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Recorder: JOHN C. VIEREN

MODERATOR-MR. BRUCE L. CALDWELL: I would like to start this morning's session off with a quote of one of the several hundred articles which have appeared in industry and national publications regarding annuities over the past three or four months. This particular article was written by a gentleman by the name of Leonard Slone, and the article is entitled, "Annuities: A Life After Baldwin United's Fall". The quote goes something like this: "The reputation of annuities should have been tarnished forever. The downfall of Baldwin United left thousands of annuityholders unable to redeem their policies, at least temporarily. Shortly after the Baldwin debacle, the average interest rates on various types of annuities dropped, further tarnishing their allure."

Despite bad publicity, more and more consumers have discovered the advantages of the annuity as an investment vehicle. Experts say that premium volume will rebound about 10% this year to about $6.1 billion. We are seeing a movement toward the big mutuals and maybe some of the larger stock companies that have a reputation and a perception of sanctity, quality and safety.

Here to discuss these issues and others with me are our panel members. From right to left: Michael Winterfield, who is Vice President and Actuary of the Equitable Life Assurance Society. Mike, among his other duties, has assumed full responsibility for Equitable's annuity lines. Bobby Dunn - Bobby is partner with Peat, Marwick, Mitchell & Company in Chicago. Bobby was instrumental in drafting and writing the original Audit Guide for life insurance companies and has been active in updates of the Audit Guide. Finally, there is Jay Jaffe with Tillinghast, Nelson & Warren, Inc. in Chicago. We like to refer to Jay as the Guru out of Chicago. Jay has been active in annuities, as well as many other specialty product lines, and Jay also has been instrumental in developing a new division (the nontraditional marketing section) for the Society of Actuaries for specialty product lines.

Our recorder is John Vieren with Tillinghast, Nelson & Warren, Inc. in Jacksonville, Florida.

MR. CALDWELL introducing Mr. Michael Winterfield: When one speaks of sanctity, quality, and safety, in the same breath, one can mention the Equitable. Historically, annuities were sold on the basis of the highest interest rate available. Are we now seeing a flight to quality.

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MR. MIKE WINTERFIELD: I will let you judge for yourself on that one after the meeting. My comments will cover both the periodic-payment and single-payment deferred annuity markets (both in the non-tax and tax-qualified areas). Partially for fun and partially for historical respective, I looked at the comments that I had made two years ago before the Society of Actuaries meeting in Houston. I found that of the six forthright positions I stated at that time, only two basically have remained intact, two were altered significantly to other positions, and the last two were rejected totally. I hope this says more about the whole process of change in the annuity area rather than the strength of my convictions. One cannot make any predictions about how long my current ideas will hold up.

I would like to review briefly some of those positions that were taken a couple of years ago, update them a little bit, and then open some new territories. Let me start off with marketing costs. Two years ago, my feelings were that we had to reduce marketing costs further in order to compete in the IRA and other periodic payment annuity markets effectively. I think we found that shortly thereafter we really had gone as far as we could go during the ten-year period leading up to 1982. My figures indicate that during that ten-year period the average lifetime commission rate for a career agent dropped from approximately 6% to approximately 3%. That really was enough. If we had gone any further, we really would have killed off the incentive to sell the product.

I believe that our sales problems today in the IRA type market are primarily communications driven rather than cost driven. For example, the banks continue to write about six times the volume of IRAs as life insurance companies. Our IRAs now provide interest rates that are as good as the banks, and we provide a lot more too (namely, investment flexibility with the range of separate account options, plus annuities, settlement rates, and, of course, a trained agent). I think the key here is for insurance companies to be more comfortable with agents selling IRAs. It is not a conflict for an agent to sell life insurance and sell an IRA. There are plenty of dollars out there for life insurance, IRAs, along with all other annuities.

A recent LIMRA study indicated that, when an agent does go out to try to sell an IRA, his close rate has been about three out of ten, which is a pretty good rate.

Two years ago, I felt that separate accounts were ready to make a big move and I still think they are. My thinking, more at that time, was along the lines of expanding in the direction of money market accounts. Most of us in the industry at that time were motivated along the lines of minimizing investment antiselection rather than being market driven. Today things have changed significantly with separate account expansion. Instead of money market accounts, we are working more with separate accounts that have pizzazz (e.g., balanced

accounts and aggressive stock accounts). Our pitch is that we can build up a really superior accumulation for the long-term-oriented investor with patience.

In 1982, I called for limiting investments to the short to intermediate range to provide investment flexibility. As most of you know, with the current reversion to the normal yield curve it is competitively impossible to stay within the short range. Our approach today at Equitable is more of a balanced nature. We never will take the level of maturity risk that we took five to ten years ago, but we are more comfortable taking some quantifiable risk. We don't mind working with intermediates and telling our board members that we can withstand interest rate shifts, of say, 5% over a limited period of time. We believe now that we have a clear responsibility to minimize risk but not necessarily to eliminate it totally.

Back in 1982, we also noted the need for clear communication to our agents on both our product design and investment policy. I am beginning to think this is still the case. The agents have to know how we are playing the game. For example, they want to know exactly how our renewal interest rates are going to change as new money rates go up and down.

I would like to go into more detail in a few of these areas. First, I will move into the separate accounts. I think that here we are really in a period of very substantial expansion. Currently, we're seeing about 30% of our new IRA and other periodic payment money going into our separate account options. We don't think that we have done much more than scratch the surface with all of the necessary promotion of those options. Clearly, the 1984 financial market doldrums are going to slow down the momentum, but I don't think that's going to last for too long.

I would like to indicate five reasons for my optimism about separate accounts. The first is that once again we have some really good performance tracks to quote. The S&P 500 averaged an annual compounded growth rate of 17.3% from 1979 to 1983. Over the ten-year period (1974-1983), the growth rate still was a respectable 10.6%.

Secondly, mutual funds really have done some terrific advertising of the equity concept. The Fidelity Mutual fund group runs great ads in the New York Times every week showing their funds growth of 517% over five years and 1125% over ten years.

The third and fourth reasons are that we are offering greater contract flexibility now with combination fixed and separate account options, and the separate account options are ones that have broader market appeal. I remember back in 1979 at Equitable, our individual separate account clients were limited to stock and long-term bond investment options and when interest rates went up, they had no safe haven. They had the

double whammy. They lost both on their stocks and on their bonds at the same time. As of May 1 at Equitable, our standard contract for the IRA and other tax-qualified markets will be offering five accounts, a regular stock account, an aggressive stock account, a balanced account, a money market account, and a guaranteed interest account. Furthermore, we allow unlimited transfers back and forth except that we are not allowing any transfers into the money market account.

With these kinds of provisions, an equity-oriented client today can feel that he can take the chance on a high-growth risk account and without being locked in. You can switch to a safer vehicle whenever you get cold feet.

I would like to say a little more about some of these newer accounts. The recent proliferation of aggressive accounts (I think has largely been inspired by the Fidelity Magellan fund),but I think, in general, the aggressively oriented stock mutual funds have shown some really excellent growth rates over recent years and all that's been a spur too.

The balanced account is a more unique approach. The idea here is to allow the investment manager to vary the mix of stocks and bonds and cash based on his/her perception where the various markets are headed. This means that the buyer theoretically really can participate in an account that follows the markets and is attempting to buy low and sell high. It also makes life much easier for our agents. The clients don't have to call the agent and ask when is a good time to be in the market. The manager will make the decision for you.

The fifth factor in moving separate accounts ahead is the proposed elimination of the nonqualified capital gains tax under the 1984 tax legislation. Presently, there is a 28% tax on all long-term capital gains. Furthermore, there is a 46% tax on short-term gains unless a unit investment trust (UIT) mechanism is used. Because of these tax problems at Equitable, we pulled out of the nonqualified variable annuity market. We didn't like the cumbersome nature of a UIT. We thought it was expensive, and we did not like the idea of having to run an investment policy on the basis of churning gains within a 12-month period. However, if the tax legislation passes, we will be able to take our present range of tax-qualified separate accounts and apply them to the nonqualified market.

Now, let's move on to the SPDA market. We have begun to offer some optional interest guarantees, one-, three-, and five-year guarantees within the same product framework. Many other companies, such as Executive, also are offering a range of guarantees. One of the financial reasons why many of us have moved to the longer guarantees within the last year or two has been the changes in the dynamic

valuation law. Although there still is a sizable reserve strain under the dynamic valuation law in offering longer guarantees, it is sharply less than what it would be under the prior reserving standards.

Also in the SPDA area, we are beginning to see some exotic indexed guarantees. One of the National Home's contracts offers a renewal rate guarantee that is never less than 2% under the Salomon Brothers long-term bond index. A second contract sets the renewal rate at not less than 2.5% below the 20-year Treasury rate. These guarantees partially are backed by inflation adaptive investments and partially by hedging techniques.

One last product marketing idea I would like to cover is the combination annuity that has been popularized by E. G. Edwards and some of the brokerage houses. The combination annuity restores a large part of the tax efficiencies that formerly were provided by the use of the older 10% capital withdrawal feature. Most of you know that with the TEFRA changes, any normal withdrawals are subject to ordinary income tax on the LIFO basis, and there is a 5% penalty up to age 59 1/2 or ten years if earlier. The idea behind the combination annuity is to make effective use of the five-year installment option which is taxed under the normal annuity exclusion rules. The common form is to take a $50,000 SPDA and immediately apply, say, $20,000 to a five-year type installment and allow the remaining $30,000 to accumulate. The $20,000 going into the installment will produce about $5,000 a year, which is 80% excludable from tax. The $30,000 that's deferred will grow to about the original $50,000 at the five-year period, and then you can start all over again.

MR. JAY M. JAFFE: Since I'm supposed to be Bill Britton and I'm not, I think I'll just speak right from here if it's all right. I'm kind of like one of these ball players who sat on the bench all year and then the manager says, "hey you're hitting". That's how I found out about this. It's two out, the last of the ninth, and runners are on second and third.

I'm going to take a slightly different tact here and talk about the subject from another point of view. I'm going to be taking the point of view of the marketers. Mainly the large brokerage firms to give you some of the insight to what they are thinking at this point.

The subject that I'm going to be discussing covers really more than annuities for individuals - certainly the single premium whole life policies that you have seen in the marketplace are part of this subject as well. The due diligence that the brokerage firms are getting into right now certainly has existed since they began writing annuities and certainly prior to Baldwin-United. The activity level, however, at the present time, as far as due diligence is concerned, I think is significantly greater than it was approximately two years ago before Baldwin United.

All you have to do is look at what happened in New York State. Some of the marketers of these products have had to come through with a little extra money in order to make their policyholders or make their clients whole. This shows you the importance of the due diligence.

These are the questions that the brokers are asking. First, are the insurers assets suitable in relation to the types of liabilities it assumes when it writes annuities? This is a very important question. If you go back and look at some of the discussions that have been held at the Society of Actuaries, one of the key questions that always has been discussed is, have you matched assets and liabilities properly? The marketers of the products now are asking this question.

Secondly, is the insurer establishing suitable statutory and GAAP reserves for the annuities that it has in-force? Again, this is a question that historically might have been glossed over by the marketers of the annuities. I think they understand the importance of having a proper solvency position, that you are not in this just to report GAAP earnings, and that if you overstate GAAP earnings your healthy rosy company of today will not be so healthy and rosy down the road. Now, they are wanting to know what is going on.

Thirdly, is the insurer capable of withstanding substantial requests for cash values - on an immediate basis? In other words, how solvent are you and are you locked into long-term investments which could be or could become illiquid? Can you meet massive obligations over a relatively short period, say 6 to 12 months? This would require the company to have liquid assets and sufficient earnings which could be used as well for a period in order to pay back policyholders.

Fourthly, what would happen if interest rates were to increase? Would you remain solvent?

Fifthly, can you produce enough from your anticipated earnings (this ties into the 6 to 12 month timeframe as well), and finally, can you raise additional capital if necessary in order to meet your obligations to policyholders?

Putting it another way, I think the annuity marketers today don't want to be left holding the bag. The marketers also have become more sophisticated and they are inquiring about the Insurers to see if there are any skeletons in their closets. In other words, does the Insurer have any hidden liabilities? One such example might be federal income taxes, which, under normal operating conditions, would impact your solvency.

Essentially the marketers now are saying that if we are going to market annuities together and be an important part of your company, we want to know everything about you. The marketers are very concerned today, more than ever before, about the products that they are offering. They want to know whether their products are comparable to those offered by other companies in the marketplace, and how

competitive they are. It's not just that we have the best interest rate, but what effect will it have on our clients.

The brokerage houses are more concerned today about the brokerage business that is being placed by the insurers, especially when the brokerage house is a major marketer for an insurance company. I don't think this is quite to the point where I scratch my back and you scratch mine, but I think it is to the point where they want to know that there is at least a fair amount of commission income coming out of it for themselves, or if not, who is it going to?

They want to make sure that, if you are not possessing large amounts of surplus, that you will be able to meet your obligations in the future and, in effect, if you have not mortgaged your future for today's premium income. The marketers are very much aware of a phenomenon that is certainly not new to us as actuaries, economists, and the rest of the people who are just observant about what goes on in our country, but certainly is one that is becoming more important and they call this financial antiselection. They understand the effects of financial antiselection and what causes it. Let me give you what I think might be a fairly good definition. Financial antiselection is the tendency of a knowledgeable policyholder to withdraw his cash at a time advantageous to him and disadvantageous to the insurer. There is a clear understanding when financial antiselection will occur and then how to do something about it.

Let me just tell you first when the likelihood of financial antiselection is greatest. One of the points is when there is a relatively large amount of money involved. I think if you have a $5,000 bank account, it's a lot different than a $50,000 single premium deferred annuity (SPDA).

Secondly, financial antiselection becomes more acute when the policies (the annuities we are talking about here) are purchased more as investments than they are as insurance. Obviously, if you keyed into the concept of an investment, you are going to be more inclined to do something when interest rates change.

Thirdly, this comes back to Mr. Winterfield's point about communication, financial antiselection comes about when the owners of the annuities are knowledgeable about levels and trends in prevailing interest rates. Today, we have better communication and we have better advertising as to prevailing interest rates. Just the other day, Best's published the interest rates used by approximately, I would guess about 120 or so, insurance companies. Well it doesn't take much for somebody to go down the list and figure out that his/her annuity is not yielding what it should be.

Lastly, financial antiselection will be particularly acute when the annuities are purchased through a strong marketing organization and in concentrated amounts. When this happens, the insurer should be

very much aware that things can happen. It would be easy for the major marketers of annuities to direct their clients to take action with the money.

The most pressing problem that we face, I think, is an influx of surrender requests in this business. Here's what has happened in the past. Recently, there is the unfavorable publicity about SPDAs. In general, or about a specific company, which has a tendency to create a run on the bank. This also will occur when there is a perception of weakness of the carrier by the public, so it's very important that you have a strong carrier.

The surrenders are likely to increase when there is a change in the prevailing interest rates, and you cannot meet this for in-force policyholders. This was particularly acute when there was a high runoff of interest rates a few years ago. As a word of caution, I would mention that we are seeing the prime rates edge upward again, and living through 1979 and 1980 as most of you did, I wonder if it couldn't happen again.

There will be an influx of surrenders if one of your major marketers of SPDAs decides to tell its customers to shift funds. You have to protect yourself against that. Last, but not least, adverse tax rulings are not out of the realm of possibility today given the status of our government's need for more money.

Now, is this situation serious? I believe it can be. Years ago when we priced some of these products and had looked at blocks of business from time to time, if it's running along as planned, you might see surrender rates as low as 5% a year - 2%, 3%, 4% maybe up to 7%. Five percent might have been a good average.

Today, in an extreme case definitely but not out of the realm of possibility, the 5% per year lapse rate could be correct, except that we have to change the phrase "per year" to "per month". We could go from 5% per year to lapse rates of 5% per month and that will create problems obviously.

In looking at the solvency of the companies for some of the brokerage firms, we first define solvency as the ability to meet the companies' obligations if all its policyholders were to surrender at the same time. We ran some studies on companies largely based on published data and it indicated that even a 2% swing in prevailing interest rates, obviously upward, could cause some companies to become insolvent. It's conceivable that even as low as 100 to 150 basis point swing could cause this insolvency. The point we are trying to make here is that even a small change in prevailing interest rates

can be a very serious question to a company, especially because of the the volume of annuity business that many companies have in relation to their total assets.

The way you would do this kind of a solvency study would be to model your assets at your company and then simply change the yield rates. You would have to get your maturity dates, average maturities by years, and then recalculate the market values and apply these as compared to your cash surrenders.

Along the related line and something that in a sense has been on the table for a while, certainly something that I was part of many years ago. I'm the fellow that wrote the paper "The Application of the Commissioner's Annuity Reserve Method to fit Single Premium Deferred Annuities". If anybody wants to throw darts, I'll leave now. In the paper, one of the questions that I had was, "how do you treat bail-out or window options?" When I first was working on this (this is a matter of historical interest), the first one I saw said, "well, you are never going to pay less than the passbook savings rate". I don't know if anyone in this room has a passbook today. You can remember what that is - those are the little things about so big and you have to take it into the bank and they would record your savings and maybe you got 3% to 4%. By the time we were working with these, believe it or not, the passbook savings rate was 5% to 5.5% and nobody could conceive of ever having to pay less than the passbook savings rate. That is not what the bail-out options look like today as you have just heard.

We have seen open-ended bail-out options, we've seen these other long-term guarantees, and one company justifies their open-ended bail-out option in that the concept will be that the policyholders will feel more secure. They won't ever have to worry about the problem in operating within this 60-day window or 30-day window whatever it is around the bail-out day.

I questioned how to reserve for the bail-out interest rate back when the paper was written. I see the problem as being cleared up today by the states; in particular, there is a ruling that has come out from Connecticut. Just briefly, I will go over that and that will conclude my remarks. The ruling or regulation is such that all SPDAs and SPWL forms will be disapproved as of the 15th of April, and must be reapproved. There must be significance to the April 15th, since that is the date that we all pay taxes. The following provisions will not be approved:

1. A bail-out, if the second-year interest rate declared drops below a stated percentage, which is below the first-year interest guarantee.

2. They won't approve longer than 12 months interest rate guarantees in excess of the contractual guaranteed interest rate.

3. They are putting in minimum surrender charges of 5% graded off over five years.

4. The State of Connecticut definitely is putting a clamp on reinsurance with affiliates, subsidiaries, parents, and insurers that are controlled by the parties producing the business will require the approval of the Connecticut Commissioner.

Furthermore, SPDA and SPWL policy reserves may not be invested in parents, subsidiaries, or affiliates, except that companies writing these products may invest up to 100% of their capital and surplus in their parents, subsidiaries, or affiliates. The ruling applies to both individual policies and those group policies, which are really, in a sense, individual plans.

I know of three or four other states, at least, that are looking into this. I think this is a definite reaction of Baldwin United's situation and some others that may be on the horizon. It's kind of like closing the barn door after the cows have fled.

MR. CALDWELL: In keeping with the times and the latest game craze - Trivial Pursuit - I had my research department do a little bit of background checking on certain companies which issue SPDAs, which happens to be the product that my company is the most interested in. We do a periodic survey once a month of what we deem are our 13 largest competitors. These are companies which offer a one-year guaranteed product and this survey was conducted on March 15th. With the interest rates shooting up last month, I have no doubt that this has changed.

Of these 13 companies, the first-year interest rate guaranteed ranged between 11% and 12% (a very narrow range). As most of us who have been in the business for several years are well aware the range between the low and the high of these so-called 13 competitors can be as much as 250 basis points. Right now, a very narrow range. The average of the 13 companies was 11.34%, median 11.3%. There is another survey out, I believe Mr. Jaffe made a reference to it from Best's of 129 companies. Thirty-five of these companies had interest rates of 11% or more. Of the 35 companies, 10 paid the state premium tax, the others did not. Thirteen had a bail-out option, 4 of which only had a window only bail-out. Surrender penalties ranged from 10% in the first year all the way down to 5% in the first year. The duration of the penalties ranged from 13 years for one particular company all the way down to 5 years for some companies. The majority of the companies had seven-year surrender penalties. Only 4 had front-end loads. Only 4 had maintenance fees.

The conclusion that we come to, when we look at our competitors, is that the SPDA product, in particular, is becoming a very competitive product. The margins are being squeezed. We're seeing less and less profit even though we are seeing fewer competitors coming in and offering the very high interest rate guarantees that we saw two years ago.

The American Academy of Actuaries recently issued an exposure draft which discussed the appropriate GAAP treatment for SPDAs. Also recently, Jackson National announced, in an article published by Best's, that it was changing its accounting practices for SPDAs.

More recently, Charter announced that it would restate its earnings on SPDAs. Now, Mr. Dunn, when the Audit Guide was released, I thought the purpose of the Audit Guide was to promote consistency of accounting principles between insurance companies. Would you like to tell us what is happening here.

MR. BOBBY DUNN: One thing for sure, we are not getting much consistency with respect to accounting for SPDA or a number of other products. I would like to spend some time this morning telling you or giving you an update as to where the rule setting bodies of the American Institute of CPAs stand now with respect to accounting for some of these nonguaranteed premium products.

Back about three years ago, a few companies started writing adjustable premium whole life products and there were some questions as to what the GAAP accounting would be for that. The American Institute of CPAs appointed a task force called the Nonguaranteed Premium Products Task Force which was charged with the responsibility of developing what GAAP accounting rules would be for this one product. I happen to be chairman of that Task Force. We jumped right in, and found that we really didn't see much of a problem. It seemed to us that with respect to the adjustable premium whole life products, that the only accounting change that needed to be made, or the only clarification that was needed, was that people needed to be told to account for them just like regular whole life products, except when you do, in fact, adjust the premium, unlock the assumptions on a prospective basis, leave the reserves alone, and go forward. So that wasn't much of a chore. However, about that time, people started writing a lot of Universal Life products, and they became common. SPDAs were getting big and the Task Force charter, in effect, was changed for us to deal with the Universal Life and all the myriads of products that had come out since the Audit Guide.

We thought for a while, foolishly, that we would have a fairly easy chore, all we needed to do was decide how to account for Universal Life. If we could decide what proper GAAP accounting for Universal Life would be, then it probably would become fairly clear what the accounting should be for the entire myriad of new products that had come out since the Audit Guide. Well, we quickly learned that we weren't going to quickly solve the Universal Life accounting questions. Unfortunately, the industry already had started deciding on its own what the appropriate accounting should be. As you might know, about half the companies do it one way and about half the other way. When we get two constituencies out there lobbying with the individual members of the Task Force, etc., our decisions become very

difficult and we tend to procrastinate and not be able to make them as timely as we should. We then decided to back off and do something that should be really easy.

How do you account for SPDAs? Now most companies and most of the Task Force believe that, in fact, the existing Audit Guide and FASB 60, which is just a codification of it, did in fact deal with the SPDAs and would indicate that, in fact, it was an appropriate interpretation of the Audit Guide to say that profits should be recognized as a percentage of premium. That's what the Audit Guide says clearly with respect to single premium whole life. If that's so, and if you only have one premium, then you have all your profits the day you sell SPDAs.

While that in my opinion is still an appropriate interpretation of what the Audit Guide and FASB 60 says, it doesn't make any sense. We didn't want to have to challenge our basic literature (the FASB 60 and the Audit Guide), but we concluded (after about two years of debates) that, in fact, something had to be done with respect to the accounting for SPDAs. Maybe if we could solve that and say what the accounting really should be, then maybe that would help with the Universal Life question.

About the middle of last year, the Task Force finally came forward with the draft issues paper (many of you may have seen it). It was circulated quite widely. It has no authority as of yet. It hasn't even gone past the insurance companies committee of the American Institute but, in fact, it has become defacto GAAP because the Securities and Exchange Commission (SEC) got a copy of it. Naturally they were concerned about Baldwin and some of the other SPDA writers and so they concluded that, for any company who wrote a material amount of SPDA business, that this exposure draft that the Task Force came out with would, in fact, have to be adopted by any registrants dealing with the SEC. I think that word is pretty much around now, and I think all the major writers of SPDAs now are following the accounting suggested in the exposure draft. The bottom line says that there will be no profits recognized at issue. Without saying it, but in fact the new accounting is that the investment spreads have, in effect, become the revenue to determine profits.

One can determine profits on any SPDA according to the issues paper that we came out with. That paper says you can do it one of two ways. You can set up your full accumulated value as a liability and defer your deferrable acquisition cost amortizing those costs forward in proportion basically to investment spreads and maybe some expense charges, surrender charges, etc. They pretty much use a straight forward approach. That was the earliest position we had. Then in close cooperation with the number of actuaries who have been working with the Task Force suggested that, well if we are going to deal with the Universal Life issue, we ought to have something a little bit more sophisticated and a so-called prospective method of accounting for SPDAs was developed.

With respect to the overall contract, put in all of the actuarial assumptions that you normally would put in lapse rates, etc. and then to solve for the interest rate you would have to exactly break even at issue so that the interest assumption can be used to discount the SPDAs. In effect, the break-even assumption. In either case, profits emerge as realized as a percentage of investment income as it is actually earned.

As I say, this probably is not officially GAAP yet, but I can tell you for sure that if you are going to deal with the SEC, that is what you are going to have to do in accounting for SPDAs.

After that project was completed, we decided that it would make more sense if we would put the SPDA issues paper aside and go back to dealing with other products. Well we better put that aside and before we lock it in stone and it becomes, in effect, accounting law (that incidentally won't happen until it goes before the accounting standard board and they deal with the subject). We decided maybe before we get to Universal Life, let's try one other annuity kind of product and we started taking a look at periodic payment deferred annuities.

This gets to be a little more difficult of a question. The question is not so much as to what good Accounting might or should be, but the fact that it is absolutely clear when one looks at the literature and existing Audit Guide that the periodic premium annuity would clearly, under traditional GAAP accounting, have profits emerge as level percentage of premiums. Does that make sense in view of what we decided about SPDAs?

A concensus was developing that would indicate that no, it didn't make sense. It became fairly clear that a majority of the members of the Task Force were leaning towards saying we just got to change our basic literature if it makes sense that profits should emerge not as a percentage of premiums but as a function just like any other investment vehicle. This probably should be true for any annuity product - any true interest-sensitive product. This, of course, is a very radical possibility. We decided before we got down that road, to stop that and get back to our main charge of dealing with Universal Life. That's what we currently are working on. I can't tell you what the answer is going to be with respect to Universal Life or flexible level payment annuities, but I will tell you that its looking more and more like that we will abandon the concept of having profits emerge as a percentage of premiums. I don't think we will change the definition of premiums as revenue, but it's beginning to look like, certainly with any interest-sensitive product, that the bottom line answer is more apt to be something similar to SPDAs where we will be asking companies to solve for break-even interest assumptions and let profits emerge that way.

We have looked at the ten-year fixed annuity with a level premium, Steve Summer with Milliman & Robertson did a few calculations with us. Some of you might be interested in just how dramatic the difference

might be for a typical product that was going to have $33 worth of profits over the ten years (that was the best guess anyone could make). If one used the traditional Audit Guide approach, saying that premiums are revenue and all costs must be matched with premiums, and therefore profits emerge as a percentage of premiums, the traditional GAAP answer would be something like $5.92 profit in Year 1 down to $4.22 in Year 10. The present value of $33. If one determined profits using a prospective type calculation, solving for break-even interest, instead of $5.92 profits the first year, you would have $.60 profit. A rather dramatic difference. I think that when a number of companies see this kind of result that we better be doggone sure of our ground before we made such a radical change. That's why we are back to the drawing boards studying it.

I wish I could stand up here today and tell you what the final answers are going to be. I will tell you that we are under a tremendous amount of pressure to come out with an answer before the end of this year that will answer all the new products - Universal Life, SPDA, and flexible annuities. Any of the products that have come forward since the Audit Guide that we need to have a paper and intend to have a paper published by the end of next year. That is going a whole lot faster than a group of accountants are used to working, but I don't think the SEC is going to let us wait any longer. If we go through the normal deliberative process and wait another year or two, I'm rather certain that the SEC will decide they will usurp the FASB rule making authority and they will tell the industry how to account for any interest-sensitive product.

Premiums on interest-sensitive products, including all annuities, will no longer be revenue based. Revenue will be investment spreads. What that means is a much slower recognition of profits. I wish I could tell you that the (I think I can promise) industry will have a working draft before the year-end as I have said. It will take, however, some additional time to get it from the Task Force in which I chair through the insurance companies committee, from the insurance companies committee to the American Institute of CPAs and then from the American Institute to the FASB. That normally takes a great deal of time. What I really expect to happen is once the Task Force comes forward with the paper, the SEC will get a copy of it and may very well short circuit the whole process and, say, well good job guys - this is what we are going to insist that all of our registrants do. For those that are not filing with the SEC, of course, until the FASB pronounces, there is no reason that a company should not follow the current literature. I would caution anyone that is going to for the first time GAAP new products, such as Universal Life. Be wary about jumping to the conclusion that you can just look at the existing literature and conclude that profits emerge as a percentage of premium. I don't think that is the answer.

MR. CALDWELL: The Task Equity and Fiscal Responsibility Act of 1982 and some of us lovingly refer to as TEFRA 2 put restrictions on annuities which some felt would hinder the growth of the SPDA, in particular. Stark-Moore introduces further restrictions on annuities and some consider the restrictions of Stark-Moore to spell disaster for the annuity business. Mr. Winterfield - do you have any comments on this?

MR. WINTERFIELD: I don't think that the current provisions that we are looking at really will be that big of a deal. We had a lot of concerns earlier, but I think that they are going to be worked out. The first change is that where we are right now is a penalty tax on withdrawals of 5% if they occur prior to the earlier of 10 years or age 59 1/2. The ten-year provision here will be knocked out. It will be just to age 59 1/2. That is not going to affect a great deal of the SPDA business, since the average SPDA buyer is in the 50s. Apart from that, we think that the elimination of the ten-year rule actually will be quite advantageous in putting together attractive nonqualified periodic payment contracts. It was mentioned earlier that the proposed elimination of the capital gains tax also will help there.

In addition, with the ten-year rule out, it will be much easier administratively to offer nonqualified periodic contracts. Right now, for a nonqualified periodic contract, you have to set up some pretty sophisticated systems in order to attract the gains on individual premiums. With the age 59 1/2 only, it will be a lot easier.

The second set of changes which really had been scary for a while to a lot of the major SPDA writers were the changes in treatment on the death of the annuity contract holder. At first, we were looking at the possibility that income tax would be due at the time that the annuity holder died. That has been fought vigorously and the expected provisions now are a lot different. We are expecting something that will be comparable to the distribution rules under IRA pension contracts. A spouse beneficiary will be able to pick up the contract and avoid any taxes until death or the time that the spouse takes a distribution. A non-spouse beneficiary can defer for five years; a child can hold on to it until age 26.

I would like to mention one tax challenge outside of the new federal tax laws that is creating a big stir within the 403(b) tax-sheltered annuity world. Prudential is in the midst of seeking a Private Letter Ruling as to whether the policyholder has constructive receipt under the 403(b) contract at the time that the withdrawal charge is gone. There is also a challenge even for the 10% type free corridors under this kind of a contract.

Previously, it was felt that there was never any constructive receipt problem with these contracts. Apparently, the Treasury position was that all of this was fine with the older style front-end loaded contracts. If a client wanted to leave, then the client would have to go to another company and pay another front-end load, so there wasn't

any constructive receipt. The feeling now without any front-end load when the termination charges are off, the Treasury is concerned that the 403(b) contracts could be used as a tax-sheltered passbook savings account. You take out money at no charge and put it back in.

The ACLI is putting together a Task Force to work with Prudential and to examine some alternatives. It is possible that the industry will have to come up with certain provisions in order to maintain the present position. They are looking at such possibilities as having to say that, if a client withdraws money, then it will not allow any additional monies to put in for, say, a 12-month period. There are a lot more offensive possibilities that are being looked at like the Treasury and IRS using the IRA type penalties on early distributions.

MR. JAFFE: Can I go back for a moment. One brief comment, a problem that I have run into concerning statutory accounting with variable premium annuities that are back-end loaded, particularly the SPDA type, is that the valuation law for the variable premium annuities seems to be inconsistent with the fixed premium valuation law. When there is a back-end load, the Commissioner's Annuity and Reserve Method gives a fairly clear indication of how to treat it. Yet, when you get into variable premium, the provisions do not exist to take into account the surrender charge. There may be ways to get around this. I notice one head shaking and agreeing in the audience. There may be ways to get around it, but my experience has been that you have to seek relief on an adhoc basis state by state.

MR. CALDWELL: Mr. Winterfield, we have heard a lot about how companies declare their renewal interest rate guarantees or determine their excess interest. There seems to be some concern among some of our regulators that the method of determining the renewal interest rate guarantees should be consistent with the method used to determine the first-year interest rate guarantee. I would like to refer to these as the non-sandbag rules that are coming out. Recently, I heard (as late as this morning) that one company now has come up with a 13% first-year guaranteed SPDA with a bail-out that is several points below the first-year guaranteed rate, suggesting perhaps that the 13% first-year rate is a come on rate.

Would you like to share with us how your renewal interest rate guarantees are determined at the Equitable?

MR. WINTERFIELD: I'm glad you mentioned the sandbag terminology. I think that has been the critical concern with us in setting up our renewal interest rate policies. We have been required by New York to have official interest rate criteria approved by the Board. They are quite broad and really are just two basic principles that we have been working with. The first one is that we do, in fact, strive to set the renewal interest margins consistent with the first-year margin over the lifetime of the contracts. The key thing here, this is the primary New York concern, is that you don't sell your contract in the first year with zero margin and then have people locked in with their

termination charge and then open up a 200, 300, or 400 basis point margin in the next year.

The second principle that we have established with our renewal criteria is that we are prepared to increase the renewal rate and lower the renewal margin on a particular block if we find that the normal rate consistent with the first year would produce a rate that would be so subpar in the market, and that we would be faced with the prospect of losing a lot of that business. This does create some conflicts with the first objective when we do that where we are prepared to reduce margins on some classes in order to stay competitive. It does mean that for some classes at times when things are working out quite well and the portfolio rate is running significantly higher than the new money rate, we might (in some of those cases) have to open up the margin a little bit in particular years in order to work things out for the business as a whole.

Our feeling then is that the principle of keeping the renewal margins consistent with the first year has to be one that really is measured for the business as a whole over an extended period of time.

MR CALDWELL: We have discussed SPDAs, IRAs, TSAs, variable annuities, tax qualified and non-tax qualified, I think the thing we have missed is structured settlement annuities. Mr. Jaffe, could you give us a few comments on what is happening in that marketplace?

MR. JAFFE: It's definitely part of the marketplace today for a select group of companies. A structured settlement annuity is an annuity which is (for those of you who are not aware, I think I should define it) an annuity which will provide a stream of income payments to a plaintiff normally from a personal injury claim. The purpose of such annuities perhaps from the attorney's point of view could be to spread out the attorney's fees. They also provide a way to lock in money and secure it so that the individual receiving it will not run out of money. There are many good reasons for structured annuities.

The income normally is the result of negotiations or a court settlement. It normally is paid by a casualty company. The advantages also of the structured settlement is the indivdual receiving the large sum doesn't have to worry about an investment manager and, of course, the interest earned within the annuity is non-taxable to the recipient of the money.

How big is this marketplace today? It can be darn large. There are probably 10 to 20 companies that run in and run out of the marketplace. It can generate individual sums of money from a particular claim in the several million dollar range. I think most of them run several hundred thousand, so this would be considerably larger than your SPDA which I would presume is in the neighborhood of $20,000. The advantage, of course, to the casualty company who has to make this payment is that by buying an annuity from a life insurance company, it can discount the future payments; whereas, if it's a casualty company, on its annual statement, it can't discount the future liabilities.

From the life insurance company's point of view, one of the nice things about this structured settlement annuity (there is risk involved of course), is that there is no withdrawal. The money is locked in and you do have an opportunity to match assets and liabilities. Of course, there is a problem if you get involved with substandard underwriting, substandard lives, and the underwriting of the substandard lives. It's kind of a neat thing that you can price it and know that the money isn't going to leave. There is no right of withdrawal normally.

There is a marketplace out there pretty well controlled by some specialty brokers, although occasionally you get life insurance company agents and a few others which will bring the money into the company. Certainly, those life insurance companies that are affiliated with casualty companies are in the marketplace, and as I said, I think there is a number of other companies that are fairly active in the marketplace.

Your competition in this area will be trust companies, trust departments, and even casualty insurers who decide to do their own thing.

Just a couple of general comments about what structured settlement annuities, regular SPDAs, and similar products seem to have in common. One is that you may want to set up some kind of a dedicated portfolio of assets, if it's not a major part of your company, just to make sure that you are running these products properly.

In general, this market and the SPDA market is very competitive. My feeling here is that it's really not a marketplace in which you can dabble. Profit margins can be quite small so that, even though you have large sums of premium coming in the door if you're operating on profit margins of perhaps 25 to 50 basis points per year for your assets, that it takes a large amount of reserves in order to make a meaningful profit. I would be interested in anybody else's comments. I have heard the rule of thumb that, in order to justify your operations, you must have at least $25,000,000 or more of reserve. It's not a market for the faint of heart is my point and remember that you are operating with very very small margins.