings and loans and banks have a captured audience of depositors walking by who could walk past a life insurance desk with deferred annuity literature clearly displayed. This combination of packaging and exposure

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could work, as it already does sell life insurance through savings and loans in New York and Connecticut. To the bank that wants to risk losing depositors to a life insurance company's money management, or to the bank that's made up its mind - we might as well get this business while it is going out the door - it could be an effective marketing approach. In my opinion, the most effective marketing representation a life insurance company can have is a group of highly professional wholesalers bringing their product face to face to the retail community, whether that is life insurance agents or licensed stockbrokers. I think the company that goes direct to the retailer eventually ends up turning into ashes. Where they're paying the retailer the wholesaler's and the retailer's commission, their product is going to be one of a chorus line of products eventually, and they're not going to have dedicated representation eventually. It could and probably would work temporarily, especially if the retail firm took some of that extra commission and put it into the marketing effort. But when another company comes along with the same direct to retailer commission and a slightly better product in their opinion, then your company might be in trouble, and they have an awful lot of money concentrated in one place.

I sincerely believe that marketing of non-tax qualified annuities today is in jeopardy. It might not be applicable to the real world if the proposed tax legislation is passed. Tax deferral without income averaging is nonsense. It is just stupid. It would be criminal to sell it, as well as stupid to buy it. The proposed tax legislation has a provision that if the deferred annuity contractholder dies at any age before the annuity income commences, his death triggers an ordinary income tax liability in that tax year for all of the deferred income built up to that point. What that means is that when grandparents buy a \$10,000 deferred annuity for their 3 year old grandchild, if that child was killed in an automobile accident at the age of 19, all of his 14% tax bracket income has been moved into a 50% tax bracket in his 19th year. This provision in the law wipes out the existence of the annuitant, as well as the beneficiary. It would make the tax-deferred annuity, variable or fixed, the only tax-deferred savings program in America that must be income-lumped, due to a totally uncontrollable event on the part of the consumer - dying.

If you consider the mutual fund and variable annuity example which I described, not only do you have that unfavorable tax position while the taxpayer is alive, but if the mutual fund were to grow from \$10,000 to \$20,000, and the taxpayer - the owner were to die, he would have a stepped-up cost basis. No one would pay the income taxes on the \$10,000 of deferred capital gains. If, however, he were to buy the same mutual fund in the variable annuity, not only would he be in the horrendous triple taxation situation, at the time of his death, he would have ordinary income tax in the year of death on a full \$10,000 of interest income in that year. If you think a variable annuity is taxed unfairly versus a mutual fund today, consider how adversely it's going to be taxed under this new provision. It is a dead product. The deferred annuity has really been given a death sentence by this provision in the law if it passes. There is no way it would be purchased. Every financial analyst will recognize what is going on. Keep in mind the alternatives the consumer has. He can buy \$10,000 worth of IBM, then if it grows to \$20,000, he has tax deferral on his unrealized gain. If he dies, he has stepped-up cost basis. Currently, if he buys a deferred annuity at age 45, he may name his wife the annuitant in case he dies prior to retirement, since he wants the income to go to her

if she survives so she will have retirement income. He can name his children as beneficiaries in case he and his wife both die before they reach the retirement age. But, under the proposed tax legislation, if he were to die on the way to work at age 55 ten years later, that whole program of future retirement income, which is the heart of the annuity product, would be destroyed through income lumping taxation, and if this provision was exchanged in the bargaining on the tax bill for annuitization at 70-1/2, I sincerely believe the people who negotiated the exchange couldn't possibly have known what they were doing. The sentence of death hangs over the product.

MR. AFFLECK: I'd like to ask Sam Weinhoff to add some comments in the marketing area.

MR. SAMUEL J. WEINHOFF: When Reliance got into the annuity business about 2-1/2 years ago, I can remember sitting in a room with several actuaries, and we had in front of us a big pile of competitors' annuities. We went through the pile and wondered how we could get into this business, and what bells and whistles should we develop to make our product different than our competitors? So, we looked at surrenders and saw this company's at seven, we'll be at six, and we looked at bailouts and decided we'd be at 75 basis points while other companies are at 100, and we continued through the whole list of different specifications. However, we have found in the last two and a half years that there are really three things that sell SPDAs - that is rate, rate, and rate. The brokerage market is conditioned to know one number, and that is the rate, which is what they push. Another thing we have discovered is that at most times a differential of as little as 5 basis points will make your product a hot product, and in looking at our results and some competitors' results, we really see swings of cash flow with as little as 5 basis points. Another point I would like to make is that once you're selling through the brokerage market, you must remain competitive. You are just like Procter & Gamble. You are really fighting for shelf space. Once you have identification in the broker's mind, he comes, and you have to give him a reason to sell your product every day. If he forgets about you, it's very hard to get back into the market once you are forgotten. There are just too many new entrants waiting in the wings trying to get in with their new products. We have enjoyed some terrific success marketing SPDAs through the brokers. Sometimes we have used wholesalers such as Pat, other times we have dealt direct. I thought very few companies would get up here and talk about their failures, but let me share two marketing failures we had with you. We are the controlling shareholders in two very large S&Ls. One is Gibraltar Savings of Texas, which is the largest S&L in Texas, and the other is Imperial Corp. of America, which is one of the largest in California. They each have 100+ branches in their respective market areas. They are very strong, and you would think these would be great states to sell annuities in. We thought so too, so we discussed the idea of selling annuities in their branches. They sell SPDAs for us, and we pay them a commission. But they said absolutely not. They were afraid it would jeopardize their 5% passbook money, and they would end up in worse financial straits than they already were in at that time. So, they turned that idea down. Finally, when they realized they were going to lose the 5% passbook money anyway to a competitor or some other annuity writer, they offered to sell the annuities, but they wanted to keep the money. Obviously, we never struck a deal, and these were our own savings and loans. Our second failure was offering annuities to our 10,000 employees. We put an article in the company newsletter. We were going to

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credit 15% and waive the 6% front end load. We received about half a dozen applications in all. I think you need direct contact to sell these annuities.

MR. AFFLECK: Cal Winter, do you have anything you would like to add on marketing?

MR. JOHN C. WINTER, III: In preparing for this session, I recalled that the work of actuaries is "to substitute facts for appearances and demonstrations for impressions". I tried to do some evaluation of the market, which is subjective at best. I surveyed the June, 1983 10 Q's of 6 companies that we look at as our competitors in the brokerage market and who accounted for approximately \$6 billion of SPDA premiums last year.

What I found was that sales across all companies are down this year. The June, 1983 year-to-date sales average 64% of the 1982 levels. From company to company they range from 25% to 95% of 1982's sales levels.

There are a number of reasons for the decline. One of the things we are starting to see is that this is a mature market. It was a market that was new to companies about 3 or 4 years ago, but now it seems to have lost its glamour.

A second reason would be TEFRA, the tax act that passed in 1982 and really affects annuity contributions after mid-August, 1982. Among the changes are that partial surrenders represent interest first, and there is a 5% tax penalty on withdrawals prior to age 59-1/2 or the 10th contribution anniversary if earlier.

Also, it is our impression that a substantial amount of the initial sales of this product were generated from people that viewed this product as essentially a short-term investment vehicle. And some distributors in fact advertised that you could "withdraw your interest earnings without penalty". (Several companies allowed the first 10% of your accumulation to be withdrawn in any year with no penalty). That market is now obviously dried up.

There is uncertainty recently due to proposed new tax law changes. Last year's changes were supposedly permanent, and this year's are supposedly permanent as well. One has to wonder what it really means to be a permanent tax law change anymore. This perception appears to have hurt the market lately. At first the new tax law proposed to apply IRA conditions to non-qualified annuities, so that money would have to be annuitized by age 70 1/2. That provision is going to be gone. However, one of the features that was helpful last year was the ability to avoid the tax penalty by having the money in at least 10 years. This feature appears to be gone.

Another reason for sales declines would be the stock market rise. From August of last year to August of this year the Dow Jones Industrial Average has gone up 30%. That probably doesn't tell the true tale since John Manville was one of the companies included in that average, and most of you are aware what happened in their situation. Only 40% of long-term capital gains are taxable on one side, but on the other side, TEFRA has made annuities less advantageous from the tax standpoint.

Other reasons advanced are negative public reaction to Baldwin-United's problems and general interest rate levels are down.

My own perception is that the factor that stands out the most is the TEFRA changes. The way you try to determine major influences is by looking at quarter to quarter results on a 10Q. When did sales start to go down to the new level, and have they been constant since? I would say this occurred starting in the late third quarter and fourth quarter of last year, which would give the general impression that it has to do with the stock market and tax changes and very little to do with Baldwin-United.

Competition that we can see is based on rate, rate, rate. You have to be within 100 basis points of the top of the market to sell, and if you are 100 basis points below you may sell about 1/3 of what you would like. To be really competitive, within 50 to 25 basis points is where you must be.

Competition has nothing to do with product features, as far as we can discern. It also really has nothing to do with the financial integrity of the company, other than that people are no longer buying Baldwin-United. If you were to try to correlate sales with a GAAP financial report, with the strength of the balance sheet, with the investment philosophy, you would not get a very strong correlation.

The other thing I'd like to talk about is the non-qualified flexible premium market. It is one that we do not get involved a lot in at John Alden. We do on the IRA side.

My general impression is that this market has declined as well. It is probably down to 1/3 to 1/2 of last year's results, but it is a lot more difficult to get data. This product is less generic than the SPDA, but you still probably need to be within 200 basis points of the top of the market to sell. And to have any sort of appreciable share, you have to be a lot closer than that. There is some segmentation as far as surrender penalties, fees and the like. But that has limits as far as rates go. In summary, the market is down, it's very sensitive to interest rates, price is what competes, and it is a mature market.

MR. AFFLECK: I might add a comment about the savings and loan market. While I think I would agree with what was said in general, I am aware of some situations where, particularly through the use of seminars, some life insurance companies have been successful in writing substantial amounts of single premium annuities through savings and loans.

We're going to move on to the investment-related areas of our topic, and I'd like to ask Sam Weinhoff to be our leadoff speaker.

MR. SAMUEL J. WEINHOFF: Let me start off with a little background about who we are and what we've been doing. Reliance Group entered the single premium deferred annuity business in early 1981, with our largest life carrier Reliance Standard Life. We sold annuities exclusively through Dean Witter, with Witter performing both the retailing and the wholesaling functions. In our first year of business we sold about \$200 million in premium. Reliance Standard Life was sold to Dresser Industries at the end of 1981, momentarily taking us out of the annuity business. Fortunately, we have another life carrier, United Pacific Life, so with a great deal of effort on United Pacific Life's part, we got back into the business in

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early 1982. We had to get licensed in half a dozen states that we were not already in. We had to design the product, test for profitability, and get the new annuity product approved. Finally, we had to sign up some brokers to sell our annuity. We did all of this in less than six months.

Since May of 1982, we've written another \$300 million in premium. We are selling our annuity policies through E.F.Hutton, Shearson/American Express, and Prudential Bache, plus a large number of small regional firms. In August of this year we introduced a single premium whole life policy sold through Shearson, Paine Webber, and E.F. Hutton.

Allan asked me to cover some of the recent changes in investment strategies regarding annuity assets. Two of the latest changes are the positively sloped yield curve and the effect of the Baldwin-United situation. I will expand on these two items later, but I'm sure some of you thought one of the biggest changes in the last 12 months has been a decline in the interest rates. In fact, that has not been the case. In mid-October of 1982, the six month treasury bill yielded 7.8%, with the 20 year treasury at 10.9%. A year later, short rates are up over 130 basis points, and long rates are up 100 basis points. Most people think rates are down, yet clearly they are up. Another interesting aspect about annuities is that a little more than a year ago annuities paid 15%+. Inflation was 12%, so policyholders had a 300 basis point real return. Today, annuities pay 11% to 12%, and inflation is 3% to 4%, for a real return of 800 basis points. In spite of this, industry sales are about 50% of their peak levels. So, what is happening? There are two things that are happening. One is a raging Bull Market. Brokers would rather be paid often than only once. The problem with annuities from a broker's viewpoint is that once you sell it, you never have access to that money again. On the other hand, if you sell him IBM, tomorrow you can recommend he sell his IBM and buy something else, so you can get paid every few days as opposed to once every ten years. Brokers have figured that out. And the second thing that is happening is the Baldwin-United scare.

In most of 1980 and 1981, we saw an inverted yield curve. A-2, P-2 commercial paper was yielding 18% or higher, with long treasuries yielding 13% to 14%. Annuity writers, who were selling in large amounts at the time, had the best of all possible worlds. They could keep the money short, take no investment risk, and get the highest yield. They paid no penalty for liquidity. In those days, we did not know how sticky these assets were. The fear was that this was hot money and would be out the door to the carrier with the highest rate. Now we have a situation where I can get 10% on short commercial paper and approximately 14.5% on a long high yield bond. Because United Pacific Life and its competition are promising 11.5% to new policyholders, I have no choice but to invest any new cash into long bonds. So in the last 18 months, carriers have had to assume an investment risk. The normal yield curve has forced us to do so. The good news is that we have found annuity money to be very stable. In the last year, we have lost less than 1% of our assets in both surrenders and withdrawals. Remember, the average policyholder is in his mid-50's. I believe that he has purchased this annuity as part of his retirement program. I think the money will stick around for at least 10 to 15 years. I might add that the average life of our portfolio is currently 12 years.

A second force on investment strategy has been the Baldwin-United situation. A few months ago, we were afraid that the press would be so bad on Baldwin-United that policyholders and, of course, brokers would force a massive run on the bank. Let me explain. We have a situation here where a company that was holding \$3.7 billion in retirement funds for almost 200,000 people is in bankruptcy today. These people cannot get their money, nor do they know if, when, or to what extent it will be returned. The industry has been very fortunate so far. We have been spared a segment on "60 Minutes" where some pathetic policyholder desperately needs his \$20,000 back so that he can take care of his aged mother's medical bills. Our industry has never been a favorite of the press. The Baldwin-United story gives them an excellent opportunity to prove many of their suspicions correct. We at Reliance were so convinced of the run on the bank problem that we converted 15% of our portfolio to cash, fully expecting that people would be so confused and alarmed that they would want their money back immediately, regardless of the carrier. That has not happened yet, but it may happen still. It is a concern of ours, and I am sure a concern of many other prudent annuity writers.

Another effect of this Baldwin-United situation is the toughening up by the brokers on the investment practices of the annuity writers. All major brokerage houses have been calling us, and we have been going through how we invest our funds with them. Two weeks ago, I answered the written questions of the Chief Insurance Examiner in the State of Connecticut. He asked that I review our annuity investing and describe how we monitor the spread. Connecticut is examining the investment practices, among other things, of every annuity writer in the state. The Commissioner of Insurance for the State of Washington sent a letter to every member of the Board of Directors for United Pacific Life and every other Washington domiciled life and property/casualty company. The letter contained 24 questions asking about the company's ability to write annuities, matching of assets with liabilities, ability to measure profitability of products, and finally, to quote directly: "Has your company reviewed the unfortunate experiences of Baldwin-United's insurance subsidiaries and taken steps to preclude the same sequence of events at your company?" Believe me, our directors asked at the meeting that we answer them formally, and they are entitled to answers.

We at Reliance have absolutely no notes, stock, or any other type of assets even vaguely connected with any of the Reliance Group, Reliance Insurance, or any Reliance-owned companies. In fact, our common stock portfolio has been reduced to no more than a couple percent of assets. In addition, we have tripled the surplus in United Pacific Life since we have begun to write annuities. I think it is our responsibility to regain the confidence of the brokers and the public. I frequently receive phone calls from brokers asking about how Reliance invests its assets. I immediately send him a full listing of our assets, including the cost and current market price of each. I invite him to study the portfolio, and then I will be happy to answer any questions. We have to disclose much, much more about how we're investing if we're going to continue to sell these products successfully.

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I'd like to talk briefly about the risks I see in the annuity business from an investment viewpoint. One risk is that rates go up, and you have invested your portfolio long. Under that scenario, you have the disintermediation risk. That means, policyholders want their money back to invest in somebody else's higher yielding annuities at a time when the market value of your long bond portfolio is less than what you paid for it.

The second risk is that you've invested your portfolio long and rates go down. Under this scenario, you have the reinvestment risk, meaning that you are unable to reinvest interest payments at the same rate as previously. This has the effect of narrowing the spread on that block of business. If you are long and rates go up, you risk disintermediation, and if rates go down, you have the reinvestment risk. Sometimes the solution is to keep the portfolio short. This investment strategy worked for much of 1980, 1981 and the first part of 1982, but not so since then. Since the third quarter of 1982, we have had a positively sloped yield curve, where the spread between the long and short instruments has been over 200 basis points. Carriers have no choice. They must take their portfolio long.

Allan also asked that I comment on what would happen if rates go up to higher levels. We saw that only 5 quarters ago, the long treasury bill had a yield in excess of 14%, and annuities offered a rate in excess of 15%. I think that if you study the past, the only solution from a carrier's point of view is to write more product. This accomplishes a number of things. First of all, with higher rates the spreads between instruments tend to be wider, at least temporarily. This produces more profits for the carrier. Second of all, the profit on large blocks of business, written at very high rates, will lessen the impact of disintermediation on smaller blocks of business written at the low rates.

We invest our assets primarily in high yield bonds with sinking funds. Some people are concerned about the credit quality of our portfolio. I guess that my only rebuttal can be that this country came through the worst recession since the Depression. The only group of high yield bonds that had financial problems were the oils. As a footnote, we own no oils. We liquidated them very early in the game. In addition, our portfolio is well-diversified among industry groups. The spread differential between high yield bonds and treasuries was as high as 500 basis points when treasuries exceeded 14%. This differential has come down to 300 to 325 basis points today. So, we have been enjoying yields much higher in the last few years than most other insurance companies, and have had no credit problems in our portfolio.

Finally, I was asked to talk about hedging, futures and options. I am not an expert on these items, but I do have a couple of comments. Most studies show the beneficial effects of hedging, but fail to talk about the costs. I think that the numbers indicate that in the long run, the cost of hedging approaches the cost of not being hedged. The cost of hedging the long bond approaches the differential between the long and short bond. What hedging does is protect against volatility of interest rates but not against trends. We regard annuity funds as a long term liability and assets on our balance sheet. It has been my experience that when you ask about the cost of hedging for 10 years, the response is that once it is clear where rates

are going, you stop hedging. Well, I don't know what period of time in my lifetime when anyone has agreed where rates are going, so I would not know when to stop hedging. We conclude that the cost of hedging is substantial, and we'd rather be right on our initial portfolio decision.

A second observation, even if you think hedging is good, is that you can rarely hedge perfectly. Single "A" industrials, which is what most companies buy, had a yield 150 basis points higher than treasuries a year ago. That spread has compressed to less than 90 basis points today, and a few weeks ago was less than 70 basis points. My point is that you hedge with treasuries, but they don't track with industrials. I was talking to the chief investment officer of a large annuity writer that does hedge their portfolio. He was very enthusiastic about hedging. He said that they had over \$1 million of "undeserved" profit in their hedges, plus they were making money on their investment. This is great, but it seems to me that if he has an unexpected profit, he could also have an unexpected loss. However, having said all that, I think ultimately that insurance companies will try hedging when they are more comfortable with it.

With regard to the future, I see too many products on the street today that cannot be intelligently invested for without taking major risks or unprofitable spreads. I saw one product recently that tried to share the investment risk with the policyholder but it had no surrender charges at most interest rate assumptions in the early years.

Also with regard to the future, notwithstanding history, where variable annuities have not traditionally sold, I think that variable annuities and variable universal life are really the future. Companies are going to want to shift the investment risk back to the policyholder. A lot of companies would enjoy a management fee and an administration fee. The public is in love with the stock market again, and mutual fund sales are soaring. I think the time is right for a hot variable annuity. I can envision variable annuities sold in large volumes.

MR. AFFLECK: Cal, would you like to comment on the investment issue?

MR. WINTER: Investment decisions for annuities would go under the heading of the comfort/yield trade off. Most actuaries would be heavy on comfort. Unfortunately, you can't sell anything that way. But on the other hand, you want to have some comfort in it all together.

It is very important to do asset/liability matching, and there are different ways you can do that. If you look at the New York Regulation or much of what the Society is looking at, they would say to look at your cash flows for your assets and liabilities, discount them, and that is all fine and dandy. However, those cash flows are not certain things, and they depend on the relationship of your assets and liabilities, your credited rates and where market credited rates are. So what you really get down to is running simulation models on different types of investment futures, trying to identify what investment philosophy makes the most sense to you.

My apologies to Sam, but don't let the investment department choose the maturities for your investments. That's one of the primary rules.

What do you look at when you do this matching? Well, the first thing you look at is who am I selling through? It makes a great deal of difference whether you're selling through stockbrokers or ordinary insurance agents. The first thing you could do is go down to your policyholder service department. Look at your replacements, and try to evaluate what they mean. The thing that you would look at is, "how many years will it take for the new company's higher interest rate to make up the penalty on the policy that is being replaced?" If you look at sales through an ordinary insurance agent, you would probably find that unless that penalty could be covered in one or two years, that sale is probably not going to be made. If you look at sales through stockbrokers, it might be 2 to 4 years or perhaps longer. And that gives you some idea what the difference is between the distribution systems.

The other thing that you have to look at is, what is the size range of your policies? The larger the policy, the hotter the money is. Why is that? There's a lot more potential commission involved for whoever it is that is moving it. And the owner has a lot more riding on what their yield is.

You also have to look at your lapse rates and how they vary relative to the market. Sam was talking about being able to increase your market share to offset cross-subsidization in your portfolio. You have a choice when rates go up and your assets are too long. One option is that you can sell assets and take a capital loss. The other is that you can invest new money in old asset yields, instead of market yields. In an earlier time in the annuity market's history, when sales were growing and it was an increasing market, it was possible to pyramid like that. Please do not draw the conclusion that it is still that type of a market now.

If you look at the portfolios of most companies right now, they are heavily in bonds, probably 75% to 90% of the monies in bonds, and a smattering in the rest. Short term assets now are probably 5% to 10% of assets; stocks, principally preferred, 5% to 10%; and mortgages 0% to 15%. An average company might have bond ratings slightly above "A".

Companies that are competitive now seem to be stretching beyond the limits of the standard investment portfolio. Some are going long, increasing the length of their maturities. We feel our company should have maturities between 6 to 10 years. Some companies are lowering their average investment quality. Other companies seem to be experimenting with different types of investments. This might include mortgages, which for some reason companies do not seem to have gone into on a very large basis.

Another factor you have to consider, as Sam mentioned, is the regulatory side. John Alden didn't file statutory quarterlies until this year. We have had seven states so far that have asked us to do so, primarily because of the fact that we're issuing annuities. Another thing that you see on the regulatory front is the states asking to see the market value of assets. I think a lot of the push behind that has been the California Department. And I think it's a trend that's really going to be prevalent in the future. The arguments against it are not very convincing. The final thing that we see on the regulatory side is there are a number of states actually looking for a demonstration of your matching. New York is the first to use one of the higher valuation interest rates. In that state you have to do a discounted cash flow matching demonstration every year to use the higher valuation rates. As chief actuary, you have to certify the demonstration.

In summary, you have to look at your investment philosophy. You, as the actuary, have to get personally involved to make sure that it bears some resemblance to your marketing, to your surrender penalties, etc. You are going to learn a lot about investments that you never knew from the syllabus. If that's not something that you're up to, then this will not be your cup of tea.

MR. AFFLECK: Pat Maher, do you have any comments?

MR. MAHER: I am not an expert in investments, but it is a complex situation. It involves work and means your investment people taking risks. You are an intermediary, you're not a non-risk taker. The large mutual companies in this country between the 1940's and 1950's who managed money in their traditional fashion really did a disastrous job. When interest rates were high, they were out about \$20 billion of policyholders' funds. If they had to be liquidated at that time, they would have taken a loss of \$20 billion. I don't call that money management. I think some of the smaller companies in this business who've been working harder, taking more risks, and managing their portfolio a lot more actively have done a better job than that. With regard to Sam's comments about the variable annuity, I agree with him that the variable annuity is going to enjoy a renewed market stance, especially if the Bull Market continues. All I am saying is that on page 34 of the prospectus under the tax considerations is a point that neither the retailer nor the consumer understands, but will someday understand, because it will come back to the rue of all of us. It is the form of punitive taxation, buying a capital growth vehicle in the variable annuity. If it is not disclosed and understood, the retailer will come back at you, and the consumer will come back at him. Why build your business on that? That is simply lack of disclosure, or perhaps too much disclosure, because that's a pretty thick booklet nobody reads. All I am saying is why not invest for capital growth with a qualified dividends portfolio. Do it right, and disclose while you are doing it right. If you want to go for long-term money management and get fees that way, go into the mutual fund business. It is a better thing for the consumer, and in the long run it will be better for you. Manage money outside the variable annuity for long term capital growth.

MR. AFFLECK: We are going to move on from investment-related issues and discuss product design and cost considerations. Our lead-off panelist will be Cal Winter.

MR. WINTER: This is kind of a difficult situation for me. I was told I was going to talk about pricing considerations and that one of our major marketers was going to be on the panel. So, in deference to Pat, let me start out this discussion by saying that we do not make any money on the product. I am not sure why we are still in the business. Having said that, let me launch into it.

The first thing I'd like to do is give you an idea of what my perspective is. For the John Alden Insurance Group, the single premium deferred annuity is our principal annuity product. From 1980 through 1982, our sales averaged about \$185 million per year. We currently have about \$650 million of SPDA accumulation values under management. Our second annuity product is a tax-qualified flexible premium annuity for the IRA market. In 1982 we placed about \$20 million of premium on that product and that was

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our first year in the market. We have about \$40 million of accumulation values for qualified flexible premium annuities in our portfolios. As far as marketing is concerned, we don't have any captive agents. We sell two ways; through the wholesaler, principally MSM, and also through ordinary insurance agents that we approach through a brokerage network. SPDA's are sold through both distribution systems. We sell very little flexible premium annuity business through stock brokerage wholesalers. There doesn't seem to be much interest there in this product.

With respect to current trends in product design, I will give a few ideas of what's going on with SPDA's. The first would be the removal of what would be called "nuisance fees". SPDA contracts originally had service fees of perhaps \$25 a year, possibly from excess interest, with flat dollar fees on surrenders as well as a percentage of accumulation. Those have been pretty negatively perceived. John Alden is probably one of the last companies doing something about that, and we're in the process right now of changing our policy forms.

Another trend would be more conservatism on "bail out" provisions and surrender penalties. At the point that we entered the market, it would be typical to see around 100 basis points between what your initial rate is and the "bail-out rate". (If the company ever goes below this rate, there will be no surrender penalty.) Bail outs now range up to 225 basis points. A newer bail-out feature is called a "window" bail out. If you go below this rate, money has to be withdrawn within typically the first 90 days to avoid the surrender penalty. At one point, as long as you were below the bail-out rate, it was pretty common in the market that there would be no penalty on full surrenders. In surveying contemporary products, the surrender penalties seem to be more conservative - they are decreasing slower and in some instances are a little higher in the earlier contract years.

The last trend that we see is renewal interest floor guarantees have come up. That probably has a lot to do with the new annuity valuation laws. Where earlier the long-term guarantee might be 3% or 3.5%, it is now probably in the 4% to 5% range for one year SPDA products.

There are also a number of companies that are out there with longer term guarantee SPDA products. My own company and our New York subsidiary have experimented with a five year guarantee product.

There are two types of long term guarantees: those with and without market value adjustments. Contracts without market value adjustments will have a high initial guarantee period of somewhere in the 3 to 5 year range. And the initial interest rate would probably be around 50 basis points less than for a comparable one-year product from the same company.

There perhaps is not a great deal of theoretical basis for the 50 basis points differential. Any theoretical differential would depend on what your vision of the future is for interest rates and at what point in the interest rate cycle you assumed that contracts were purchased. The theory is, however, something you have to be very careful about with this type of product. Our initial sales results show that when rates appear to be going down, money comes in. But when they appear to be going up, you get very little money on this type of product. If you were to assume that you would get an even spread of money between when rates are going up and when they are going down you would have real problems.

The second type of long term guarantee product is the type with market value adjustments. We do not have this type of product. We have looked at it.

A typical product would have interest guarantees for about 10 years at issue, but the guarantees may not be level. In addition to regular surrender penalties, there are market value adjustments in the accumulation value. If the new money rate for comparable contracts with the company is less than your contract's rate, then there would be an upward adjustment. If the new money rate is more than your contract's rate, the adjustment would be downward. One problem with this type of contract would be to demonstrate nonforfeiture compliance. Unless these contracts are sold in employer/employee group situations, they would be subject to the new annuity nonforfeiture law. To demonstrate strict compliance with this law, it would appear that the company would have to place a maximum limit on market value adjustments on these contracts. What that maximum would be would depend on the duration of the contract. The adjustment might be capped at a 200 basis point rate differential in the first year. And it would quickly grade up to somewhere around a 1000 basis point differential in year 5.

What are the advantages of a market value adjustment? One would be that it would allow you to use a higher valuation rate. For 1983, with a typical market value adjustment contract you'd be able to use 11.25%, versus 8.75% for a one year SPDA contract. Another advantage to the company is it would give you some protection on disintermediation. For some companies, this type of contract is a large portion of their sales, and they no longer get much out of their one year contract. It seems to vary, however, primarily relating to who they are distributing through.

For flexible premium annuities, the principal product trend would be the move to "new money" interest from portfolio interest. Portfolio contracts were probably adequate when rates were fairly level from year to year, up to perhaps the mid-1970's. Contracts that are competitive now will give different interest rates to different pieces of money.

The advantage is that the company can, with an acceptable level of risk, move beyond short term investments into intermediate term investments.

The disadvantages are the administrative system complexities. For example, when you have to figure out which investment generation to assign a particular partial surrender to, then apply a surrender penalty, etc., it gets complicated. For the actuary, new money is also difficult because you will undoubtedly get a great deal more inquiries from policyholders than only the actuary can answer.

Another flexible annuity trend is that initial surrender penalties have been reduced. These penalties are probably now around 8% initially, graded down over time. Along with penalty reductions, commissions have reduced in the first year and leveled by duration. That is a big change from 3 or 4 years ago when it was fairly typical to have something in the range of first year loads and commissions of 40% of premium.

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In addition to product trends, I was asked to comment on group versus individual policy forms.

Prior to the new nonforfeiture law, it was typical for companies to try to use group policy forms to file their annuity products. This would allow a different set of nonforfeiture values. On the valuation side it would allow more acceptable valuation interest rates.

Those advantages are no longer there. The new nonforfeiture laws make a distinction not between group and individual forms, but between employer/employee group contracts and all other types of group contracts.

There are some companies that still use group forms. The advantages might be that the group form can be used to provide "proprietary products" for a particular distributor. That way you do not have to worry as much about discrimination problems, or explaining to different people why a particular distributor has a unique product.

The other advantage for group forms would be that they may reduce the number of states you have to file in. The second advantage has been hurt a lot by the failure of a lot of the group health insurance trusts. The various state insurance departments' reaction has been to say that although yours is an out of state policy, if you issue to our citizens, you really need to file the forms for our approval. Perhaps people are not as mindful of these filing requirements as they might be. Some people's attitude appears to be that it is not the law because we have not been caught yet, That's sort of a dangerous philosophy.

A final consideration on the group form side is what constitutes a legitimate "group". And that will vary a lot from state to state. Some will strictly define group as an employer/employee relationship, and some will be a lot more generous than that. If you are using group policy forms, you would be well advised not to assume that any one definition applies across the board and to look at it on a state-by-state basis.

What are the pricing considerations? Allan had asked me to comment on what was "spread", and what kind of spread does it take to cover your expenses. And in my notes I replied to him not to give your management a rule of thumb like spread to look at across the board with this product. I have a general senior management maxim: "If you cannot explain it to me in ten words or less, it cannot be true". If you give your senior management a rule like 100 basis points of cost, 125 points or whatever, they will never look at anything else thereafter throughout your lifetime.

There are other sources of revenue on this product besides investment spread. There are front-end loads. At one point these were significant, now they're generally restricted to passing on premium tax to the purchaser. There are surrender penalties and what they mean as far as revenue varies by contract. Typically, they would provide 5% to 10% of revenue on SPDA's and perhaps 5% to 20% on a flexible premium IRA. (We, as an annuity writer, look on revenue in the sense that somebody might with a variable annuity. Revenue is not premium; revenue is whatever money we have to cover our expenses, etc. Investment spread is the difference between our gross investment yield and what we credit. There may be surrender spread, the difference between the reduction in the accumulation value and what we pay out.) Interest spread is the principal part of your

revenue stream, about 90% to 95% for an SPDA and as low as 70% to 80% for flexible premium annuities. And the last item that you have is administrative fees. I mentioned that they are less common now for SPDAs. At best they would previously have provided about 5% of your revenue. They provide about 10% or 15% of revenue for a flexible premium annuity and are relatively common there.

Investment spreads do not have a strong correlation with your expenses. The relationship will vary according to average contract size, persistency, surrender penalty pattern, and the assumed time value of money on borrowed capital. You will want to do a lot of testing for sensitivity with your particular product design before you settle on some sort of rule of thumb for your management as far as what spread is needed on investments.

What are the keys to pricing?

Economies of scale are a lot more important in this product than you might at first think. The first reason would be systems requirements. Most annuity products, particularly "new money" flexible annuities, are highly system-dependent. You cannot run these products out of a shoebox. Nor can you have your actuarial student do it on a mini-computer or anything like that, and still have any respectable financial reporting. It is very important to have the timing between what goes up on your valuation system and what goes into your ledger down to a gnat's eyelash. If you miss by one contract, that may be a \$250,000 pop to your earnings.

To give you an idea of what some systems' costs can be, at John Alden right now we're gearing up to comply with TEFRA changes for policyholder reporting. On withholding for interest and dividends, if you add up all systems and administrative costs, we are probably going to invest \$100,000 in upgrading our system. It is not really a cheap process.

As a percentage of premium, your margins on annuities are a lot thinner. If you're doing traditional asset shares on an SPDA, there might be 1% to 2% at best. Therefore, it will take a lot of premium to pay for expenses. A second area where economies of scale are particularly important is in investments. A successful annuity operation will absolutely require a separate investment portfolio. There is no way you can look at your annuity funds intermingled with anything else and get any sort of sense out of them. A successful company will need investment expenses of no more than 10 to 20 basis points a year, and most companies that are competitive are in that range. The ways you keep those expenses at a reasonable level are by using large trading lots and spreading the expenses of providing more frequent and detailed management reporting over a larger portfolio. Some of the more attractive investments from a yield standpoint, such as commercial mortgages, will have large minimum purchases. An additional consideration is that it is difficult to have a small portfolio with the requisite investment diversity. A general impression right now is that you'll probably want to have about \$100 million of premium a year, and have at least \$150 to \$200 million in your portfolio before you are going to get the requisite economies of scale on investments to get the diversity, and to get the more attractive yielding investments. I guess I would regard the costs for reaching these amounts as your entry fee to the market at this point in time.

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A couple of final considerations on pricing would be to match your surrender penalties to unrecovered acquisition costs. And, I cannot under-emphasize this point - do not front-end your GAAP earnings. You will be stepping into a bottomless pit. There is a lot of discussion on this right now in the industry. You, as the actuary, place yourself behind the eight ball. Management won't be able to match last year's earnings unless this year's sales match last year's sales. That's what happens when earnings are front-ended. You'll be perpetually in a problem, and you're going to be faced with some real dilemmas.

MR. AFFLECK: Pat Maher, do you have some observations on product design?

MR. MAHER: In exchange for market valuation, you accept the benefit of long-term guarantees as a consumer, and they can be very beneficial, if that's the kind of money you're dealing with. I think that if rates are going up, all deferred annuities are affected, whether it is one-year guarantee or a ten or a fifteen year guarantee. Both the salesman and the consumer are concerned about locking in a lower rate. If there is a psychology of rates going up, it affects sales.

MR. AFFLECK: Sam Weinhoff, any comments?

MR. WEINHOFF: I do the pricing for our annuity product. I also do a lot of the product design, so people are always calling and asking how do you actually price these products? Well, it is very simple. We price our products the same way as every other commodity in the free world is priced. I find out how the competition is pricing their products, and I decide if I am going to be over them or under them. But believe me, if you are under the competition, you are not going to sell this product in the long run. Since we use the brokerage system, they are eager to notify me of any price changes among my competition. They are certainly eager to tell me when someone's interest rate is moving up in an attempt to get me to move up too. Once I have a sense of where the annuity market is, I then look at where the bond market is trading, and where the cash market is trading. The difference between what I have to pay to get funds and the yield I can obtain in the bond market is, of course, the spread. There is a certain minimum spread that we have to get before we will meet our competitor's price. If we can't get this spread, we will not meet competition, and that's one of the reasons in the last 18 months we have only written \$300 million of premium because if we had met our competition, we would have written far in excess of \$1 billion. We've seen in certain markets, particularly in the third quarter of last year, credited rates by some of our competitors that were wholly uneconomical, and we know their costs because they're basically the same costs as ours. We know how they are investing because we study our competitors, so I can only assume that what they are going to lose on the spread they hope to make up on capital gains profits when they sell the long bonds. They are hoping that rates go down and they'll make a lot of money that way, but we have not been playing that game. Another point I would like to cover is product design, which is crucial to the success of an annuity product. There needs to be a perfect synthesis between the actuarial, marketing, and investment departments. I must talk to the actuary at United Pacific Life every single day, and if you're not talking to your investment people every single day, you are not going to make it in this business. It is important to keep each other informed. Our actuaries received a real investment education through this process, and I've learned how to do profit testing through a very painful

process. You are talking about two people that never had to communicate before now having to communicate very intimately. We deal direct with Hutton, and we use a wholesaler for other firms, and I talk with the wholesaler at least three times a week. You just have to be on the pulse of this market, or else it's going to get away from you. And that is what I wanted to add on pricing.

MR. AFFLECK: Our panel have tried to cover most of the issues that were in the program. I think there have been a few controversial comments. We would like to open the floor for comments and discussion. If you intend to offer some comments, please use the microphone and identify yourself and your company.

MR. LORNE CAMPBELL: I do not usually stand up at meetings, but personally I find myself disagreeing with much of what has been said. There are a few comments I'd like to make to introduce a new dimension. Manufacturers Life has been in the single premium deferred annuity business to some extent for five years. We have not been a major writer compared to the companies discussed today. However, we recently introduced a new product which could improve our marketing effort.

The first thing I disagree with is that these products are going to be sold by rate, rate, rate. I certainly hope that is not true, as we do not have any plans for having the best rate. We plan to have a competitive and affordable rate, but it may well be 100 basis points away from the market. I consider 100 basis points to be a substantial level of profit from this sort of product.

I'm really pleased to see partial withdrawals, but is this something we normally have to worry about in terms of amortization - that that money simply won't fall out to any great extent? Our policy does not allow partial withdrawals, and I know Pat will say nobody makes partial withdrawals anyway, so it's probably not that big a deal, but I am quite happy not to have to worry about partial withdrawals.

It was mentioned that one company, and it may well be Manufacturers Life that was referred to, is passing on market value with the market value adjustment. Ours does not operate in the first year because we guarantee principal. We do pass that risk along to the distributor to the extent that, if the return of principal feature is exercised, the distributor returns his commission and that is not an issue with any of the distributors we deal with. They understand the logic and the reality of that.

I was surprised to hear there was only a 50-75 point basis spread between single A industrials and 20 and 30 year treasuries. If that is true, then 14.5% certainly isn't an available rate, certainly not a rate that we can sell at Manufacturers Life.

The other thing I want to bring out is a potential change in the law that will require all deferred annuities being sold in Connecticut to abide by certain principles. First of all, the maximum interest rate guarantee will be one year, which would immediately affect the Manufacturer's product because we are at five years since we figure that is consistent with the positive yield curve. In addition, the one-year guarantee cannot be more than 200 basis points above a 6 month treasury. Your surrender charge would be limited to 5% in the first year, grading off to nothing at the end

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of 5 years. What is critical about it is that any company selling a product not conforming in any state will not be able to transact any life or annuity business in Connecticut. I am told that the Connecticut Department was deadly serious about this. If there is any group from Connecticut that could comment on that, I would be very interested to hear about it.

One other question - the chap from John Alden indicated that they split their distribution between brokerage and MSM. If he would like to contribute, I'd like to know what your split is on the business.

MR. AFFLECK: Thank you for your comments. Is there anybody who would care to comment on the Connecticut Department ruling question?

MR. WEINHOFF: We were asked to appear, and then they changed their mind and said it meant not only us, but every annuity writer in the state. Then they changed their mind and said they had a whole series of written questions they wanted us to answer. I've seen those questions. They basically have to do with what we are investing in. They already know from our Schedule D. Also, how we monitor the spread, is it something we look at once a quarter, once a year, but in fact, in our case it is something we look at every day. They actually wanted to see formats of our internal reporting systems, for which we have a lot for annuity products, and we were happy to share this with them.

MR. AFFLECK: Does anybody else in the room have a comment on that issue?

MR. MIKE WINTERFIELD: We have basically been told that we would be asked to put together some kind of actuarial memorandum with something showing that business is being offered on a financially sound basis.

MR. AFFLECK: Would anyone on the panel like to comment, Sam in particular, on the investment yields available?

MR. WEINHOFF: First, a lot of the rate has to do with your distribution system. If you are distributing through the brokerage houses, you have to have a competitive rate, and I would say that means within 50 basis points of the top of the market. The broker has Charter and First Executive, and he has you, and if you're not within 50 basis points most of the time, he's just going to drop you. He is not going to sell your product, because he's going to find a hotter product that will give him a higher rate. However, if you're selling through career life agents, you may be his only annuity or annuity-like product, so rate is not as important because the guy does not have much to compare it to. So it depends on your distribution system. Second, I'd like to talk about the chain letter theory, to defend First Executive. I'd like to say that they have taken advantage of this bull market and raised a tremendous amount of equity. They are very heavily capitalized, their balance sheet is very strong, and I think if you took their balance sheet and valued all the assets at market, you would see that they're more than one hundred cents on the dollar. Also, First Executive hasn't gone the way of Baldwin-United. They own almost no stocks. They run a very clean operation in that sense. On the spread point, when I said the spread between single industrials and treasuries was 90 basis points, I was not implying that single A industrials yield 14.5%. In fact, it is something more like triple B or double B. The last point I want to make concerns models. When we decided to enter this business, we had

consultants come in, and we looked at several models. We agreed on a great model. We found out the problem is that you cannot invest that way. They say you have to have x% in this, and x% in that, and y% in this. But when you're taking in large amounts of money, like one single day we wrote \$35 million, you can't sit around waiting to find an optimum model. You have to put that money to work or you are going to take a terrible penalty. You'll be getting the short overnight rate, and you are also taking a terrible investment rate. In other words, the rate could go down, and you are still sitting with \$35 million in invested cash, so most of these models just don't work when large amounts of premium come in. They do work in smaller amounts.

MR. DON CODY: I am a consulting actuary, and I am chairman of the Society's Committee on Valuation-Related Problems and a member of its C-3 Risk Task Force, which is the task force which has been studying for two or three years the effect of the risk of disintermediation. I find this discussion very interesting. There has been a large amount of business sold, and the only way it could be, namely, at the market rate. Obviously, it involves speculation as to what the trend in interest rates are going to be in the future. I want to look a little into the future, not from the point of view of criticizing what you have done. You have already done it, and you are going to continue to do it in some fashion or other. What I see happening is that the valuation actuary is going to have to take into account the relative matching of asset cash flow and liability cash flow, and he is going to have to make a statement that the reserves held by the Company make good and sufficient provision for the risks. This means that he has to decide in some fashion or other what kind of scenarios are within the range of reasonable for reserves. These scenarios almost certainly are going to include down side interest scenarios with positive yield curves and upside scenarios with negative yield curves. When you have an upside scenario with a negative yield curve, you are going to have a problem that has been mentioned here of outflow, because short-term yields are more attractive than what your portfolio will allow you to pay. When you have a down side yield curve, or when you have a down side interest movement with a positive yield curve, and you've invested short, then the market will offer better rates with long term and you can't meet those rates. We see some tests of perfectly high-probability scenarios that require a great deal of additional reserve. I meant to say that the Standard Valuation Law is a minimum valuation law. It was approved by an advisory committee of actuaries in 1979 on the grounds that what I have been talking about was going to happen as soon as the actuaries could be educated to doing this. I believe that for the kind of contract you are taking about, the Standard Valuation Law provides an inadequate reserve. It does not mean that the company must set up a higher reserve, but it must have surplus available to provide for the sort of losses that the reserve might otherwise have. So, I suggest that in companies with large amounts of this business, you begin to think about this situation, because in the future, there may be some serious questions arise.

MR. WINTER: Can I say something on that? I think that companies are concerned about it now. I think the Society is belatedly getting around to saying that actuaries should look at the asset side. The actuaries of companies that are heavily involved in this market generally have been looking

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at this right along, even though your professional guidelines may say that at this point, because we haven't gotten around to codifying it, you are not responsible. I doubt that the actuary would be held blameless if something went wrong.

I see a lot of people reaching the conclusion that this line is inherently more risky than other lines of business. Certainly, anybody that has been in the ordinary business with 5% and 6% policy loans knows what the risks of negative cash flow are. Is there a surplus requirement? Yes, there is, but anybody that writes group health or other lines like that knows that there's a surplus requirement for almost any line that you have. You cannot run with a next-to-negligible statutory surplus for any line of business that you are in.

It is very important that you learn asset/liability matching. The problem I see with the proposals that are going out is that discounting cash flows is not necessarily going to give you an appropriate conclusion on what acceptable matching is. The problem, of course, is the people that enforce these things are regulators, and I don't mean that from a negative standpoint. But it is the nature of their job and the way they are judged that they must have an objective matching test. And I do not really know that there's any purely objective test that you can assign to this.

MR. CODY: I agree with everything that you've said. My point is that I don't think regulators can do this, only professional actuaries can. I am delighted for you to say that you believe in this. What I say is that it has to be required.

MR. WINTER: I have a vested interest if something goes wrong, because I'm going to be the first one that people will go looking for.

MR. CODY: What really brought me to my feet was the thought that you might have a 10 or 12 year average asset duration in a product that can have very, very short liability.

MR. WINTER: Oh no! Our average duration at John Alden is around 6 years. And there is a very specific reason for that. That is about the duration that our surrender penalty grades off. Granted that surrender periods may vary from company to company, and that this will have a great deal to do with what your maturity duration should be. If your penalty is gone at the end of six years, that means that you no longer have protection as far as people taking their money elsewhere. And you are really betting your company if you go longer on the hopes that rates will be lower when the penalty expiry shows up. That's a wholly unacceptable risk, at least from our standpoint.

MR. CODY: I hope that nobody thinks you and I are arguing with each other.

MR. AFFLECK: I am chairman of an Academy Task Force that is considering how the current statement of actuarial opinion might be extended to recognize the need for the actuary to deal with the risk of asset-liability matching, and I too would second what Don has said. One of our speakers talked about the increase in surplus in the company, and there is a need to recognize that additional surplus is required for this line of business, that the statutory reserve is a minimum reserve and that you need to have surplus

supporting it that's consistent with your investment policy and the particular matching of assets and liabilities you have in your company. You need to test alternative scenarios.

MR. NAFTALI TEITELBAUM: Just one short comment may be appropriate on one of the items mentioned by the speaker from Manufacturers Life. Executive Life Insurance Company has built up its surplus from the 1% approximately as shown in the annual statement to just about 6% of its liabilities today, which I believe makes it one of the strongest companies, and should be borne in mind with the possible shakiness of some companies that have been mentioned. It is the new wave today. You just cannot say I am offering great interest rates. You have to show some strength for the ultimate seller of the annuity to buy your product.

MR. BRUCE NICKERSON: I'd appreciate it if the panel members would discuss a little further the comments that Mr. Weinhoff had on the long investment increasing interest rate scenario, assuming Mr. Maher's hypothesis that, because of changes in the tax law, the market is dead, that it will not be possible to sell large volumes of additional product. Where does that leave the company?

MR. WEINHOFF: When Pat Maher told me about this thing, my first reaction was this will kill the market. My second reaction was isn't that great, because I wrote \$300 million of premium with a coupon of 18% and if you mark that to market, we have a huge unrealized gain, and if no one is writing the business, where's my guy going to disintermediate to? Sure, he can roll it over, but all I have to do to keep that business is continue to offer a competitive rate. Believe me, if the tax consequences are as adverse as Pat said, there's not going to be a First Executive, there's not going to be a Charter, because brokers just aren't going to be selling this business. It is the brokers who twist and disintermediate the business, and if they're out, I think we're more protected from disintermediation than ever before, if what Pat says is true.

MR. WINTER: We may be somewhat protected among ourselves. I remember when TEFRA came through there were changes in first-in and first-out interest, and there was a penalty. The original draft of TEFRA said you are grandfathered only to the extent that you stay with the company that now has your contract. There were a lot of salesmen, of course, that were not very happy about that. But that was changed to money being grandfathered, but it could move from company to company and preserve that grandfather status. If this portion of the law does stay, I would be very surprised if the grandfathering didn't allow you to move it from company to company. And there are, of course, obvious opportunities for salesmen there, although it may limit the amount of additional money that may move into the market.

The things that are in this law are not chiseled in stone. There have been a number of changes made so far from the original proposal. As I said earlier, originally all money was going to have to be annuitized at age $7\frac{1}{2}$ but now that is gone. In the first draft of the law one way to avoid the surrender penalty was to annuitize in level payments over a 10 year term. But we are now back to a 5 year term, which is where we are under TEFRA. There does not seem to be much movement on giving up the 10 year, having to keep it to age $5\frac{1}{2}$ feature to avoid the penalty.

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My own feeling is that this contingent annuitant question is something that may be resolved, and possibly favorably for us. We cannot count on it happening automatically, but I think it is something that will change if there is concerted lobbying effort.

MR. JACK FAHRENBACH: Perhaps a naive question here. Are your sales sensitive to commissions? You say they are very sensitive to rate, rate, and rate. A related question - do you ever pay renewal commissions to keep the business from leaving? We've been asked that by several of our agents. Lastly, if it's not proprietary information, what kind of profit margins do you shoot for, either on an after-tax or before-tax basis? We have recently designed a new product, and we're hoping for something like 25 to 50 basis points after tax, seeing that that is somewhere in the neighborhood, in our point of view, of what banks are earning on accumulation-type vehicles.

MR. AFFLECK: Anyone have a comment on the sensitivity to commission?

MR. MAHER: The basic commission on a fixed, deferred annuity has been roughly around 4%. Where the sensitivity has been is from some firms or agencies who have looked for more, but as far as I know, they have never shared it with the retail agent at the point of sale level. I do not know of an occasion where that was ever shared. The firm has kept it. Some firms have invested it in a marketing effort and have performed well for the issuer. Some firms have not invested it in a marketing effort, and there's been a lack of performance. If you've been number one on your rate and number one on their hit parade, and you were sold, you would have been sold whether you paid the extra commission or not. But I know for fixed deferred annuities, the commission has been 4%, and it has been basically stable.

MR. WINTER: I would say the basic writing commission is pretty flat at 4%, and overrides to wholesalers have come down somewhat over the last couple of years. Rate is a lot more important than commission, at least to the extent that we can see.

On the profit side, I wouldn't really choose to share our profit objectives with you other than to say we look at return on investment and at spread. The return on investment on this type of product is very sensitive. I guess a rule of thumb is that four basis points improvement in your spread is about 1% improvement in your after-tax return on investment. So a little swing in your assumptions as one which causes 20 more basis points of spread would improve your ROI 5%.

After you've looked at your return on investments, you should settle on some sort of a minimum spread.

MR. BERNARD RABINOWITZ: Earlier on, Cal, you said that the withdrawal charges were to recover your acquisition costs, and in response to Mr. Cody's comments, you mentioned that the length of your assets were tied in with your withdrawal charge. It seems to me that you meant your withdrawal charges do double duty.

MR. WINTER: Not really, I'm not looking on the investment side as withdrawal charges covering my investment loss. What I am looking at is that they are a deterrent to surrender to the extent that it takes a period of time for the person reinvesting their money to make up the penalty. That deterrent is there regardless of what income I realize out of the penalty.

MR. RABINOWITZ: Let me ask you another question. The annuity business is relatively new, and there are very few companies that have gotten down to 0%, 1%, 2%, or 3% withdrawal charges, and if you are 100 basis or 200 basis points out of line, there's some very slight loss of confidence in what your company's going to do. What is the deterrent between the 1%, 2%, or 3% withdrawal charge? I really think that your period is much shorter than the withdrawal charge payment.

MR. WINTER: I do not believe that any surrender charge would stop withdrawals across all possible differentials in interest rates. Several years ago we saw that a 7% flat surrender charge did not stop surrenders when there was a really large interest rate differential, perhaps 300 basis points.

I would like to make a point about career agents, or independent agents. Four years ago or longer I would have said life insurance agents would not sell deferred annuities. Of course, no sensible life insurance agent would ever work for 4%. Well, I think something happened along the way. I think the life insurance agent figured out that 4% of a \$25,000 average SPDA premium is \$1,000, and 75% of a \$300 minimum first year ordinary life premium is \$225. I can tell you that, although 4-5 years ago I thought life insurance agents would never sell deferred annuities, today they are the biggest sellers for us. We have our independent agent results reported as one group, and they outsell the aggregate of all security firms producing for us. They are the best retail firm we have.

MR. WINTERFIELD: I'd just like to briefly comment on the viability of SPDA's under Stark-Moore. I would think that we will be scarred, but I think that we will still be alive. As I look at it, the core tax value will still be there, namely, 11% deferred is better than getting 11% in a currently taxed bank CD. Also, in regards to the variable annuity, I think that the variable annuity is viable where a company is willing to work with the unit invested in trusts and generally short-term gains.

MR. AFFLECK: I'd like to bring the session to a close and ask you to express your vote of thanks to our panelists. Thank you all for your participation.