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INSURANCE COMPANY PRODUCTS IN PENSION FUNDING

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Recorder: DOUGLAS K. GERMAN

- Recent developments in:
  - -- Guaranteed investment contract products
  - -- Separate account investments
  - -- Settlement of liabilities
  - -- Annuities for terminal funding

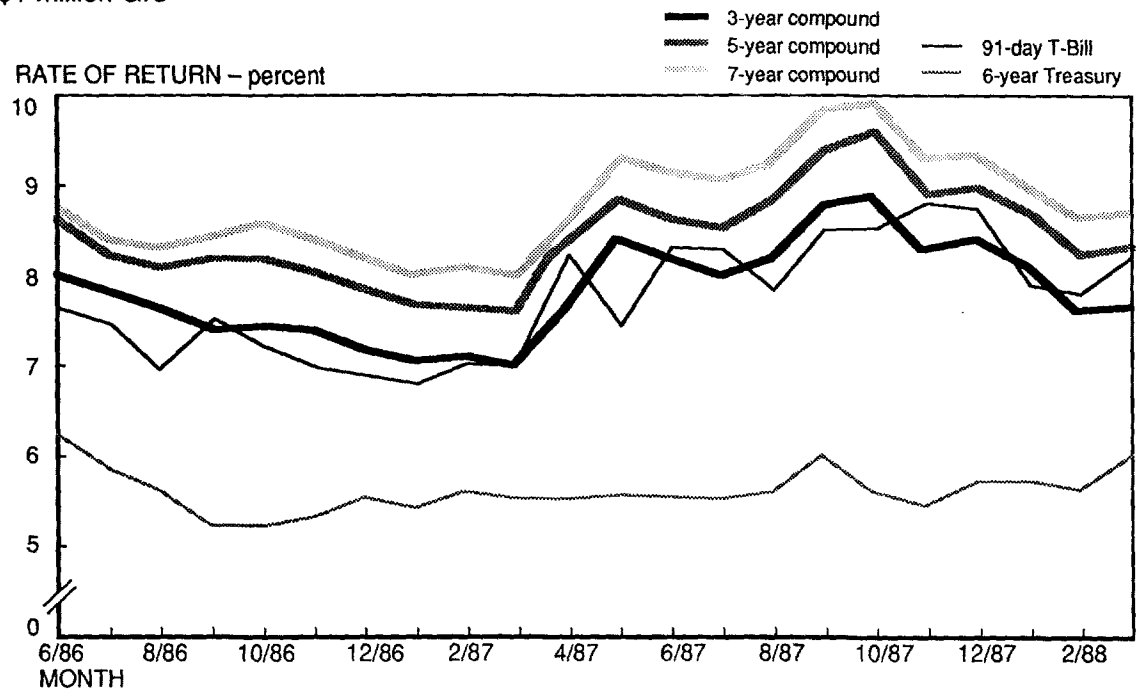
MR. DOUGLAS K. GERMAN: Speaking first will be Brian Ternoey. Brian is an Associate of the Society and an EA. He is a principal with Mercer Meidinger Hansen in their Dallas office. He will be talking to us about developments in guaranteed interest contracts (GIC). Speaking second will be Vic Modugno, he's an FSA and a pension product actuary with Executive Life in Los Angeles. Prior to that he was with Metropolitan Life and Pacific Mutual. He will be speaking about annuities for termination of pension plans. Third will be Tony Amodeo, FSA. Tony is a pension product actuary with Metropolitan. He will be speaking about the insurance company role in settlement of obligations under Statement of Financial Accounting Standards Number 88 (FAS 88). Last will be Jeff Martin, JD. Jeff is a graduate of the University of Chicago. He is a partner with the law firm of Shea & Gardner in Washington, D.C., and he will be speaking about separate accounts and particularly portfolio insurance. He's been instrumental in helping a number of insurance companies develop their separate accounts.

MR. BRIAN C. TERNOEY: What I intend to do is cover several different topics fairly quickly since I'm really not sure which ones might be of most interest to you. I hope I can give you some basic background on several items. The topics I'd like to cover quickly are outlined here. I want to talk a little bit about the interest rate environment in 1987 and the first quarter of 1988. Then, a brief background on a survey that we did with insurance carriers on the question of 401(k) plans in mergers and spin-offs. This is an area that's beginning to heat up. I'll talk a little bit about window contracts and what we've seen recently there. Then, the investment trends as far as how plan sponsors are using GICs and then perhaps some other topics if we think of them along the way. Graph 1 shows the interest rate trends from June 1986 to March 1988 for average GICs of seven, five and three years. Compare that with the lowest line which is 91-day T-Bills. The dotted line that starts below and ends

* Mr. Martin, not a member of the Society, is a Partner with Shea & Gardner in Washington, District of Columbia.

GRAPH 1

WILLIAM M. MERCER – MEIDINGER – HANSEN ASSET PLANNING, INCORPORATED
Summary of average bullet GIC data versus market yields
$1 million GIC



above the three-year solid line is the six-year Treasuries, another index that we track. It shouldn't be any really surprise that rates trended down from 1986 through about March or April 1987, then back up fairly quickly until about September or October 1987. Following the crash most rates dropped rather sharply.

Graph 2 shows what happened from April 1987 to April 1988 with regard to the seven-, five- and three-year rates. These are weekly rates where Graph 1 showed monthly rates. Again, you can see the pattern of rates rising pretty sharply from April through October 19, which is as precise as we can get. Then rates fell rather sharply through October and then fell fairly slowly after October. Afterward, rates started to rebound some so that April 1988 really doesn't look much different than April 1987. I guess you heard Dr. Laffer say previously that he thinks rates are going to go back up. I wouldn't pretend to try and predict where things are. But I think the overall story to our clients from this was that after all was said and done there wasn't a whole lot to the interest rate market after the dust settled. It caused a lot of disruption in between and a lot of people who are placing annuities would see a similar phenomenon if we graphed annuity rates here. People placing annuities and trying to get GICs in October and November certainly felt quite a bit of disruption in their own particular companies. We've had a lot of questions about just what did happen during the market crash. I find it interesting and I think other carriers find it interesting to see what happened in general.

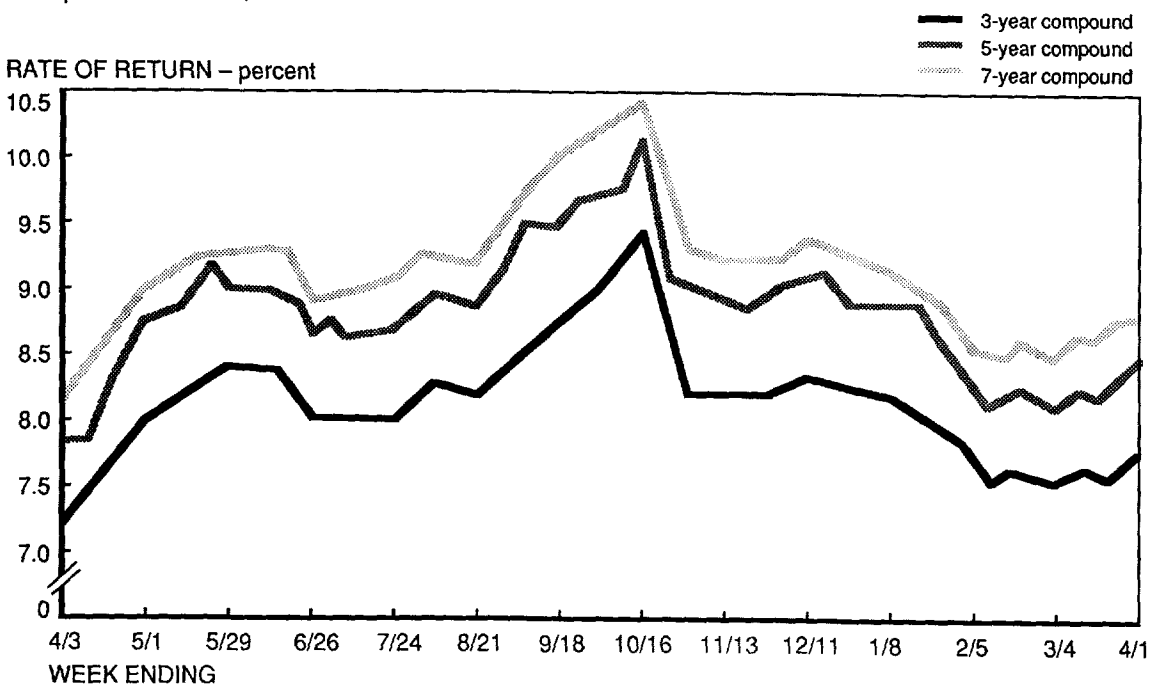
Exhibit 1 shows four different placement levels (e.g., $0.5 million and $1 million), the different rates on our database during this period of time. Again, I am showing three-, five- and seven-year maturities and also one of our ten-year maturities. For each maturity, rates are shown in two different columns, the week ending October 23, that was the week of the crash, and the week ending October 16, the week before. For instance, for the three-year rate the high rate for $0.5 million dropped about 102 basis points, in that one week. The low rate dropped about 127 basis points, and the average rate dropped about 110 basis points. That pattern was pretty typical. That's probably one of the sharpest drops that we've ever seen in interest rates in GIC's history. This was an area of concern for clients.

I tend to think of GICs as a very conservative type of investment. Clients realize their interest rate is sensitive, but this occurred at one of the more active placement times and really shook a lot of clients up, even though in the overall rate trends, there's not much difference between now and a year ago.

As another example, the $1 million five-year rates dropped almost 100 basis points on the high and the low rates dropped about 110 basis points. You see that pattern pretty consistently -- $10 million three-year GICs (down in the lower left corner) dropped about 95 basis points for the high, and the low rate dropped about 121 basis points. I'm not quite sure why there was such a large drop in the 10-year GIC. Those longer rate really did not drop as much in the flight to quality, which had a much greater effect on the three- and five-year type GICs. Junk bonds and the like were acting much differently than the Treasuries, where certainly there was quite a bit of difference. But nevertheless, I think the reaction from the carriers was to pull in their horns even if the actual investments backing the GICs maybe didn't drop that much from what we could see.

GRAPH 2

WILLIAM M. MERCER – MEIDINGER – HANSEN ASSET PLANNING, INCORPORATED
Summary of average weekly bullet GIC data – April 1987-April 1988
Compound rates – $ million GIC



Summary Of Compound Bullet GIC Data

Weeks Ending In October 1987

	Maturity							
	3-Year		5-Year		7-Year		10-Year	
	10/23	10/16	10/23	10/16	10/23	10/16	10/23	10/16
$500,000:								
High:	8.72	9.74	9.40	10.44	9.61	10.71		
Low:	7.72	8.99	8.43	9.55	8.30	9.68		
Average:	8.30	9.40	9.05	10.04	9.28	10.33		
$1,000,000:								
High:	8.87	9.84	9.55	10.53	9.69	10.75	9.65	10.98
Low:	7.84	9.09	8.50	9.60	8.80	9.70	9.22	9.91
Average:	8.38	9.46	9.13	10.09	9.42	10.37	9.46	10.53
$5,000,000:								
High:	8.92	9.83	9.67	10.67	9.85	10.94		
Low:	7.87	9.21	8.45	9.70	9.05	9.80		
Average:	8.43	9.52	9.19	10.13	9.53	10.43		
$10,000,000:								
High:	8.93	9.88	9.68	10.71	9.89	10.83		
Low:	8.04	9.25	8.92	9.70	9.15	9.80		
Average:	8.49	9.55	9.28	10.15	9.59	10.36		

There are a few more points that I'll illustrate from our basic data. This is the month of October 1987 and one of the phenomena that we look for when interest rates are operating strangely are differences at different levels of placement amounts (Exhibit 2). As you can see here, through October we did have what we would call a pretty normal situation. The $0.5 million, three-year GIC was at 9.74 and the $1 million GIC was at 9.84. There seems to be a little bit of a diseconomy as the $5 million level was at 9.83. You could actually get a little higher rate if you had only $1 million than if you had $5 million, and 9.88 for $10 million. That to us was fairly unusual. The other side is that we had a pretty decent yield curve at this time. The three-year rate of 9.84 matches pretty decently to the five-year rate of 10.53, the seven-year rate of 10.75, and the ten-year rate of 10.98. That's the way yield curves are supposed to be and those are pretty normal yield distributions.

Exhibit 3 shows the week of February 12, 1988. Under the five-year rates you see a little different pattern. For $0.5 million GIC we saw a high of 8.7%, while the ten million GIC had a high of 8.47%. So some diseconomies of size were operating in the marketplace, attributable mostly to which carriers are recording at different levels, but from the GIC investor's viewpoint there was a real change over a relatively short period of time -- and in a time when it wasn't expected as much. We would have expected a disrupted pattern in October, and we found a pretty normal one. In February, when things were relatively calm, relative to October we saw the larger amounts not yielding as well as the smaller amounts. It was really best to have $1 million to invest rather than $5-10 million at that point in time.

In Exhibit 4, which shows the full month of February, we see that same phenomenon. In the three-year, the $0.5 million rate and the $1 million rate beat the $5 million and $10 million rates. So, again, there were diseconomies of size going on in the market. But also you see it if you look at the million numbers there, a five-year GIC at 9.17, a seven-year GIC high at 9.04 and the ten-year back up to 9.3. There's another phenomenon that we see now and then and really don't know how to explain to our clients, why a seven-year GIC should have a lower yield than a five-year GIC in terms of investment logic. It is explainable only in terms of supply from the insurance carrier.

The second topic that I wanted to cover is that we recently did a survey of insurance carriers. A lot of those surveyed are here in this room and we really do appreciate the input we obtained from the insurance carriers on the survey. We hope it is one of several that we'll do over the year on topics that are of mutual interest to the insurance industry, our clients and ourselves. This one was on mergers, acquisitions and spin-offs, and the effects that they have. The base situation of discussion was 401(k) plans and what happens when they are merged, spun off, or terminated in connection with the rather heavy merger and acquisition activity that we've seen in the business community. The 34 carriers responded probably cover about 95-99% of the GIC market, certainly the window GIC market. The basic conclusions were that not a whole lot of formal attention is being paid to the merger and acquisition area right now. Our conclusions are that it probably doesn't need as much attention as we thought when we first started looking at it, because the main response from most of the carriers was they didn't mind cloning a contract if a unit spins-off from one plan sponsor's 401(k) plan and is sold to somebody else. There's really not much of a problem in the insurance community with splitting the contract proportionately and providing the same provisions and the same contract to whoever takes over that unit. And that's probably the fundamental problem that out clients have

Summary Of Bullet GIC Data

Month Of October 1987

	Maturity							
	3-Year		5-Year		7-Year		10-Year	
	Compound	Simple	Compound	Simple	Compound	Simple	Compound	Simple
$500,000:								
High:	9.74	9.74	10.44	10.36	10.71	10.75		
Low:	7.72	7.68	8.43	8.3	8 8.30	8.61		
Average:	8.82	8.77	9.53	9.48	9.86	9.79		
$1,000,000:								
High:	9.84	9.84	*10.53*	10.44	10.75	10.79	10.98	10.98
Low:	7.80	7.70	8.50	8.40	8.80	8.72	8.99	8.93
Average:	8.91	8.87	9.59	9.53	9.93	9.84	10.08	9.96
$5,000,000:								
High:	9.83	9.78	10.67	10.64	10.94	10.94		
Low:	7.87	7.82	8.45	8.35	9.05	8.90		
Average:	8.95	8.90	9.64	9.55	10.01	9.86		
$10,000,000:								
High:	9.88	9.84	10.71	10.60	10.83	10.69		
Low:	7.95	7.85	8.76	8.64	9.15	8.97		
Average:	9.01	8.96	9.66	9.56	9.96	9.84		

Summary Of Bullet GIC Data

Week Ending February 12, 1988

Maturity	3-Year		5-Year		7-Year		10-Year	
	Compound	Simple	Compound	Simple	Compound	Simple	Compound	Simple
$500,000:								
High:	7.85	8.08	8.70	8.75	9.00	9.00		
Low:	6.69	6.59	7.47	7.20	7.88	7.72		
Average:	7.47	7.46	8.08	8.03	8.42	8.35		
$1,000,000:								
High:	7.95	8.08	8.80	8.85	9.00	9.04	9.15	9.32
Low:	6.80	6.70	7.50	7.20	7.90	7.80	8.01	7.95
Average:	7.54	7.54	8.14	8.09	8.49	8.40	8.73	8.56
$5,000,000:								
High:	7.95	7.92	8.68	8.76	9.00	9.07		
Low:	6.98	6.88	7.78	7.70	7.94	7.90		
Average:	7.57	7.55	8.18	8.14	8.55	8.45		
$10,000,000:								
High:	7.95	7.85	8.47	8.44	9.00	8.85		
Low:	7.05	6.95	7.75	7.70	7.95	7.90		
Average:	7.47	7.45	8.13	8.07	8.48	8.37		

Summary Of Bullet GIC Data

Month Of February 1988

	Maturity							
	3-Year		5-Year		7-Year		10-Year	
	Compound	Simple	Compound	Simple	Compound	Simple	Compound	Simple
$500,000:								
High:	[8.53]	8.53	[9.07]	9.12	9.02	9.15		
Low:	6.69	6.59	7.47	7.20	7.88	7.72		
Average:	7.54	7.50	8.15	8.11	8.47	8.38		
$1,000,000:								
High:	[8.53]	8.53	[9.17]	9.22	[9.04]	9.19	[9.30]	9.49
Low:	6.80	6.70	7.50	7.20	7.90	7.80	8.01	7.95
Average:	7.61	7.58	8.22	8.17	8.54	8.44	8.79	8.64
$5,000,000:								
High:	[8.07]	8.14	[8.84]	8.92	9.09	9.22		
Low:	6.98	6.88	7.65	7.58	7.94	7.90		
Average:	7.64	7.61	8.26	8.21	8.61	8.49		
$10,000,000:								
High:	[8.07]	8.15	[8.84]	8.92	9.06	9.22		
Low:	7.05	6.95	7.68	7.60	7.95	7.90		
Average:	7.55	7.52	8.23	8.18	8.57	8.45		

out there now, just being able to accomplish on some basis the physical process of spinning off a unit and giving it to somebody else. Most carriers feel that they can take care of that as long as there's no real alteration of the risk. Most carriers do charge a fee for that, a very widely varying fee. The big problem seems to be that if the cloned approach is not feasible, then problems seem to develop definitely for both the insurance carriers and the plan sponsor, and probably for both the new plan sponsor and the plan sponsor that's selling the unit. The real trouble area of the future seems to be what happens when the clone approach doesn't work.

Carriers on a whole are quite willing to try to work with situations as they develop rather than trying to deal with them contractually. On plan mergers one of the most interesting results was that most carriers will consider adding a new group to an existing contract, although again they want to be a party and want it to be a cooperative effort. They will take a look at the situation when it develops and decide whether or not to extend the contract, or amend the contract to include a new employee group. The other main result is that there are few concrete definitions in the plan merger area. The only definitions that we could even get several carriers to agree on were things that were defined by a regulation, like partial plan termination. There is really a lack of uniformity in practices, and the words that are used, and the definitions of the words that are used. One of the questions in our survey was on what situations, if you were cloning a contract, would you feel obliged to impose a market value rather than a book value payout. The most often cited situation was if distributions to the participants are being made and the participant has not terminated employment or still has essentially the same job. As consultants, we fully realize the problems this causes insurance carriers; it also causes the participants problems and the plan sponsors problems, but it is something that does tend to pop up in a merger and acquisition situation. If there is some selectively by the plan sponsor as to his activity, carriers are not very interested in supporting that at book value. There is one carrier who charges market value prior to maturity regardless of the reason, and just doesn't want to talk about it. Most of the others will take a look at it and see how it fits.

The other thing that was interesting from the survey is the other factors that are important in gaining approval for a planned merger to an existing contract. The most often cited thing is where interest rates are. The main concern is the financial position of the contract at the time. Then we'll worry about whether or not we can accommodate the client. The other items are basic underwriting situations. Carriers want to reunderwrite the situation before they decide what to do.

Why don't we go on to window contracts. What we've seen on window contracts in the last year and especially since October is that there continues to be large growth in the 401(k) area and other profit sharing and thrift savings plans. The growth continues to be quite large in dollar amounts, quite phenomenal. We are somewhat concerned about the capacity of the insurance industry to supply that demand. Most of the demand is not from new plans. The growth in new plans is relatively small, especially by dollar amount, but the internal asset growth of plans doesn't seem to be affected by the discrimination and contribution laws.

Caps and minimums are areas that we frequently get questions on from clients and insurance carriers. We saw a real flurry after October 19th, with lots of carriers becoming much tighter not only in the regular underwriting standards,

but also in the caps and minimums that they wanted on contracts, trying to narrow their risk. Some carriers wanted money deferred longer than others because of the way they were investing funds, but overall we saw everybody kind of tightening ship. Since then, though, it's pretty well eased off. Carriers are settling back now and are not quite so concerned about the immediate future and are a little less restrictive. The client acceptance of these caps and minimums is very mixed. There are some clients who have a very investment-oriented attitude towards their window GICs and really don't mind if there's a cap. If they run into the cap six months down the road instead of a year down the road, they can handle that. Those are basically blended rate funds that are well diversified at the present time, and so their rate is not that much affected if they have to go out and get a second window. Those people really don't mind the caps and the minimums, but they probably represent half the marketplace. The other half really does have a lot of design and procedural problems with caps and minimums and just plain can't but them. It doesn't fit their plan design. Most frequently the predicament is a one rate or a class year plan and they simply are not in a position procedurally to accept caps or minimums.

The investment year plans were a real problem in the last year in that the clients were fed up with these plans for administrative reasons. In an investment year plan, each year's GIC is departmentalized in the participant's own account. Clients are really tired of all the extra record keeping that they have to do and want to get out of those plans, but are having a tough time doing it. Procedurally, the biggest problem is how to explain to the participant the transition that has to be made. LIFO plans also seem to be a problem in that LIFO is a relatively less common approach. The industry standard seems to be for pro rata distributions from window contracts. However, there are enough LIFO plans that started out several years ago and are now having trouble getting diversification among carriers.

The index contract was extremely popular in the last year. Lots of money flowed into the index contracts such as in Life of Virginia's. We're not quite sure that we agree with plan sponsors who put their money in there. In fact, we have some research that says you probably tend to lose in the long run on a GIC fund if what you have is just a GIC option in a 401(k) plan. It's probably not that good an idea because you can't predict interest rates and this is not really an interest rate anticipation type of vehicle. These contracts did work quite well for small plans that wanted to insulate themselves against changes in interest rates because the index contracts certainly did beat money market funds by a pretty wide margin. For larger plans which put a lot more money than the smaller plans did into index contracts we're somewhat concerned about whether or not the theory behind trying to anticipate rates in a GIC type fund has much of a chance of working.

The other phenomenon that seems to be a big bust this year, in our opinion, was participating contracts. We did not see participating GIC contracts having anything meaningful to offer our clients. We looked at some of those contracts and wanted to consider them as alternatives for our clients, but they didn't seem to work. People were much more interested in taking a rate up front rather than having a participating feature.

The types of investment trends that we have seen probably don't surprise too many people. We continue to see defined contribution plans much more interested in GICs in dollar volume than defined benefit plans, and we would attribute that primarily to the decision maker. In the 401(k) plan the individual

participant really does want a very conservative vehicle and GIC funds are certainly the ones that build the best. Preservation of principal and the intuitive investment philosophy for the normal participant is expressed much more readily in a GIC type of fund. Therefore, we still see a good 70-80% of the money in a 401(k) plan going to the GIC fund and not very much going into equity funds.

We did not see much of an effect on participant accounts after the market crash. If there was a trend, it was for participants to withdraw their money after the crash, after it was too late, and move into the GIC fund. We did not see any big distortions or big changes from our forecasted money going into the GIC contract and we saw no substantial effect of the market crash on the forecast made earlier in the year on a plan by plan basis. Some bigger effects on defined benefit plans for GICs are coming from FAS 87 considerations, the Omnibus Budget Reconciliation Act (OBRA), and the general concern about dampening the volatility of the assets. Again, we're not sure that clients are making a good decision on this any more than they are by jumping into dedicated bond portfolios to dampen volatility, but it very definitely was a trend.

The main thing that we as consultants see and probably encourage is that the clients see their GICs as a pool of funds instead of each individual GIC. They spend a lot more time managing their GIC fund and develop a distinct managerial style as they would in an equity fund. Certainly the growth of GIC investment managers in the last year is the trend that is inevitable and in the client's best interest. Quality risk has been a big issue. Which carrier should you place your money with? A lot of time is spent on that. I'm sure any of you who work in the GIC area have heard a lot of that this year. We think the insurance industry as a whole is quite solid and has a very good record, and we really don't think there is a significant default risk associated with GICs. And, as investment analysts, we feel that there's very little investment risk or default risk in a GIC with almost any of the carriers. We carry 70 carriers on our database, and have some relatively minor concern with only about 10 of them. Nevertheless, that isn't good enough for the clients. The issue, and I attribute it to the conservative GIC style, is much deeper than that and much harder to deal with than that. Once you eliminate the default risk, clients are still very much concerned about the quality of the carrier and will insist upon distinctions from one carrier to another. As for the timing risk, we see more clients concerned about diversifying away from placing all the maturities on one day each year. There is less of the Chief Financial Officer trying to predict interest rates because he's starting to learn that (1) he can't predict interest rates, and (2) the GIC fund doesn't respond much to changes in interest rates anyway. So, there's more emphasis on just plain dollar averaging.

It continues to surprise people that they'd be better off investing only $1 million at one point in time than $10 million or whatever. There is a lot of interest by client sponsors in some of the commingled funds offered, where their plan goes in with quite a few other plans in developing a fund and participating in a fund rather than having their own. I think there's mixed evidence as to whether or not that provides value to the individual sponsor, but there certainly are pros and cons to it. That's all of my remarks, and I hope it stimulates some questions when we get to the question and answer period.

MR. VICTOR MODUGNO: My topic is annuities for plan terminations. I'm going to be talking both about the sell side, the insurance company, and the buy side, the consultant who is buying annuities for terminating plans. It's difficult to

separate these annuities from the FAS 88 settlements that Tony's talking about, so we had to carefully coordinate our presentations. I'm going to start on the sell side with the marketing trends.

Exhibit 5 shows the total group annuity purchases under closeouts. The Life Insurance Marketing Research Association (LIMRA) companies have two group pension surveys. There are eighteen companies in the large group, and eighteen companies in the small group. To that we added four other carriers that we know were active in this market that are not members of LIMRA. Now there are a few companies that we couldn't get statistics on that are active in this market; also, participating annuities which utilize separate accounts are not included in these numbers.

Graph 3 shows a sharp increase in closeouts to 1985, a peak in 1986 and a small decline in 1987. We see these trends continuing in 1988 and the people I talk to said that sales were lower in the first quarter of 1988. What's also happening is that market concentration is decreasing. In 1985, 69% of the market of these sales went to just two companies. In 1986, those two companies got 50%. And, in 1987, their share was 35%. There's a lot of explanations for the decline in the amount of sales. One of them is that the stock market crash and the decrease in interest rates have lowered the surplus available for recovery or settlement. Another explanation is that all the people who are going to do a reversion or a settlement had done so. If we look at the total amount of pension assets of 1.5 trillion, annuities represent less than 3% of those assets, so there's a big market out there that hasn't been scratched yet.

Graph 4 shows benefits purchased under completed asset reversions. This is from the PBGC report. What we see is a sharp peak in 1985 and then a sharp decline going into 1986 and 1987. In 1986 a 10% excise tax was imposed on reversions, and in 1987 the Pension Protection Act, which was part of the OBRA was added. Most of that is effective in 1988, and should, in the future, reduce the surpluses available for settlement or reversion because, for one thing, it's limiting the funding. If a plan is funded more than 150% of the plan termination liability, they will not be able to make a tax deductible contribution. Another feature of this law is that if the plan does not provide for an asset reversion, they'd have to wait five years for a plan amendment to become effective. On the positive side this law increased the premium for PBGC from $8.50 to $16 up to $50 depending on funding status, and that may encourage some terminations. It also tightened up the rules for distress terminations, increased the minimum funding requirements, increased the employer's liability for underfunding, and this should result in annuities being purchased in some cases that might, in the past, have been dumped on the PBGC.

Senators Kennedy and Metzenbaum have introduced legislation that would put a one-year moratorium on asset reversions. Any asset reversion would be held in escrow until Congress decided what to do with the money. This was part of the 1987 Act which was not approved, but they are trying again and obviously this would eliminate plan terminations for asset reversions and it may be acting to discourage terminations. Small plans with less than 100 lives may see increased terminations in 1988 due to the Tax Reform Act of 1986, the minimum coverage requirements, the lower 415 limits, the excise taxes, and difficult administration. But these plans frequently don't purchase annuities. The elimination of ten-year averaging and the excise tax and lump sum distribution under age 59 1/2 should encourage the purchase of annuities from participants receiving distributions

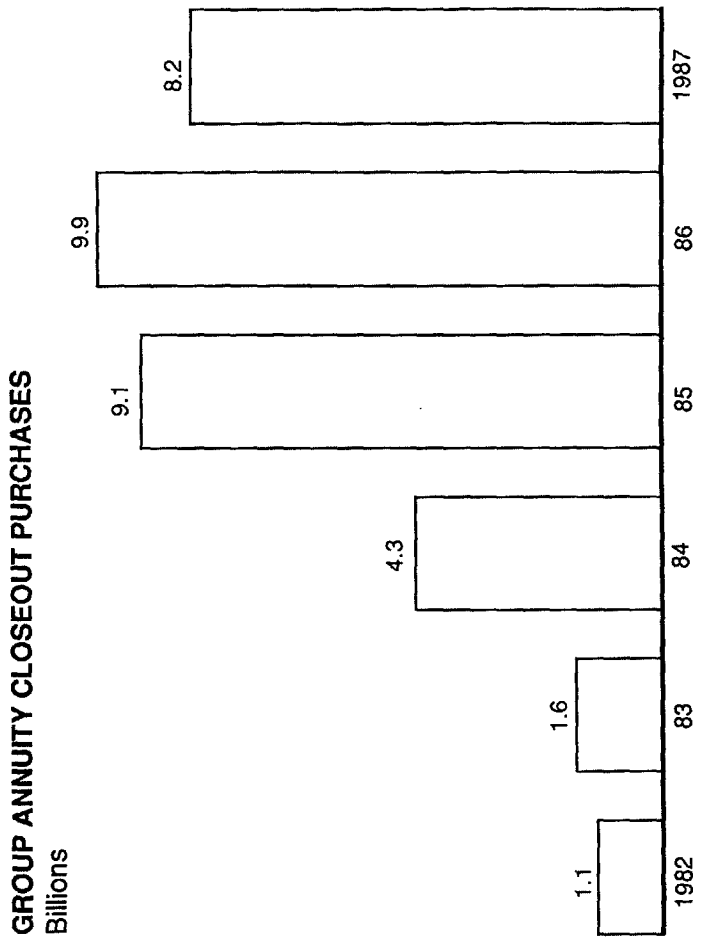
EXHIBIT 5

TOTAL GROUP ANNUITY PURCHASES

($MILLIONS)

	Life Insuance Marketing Research Association Members						NONMEMBERS		GRAND TOTAL
	Large Company			Small Company					
Year	No. of Companies	Annuity Purchases Closeouts	Term. Fund.	No. of Companies	Annuity Purchases Closeouts	Term. Fund.	No. of Companies	Annuity Purchases	Closeouts
1982	16	1,117.0	255.1	--	--	--	--	--	1,117.0
1983	17	1,564.2	218.3	20	34.5	7.3	--	--	1,548.7
1984	17	4,188.5	214.0	20	79.3	1.1	--	--	4,267.8
1985	18	8,279.5	286.7	21	456.0	19.5	2	320.3	9,055.8
1986	18	8,019.8	498.8	20	879.5	48.7	3	973.5	9,872.8
1987	18	6,662.0	392.3	18	1,073.8	110.9	4	499.4	8,235.2

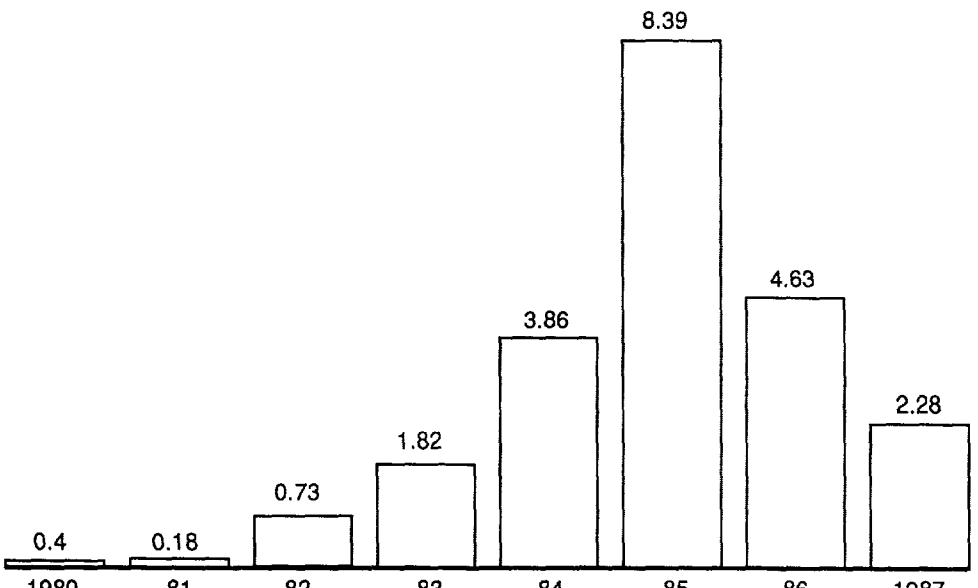
GRAPH 3


GROUP ANNUITY CLOSEOUT PURCHASES
Billions
1.1
1.6
4.3
9.1
9.9
8.2
1982
83
84
85
86
1987

GRAPH 4

ASSET REVERSION ANNUITY PURCHASES

Billions



Benefits purchased under completed asset reversion cases

from these plans, so you may see an increase in annuities being purchased by individuals who are leaving with a lump sum.

Individual annuities are being purchased under group contracts, and you'll see an increasing trend in those annuity purchases. I'm going to give you my company's experience in this market in 1987. In 1987 we put out $2 billion in annuity bids for settlements, $700 million was not placed with any company. In other words, the company did not go through with the settlement, just decided not to purchase annuities.

Moving on to the buy side, I will discuss what consultants should look for in annuity purchases, paying particular attention to certain common mistakes. I will also discuss credit quality. The primary errors that are made include not soliciting enough bids from different companies, not analyzing the bids correctly, and not following through on the final costing after sale. Bid spreads of 10% or more are not uncommon in carriers, particularly where there are active lives involved and early retirement risk. Carriers differ in their price due to variations in early retirement assumptions, mortality, their surplus position. Some of the carriers in the market may be funding an attractive investment at certain times, so I think you'd have to solicit bids from a large number of companies to capitalize on that opportunity. You know, there are two areas where this could be a problem -- in very small cases and in very large cases. In small cases of less than $1 million a lot of companies are not willing to bid. However, there are some companies that you probably never heard of who are A or A+ rated that are bidding on these cases. It might pay, if you're only doing one purchase, to subcontract the bidding process out to a consultant who specializes in this area who knows all these companies and knows who is bidding on what. The other end size range is extremely large. There are only a few companies that can bid on those very large cases. One thing you can do is to try to break the case apart. If there are a number of different plans -- a salaried group, an hourly group, different plans, different locations -- you could try to break the case apart that way. Another alternative, and this may be the only alternative in a really large case, you'd have to go with a participating annuity. That may be your only choice.

In order to maximize the number of companies bidding, it's important that the bid specifications be clear and concise, the data be available in machine-readable form, and then you hope the carriers will be these annuities on the same basis. That's an important thing. Sometimes you'll find that if the bid specifications are unclear the insurance company will misinterpret it. You have to be careful to analyze these bids to make sure that everybody's bidding on the same thing, that the bids are all identical and according to the plan specifications. A plan document is a 1,000-page thing and on some page 872 in paragraph C there's some obscure wording that should be interpreted this or that way. I think you have to spell that out in a bid specification and not just hope that they're going to read and catch that in the plan document.

Another thing is to follow through after repricing. You have to make sure that all the final adjustments and the costs are done on a basis consistent with the final bid so that your client is getting basically what you negotiated in the final bid.

The last topic I want to talk about is credit quality. Of course, there are the rating services such as Best, and Standard and Poor's (S&P). But one thing about annuity contracts in particular, these are long-term commitments so even if

a carrier is rated A+ or AAA this year you have to worry about what their ratings will be in the future. Past performance may be an indicator. The profitability of the company is another indication and the ability to raise capital and management's commitment to maintaining the rating are other important considerations. It's become fashionable today to focus on the bond portfolio and the percentage of bonds that are below investment grade rating. This ignores the other assets such as mortgage loans, direct ownership of real estate, and also ignores the liabilities. What about the exposure to AIDS, or term insurance, or group health insurance? What about the exposure to losses in the group liability cycle? What about large direct investments in an unprofitable brokerage firm or money management firms or unleased office buildings in the oil patch? On large cases I think the consultant should do his own credit analysis to help the client choose the best bid, taking into account the credit risk.

MR. ANTHONY AMODEO: One thing Brian mentioned was Dr. Laffer's prognostication respecting interest rates. Well, he's a contrarian in a lot of ways and I think that showed yesterday. A minor dip in the trade deficit that he kind of dismisses caused the market to go down 100 points. But it was an interesting discussion anyway.

My topic will be the use of annuity contracts to respond to the accounting and financial needs of plan sponsors under the rules promulgated by the FASB in December of 1985 as Statements 87 and 88. I'd ask you to keep in mind that annuities have been purchased both to achieve FAS 88 settlement accounting and to function within a continuing FAS 87 environment. In order to understand the features that annuity contracts will contain, it is valuable first to review the development of the annuity purchase marketplace, and the place that Statements 87 and 88 hold within that development. I don't believe this will duplicate much that Vic went over.

The first "closeout" or "terminal funding" annuities were written for companies that were actually going out of business and needed to guarantee fulfillment of their promises to their employees. There was no continuation of operations or employment, and so no thought was given to such possibility in the annuity contracts. Soon, however, companies in distress that hoped to stay in business in part through avoiding pension costs would freeze accruals and if they also terminated the plan, as they often did, they would purchase a similar annuity contract to guarantee the accrued benefits. This introduced the complexities of continuation of employment, and in those days mandatory retirement ages, into the previously simple contract forms. Without such complexity the plan sponsor and the insurer would face the possibility of on-demand in-service distributions. The major increase in the level of closeout activity occurred as a result of merger and acquisition activity when it was realized that a healthy plan could be terminated and its surplus assets turned into disposable cash. At first, this was done by an acquiring company the used the cash to take down the debt incurred in the takeover, especially when the acquired employees were to be brought into the acquirer's plan. Ultimately, the termination of one's own plan became a takeover avoidance ploy, because the surplus assets would appear in the balance sheet as cash, and not be hidden from the public and known only to the "sharks." Although this action generally did not immediately increase net worth, it was a pre-FASB way to bring the plan's value into the sunlight.

Now that I've touched on the accounting, I'll digress a moment to explain the standards that were generally followed at that time, pursuant to the Accounting Principles Board Opinion No. 8 (APB#8), as they apply to my topic. The

surplus assets generated by a plan in excess of its current liabilities were not directly reflected in the financials of the corporate sponsor. The termination of a plan did not in itself release this as income, or as addition to net worth, but it was generally amortized even though the cash was released and used for general corporate purposes. Some sponsors felt it necessary to set up a defined contribution plan, at least temporarily, rather than directly replacing the terminated plan with another defined benefit plan, both to justify the transaction and to book the gain. The rules for terminations were clarified with the Joint Guidelines of May 1984. With these, the IRS, Department of Labor (DOL) and PBGC jointly defined the processes of "termination/reestablishment" and "spin-off/termination." The need for immediate vesting of all participants, their notification of the termination, and the purchase of annuities and distribution of certificates to participants all became fully recognized.

Attempting to stay within the Joint Guidelines, some insurers and plan sponsors developed "participating" contracts for the plan termination market. In return for a higher initial consideration, the sponsor participates in the financial experience to varying degrees. This additional charge reduces surplus strain and actuarial and investment risks, which is reflected in lower charges. This is not participation under the traditional definition of insurance company board discretion, but rather a predefined formula basis. A further refinement exists in certain arrangements whereby the plan sponsor continues making the investment decisions, which results in continued employment for the current investment manager. The important point, as it impacts my topic, is that these contracts cover a very wide range of participation. At one end, participation can be temporary with a very low value, almost nonparticipating in financial impact. At the other extreme, the contract can be a guarantee wrapped around business as usual at the Plan, with minimal insurance company involvement and little true financial impact. The FASB has recently realized and focused on these differences, as I'll discuss later.

Another important influence on the development of contract features was Revenue Ruling 85-6. This concentrated on the preservation of early retirement subsidies for employees who has not reached adequate service at plan termination, but who did so subsequently. After the Ruling, contracts universally reflected service after the termination. The Retirement Equity Act added spousal consent and automatic spouse insurance requirements, and these, too, became incorporated in subsequent contracts.

Finally, in December 1985, FASB published Statements 87 and 88. The former acts to bring the operation of the plan directly into the sponsor's bottom line. The latter defines settlement and curtailment, calling for immediate accounting recognition. Sometimes the plan sponsor will want settlement accounting without plan termination, and other times he will have a plan termination (curtailment) and yet want no settlement. The annuity contract's participation level will govern the result.

In examining the motivation of plan sponsors to respond to FAS 87 and 88, we must keep in mind that the perception of their effects can be more important than the probability that such effects will, in fact, occur. Specifically, the volatility inherent in FAS 87 as to the financial impact on a company can be very important to a chief financial officer, even though an actuary can feel confident that a downturn is merely a temporary event.

The volatility in FAS 87 is caused by three factors. First, the "settlement rate" changes every year, and is defined through reference to three indices beyond the control of the valuation actuary. Second, it requires a shorter period of amortization of plan changes for prior service costs and actuarial gains and losses than previous practice. Third, the amortization method is not the familiar "mortgage" approach, but a method that front ends the effects of changes.

There are some inherent limits on volatility of financial results built into FAS 87. The excess of change over a corridor (which can be no greater than 10%) is amortized, and assets are valued as "market-related" rather than marked directly to market. There are also some active approaches the plan sponsor can take, beyond reexamining his valuation assumptions. A very effective method is to manage the assets relative to the liability stream as much as possible, such as through a dedicated bond portfolio. Finally, the purchase of an annuity, in particular a participating annuity, limits the cost of poor experience on the assets and liabilities covered under the contract, without totally excluding such experience.

The settlement process defined in FAS 88 is also subject to treatment through annuities, as well as through lump-sum settlement. The annuity must be irrevocable, and relieve the employer of primary responsibility for the liability, as well as substantial risks and rewards on the assets and liabilities. Some participating annuities, especially those where asset discretion remains with the plan sponsor, are clearly not settlements. This issue was firmly resolved in the recent Guide to Implementation of FAS 88. If the structure of the annuity does satisfy the settlement requirements, as nonparticipation does, then the surplus implicit in the plan can be booked as an immediate gain. Of course, no cash can be removed from the plan.

From the viewpoint of the plan sponsor, there are several differences between the purchase of an FAS annuity (whether to settle under 88, or to function under 87) and the procedures for a termination annuity. First, since there is no need to guarantee the benefits of all participants, the plan sponsor can annuities only those where the price is most attractive, such as retired lives. Since not everyone must be vested, he can retain gains on future nonvested terminations. The sponsor avoids the time-consuming approval process with the IRS and PBGC, and often union approval as well. Since no notification is required to employees, and no certificates need to be distributed, no disruption of the work force and retiree population will be necessary. The tax reporting and even the retiree check stock can be maintained as prior. Finally, since no reversion has occurred, there is no excise tax, and no income tax unless an alternative minimum tax is triggered.

These differences are reflected in the underwriting and contract development procedures of the insurer as well. Purchasing only retired life benefits will reduce actuarial risk and surplus strain, and charges can be reduced accordingly. Not purchasing small benefits for short-term employees will result in administrative expense savings that will be reflected in the price. Since not all plan benefits must be purchased, expensive and risky coverages such as early retirement subsidies and spouse coverages can be avoided.

The mechanics of the bidding and contract process can be, and usually are, very different in the FAS market. The data are generally cleaner and can often be used as final contract data. This is because a date in the past can be chosen as the date for accrual cutoff, rather than estimating accruals as of some

future plan termination date, with many salary changes, hires and terminations to account for. The simplification of benefits in a solicitation for bids can be the actual benefit purchased in the annuity, rather than the usual painstaking process of tailoring to the plan.

The timing is usually swifter, with the purchase often being made in the same calendar quarter as the decision to buy. This is made possible by the simplification of data and benefits, which allows a quick bidding process, and the lack of governmental approvals. The internal approval process is usually easier at the plan sponsor for something viewed as an investment decision with no external fallout. Another difference that could be anticipated is an increased concern about the quality of the carrier chosen. This is in part because the primary responsibility could well revert to the plan sponsor since these people remain participants in an active plan. It is also true that these are usually long-term company employees, similar to the one making the purchase decision, rather than newcomers from an acquired entity.

I'll agree with Vic that a large number of these deals fall through without any purchase. In part, this is because when the financials change in an FASB purchase, the decision can be reversed. Once a termination gains momentum, it is unlikely to be derailed. Often it is not that the financials changed so much as the plan sponsor was led to believe that the purchase rate assumptions would be more favorable than the market really bears, such as unprojected 1984 Unisex Pensioners Table (UP84) mortality, or the lack of provision for an expense charge.

A final difference is the possibility of future purchases by the plan sponsor. Sometimes a planned piecemeal approach is used in an attempt to manage earnings. The settlement gain can be distributed across years, or actually increased, through judicious timing decisions. The plan sponsor should avoid leaving himself with less and less attractive pieces to bid out. If no benefits were purchased on active lives, there can be periodic purchases of new retirees. In either event, if the insurer has demonstrated his responsiveness and administrative ability, he should have a leg up on the competition.

MR. JEFFREY C. MARTIN: I've prepared an outline covering some recent regulatory and legal developments relating to insurance company products in the pension market. It took me a fair amount of time to prepare it so I'm looking for readers. Rather than try to cover most of the stuff in that outline, I want to speak on one topic which I think is interesting. That is portfolio insurance and its prospects in the aftermath of the October market turmoil and in yesterday's market turmoil. For present purposes I think we could define portfolio insurance fairly simply as a system of instructions devoid of any market viewpoint, any views as to whether the market is going to go up or down. And, based upon options pricing theory, shifting between a risky asset such as stocks and a risk-free asset such as Treasury bills in order to participate to some extent in any appreciation of the risky asset while limiting the downside risk in order to insure a minimum plan surplus, a minimum return or limited losses.

Although portfolio insurance techniques are not offered exclusively or even primarily by insurance companies, insurance companies unlike other vendors may be willing to back up their assurances of a minimum return or a minimum surplus with a general account guarantee. Portfolio insurance strategies have been identified by many observers as a major factor in the October market break. The Brady Commission appointed by the President maintains that mechanical,

price insensitive selling of stock index futures by portfolio insurers was a significant factor in the drop. When sales in the futures market bring the futures price to a discount to the equivalent stocks, then index arbitragers will go in and buy the futures and sell the stocks. Now that brings the market back in line but it transmits the selling pressure from the futures market to the stock market. According to the Brady Commission, some market participants were aware on the weekend prior to Black Monday that due to prior drops in the market the portfolio insurers' model dictated that they should have sold a lot more securities or a lot more stock index futures than they had in fact sold by that time. The estimates in the Brady report are that they should have sold some $12 billion in the week prior to October 19th when less than $4 billion had in fact been sold. This market overhang was viewed as supplying a lot of downward pressure on the stock market. On Black Monday, the stock index futures market immediately saw a lot of heavy selling by portfolio insurers. Some portfolio insurers, perhaps because the futures price was at a discount to the stock price, didn't sell futures, they sold stocks directly.

For example, one large pension fund that utilizes portfolio insurance strategies sold some 13 stock baskets through the New York Stock Exchange's Designated Order Turnaround (DOT) system. That's the system that transmits orders directly from the brokerage houses to the specialist on the floor. One large fund sold 13 stock baskets from 10:30 a.m. to 2:00 p.m. with total sales of over $1 billion in stocks on that day. Because there is a lot of use of this stock system, delays began to develop in it and so index arbitragers, those people who are buying the futures and selling the stocks, became a little uncertain as to the prices at which their sell orders would be executed. That stopped supplying any buy side support to the futures market. Now this led to a tumble in the futures market which scared off most every buyer of the stocks and so by the end of Black Monday, the Dow had lost 23% of its value; the S&P 500 futures contract closed down some 20%.

The Brady Commission conducted a survey of some large pension funds concerning their activities in October. Overall there were 80 responding funds and they were 46% invested in equities. Of these 80 responding funds, 11 funds were using portfolio insurance strategies in October and these funds, as you might expect, were more heavily invested in equities because the market had been rising for the period prior to October. Those funds were 56% invested in equities. Most funds that use portfolio insurance strategies started using them around 1986. The survey of the Brady Commission revealed that one portfolio insurer did sell very heavily in October, primarily in the futures market. Among most portfolio insurance strategy directives the instructions from the models were not followed in full. Reallocations between the stocks and cash and so forth lagged behind and sometimes the overall program was discontinued by some fund. Three portfolio insurance strategies did moderate the losses of the funds, but they basically did not perform as well as the fund managers expected. And many people using portfolio insurance stopped as a result of the October experience. Out of 13 responding funds who has used them in 1987, two dropped the strategy prior to the October market decline and seven more subsequently abandoned their portfolio insurance strategies.

The Commodity Futures Trading Commission (CFTC), which regulates the futures market, also issued a report on the market break. It reached conclusions somewhat at odds with those of the Brady Commission. It defends the role of the futures market in October, and says the futures market did not lead the stock market down. It says that data to the contrary were basically a result of

information lags. That if you, in fact, compare the value of the stock actually being traded on a given moment on the New York Stock Exchange with the concurrent value of the futures contract, there really was not much of a lag. They also find that on Black Monday program stock sales accounted for less than 15% of the shares that were sold on the New York Stock Exchange that day, and that selling of the S&P's 500 futures contract by portfolio insurers accounted for only 20% of the selling in that contract. The CFTC basically concludes that the decline on Black Monday was a rapid, fundamental realignment of perceptions of where the market was going not caused by futures, not caused by portfolio insurance, but by fundamental economic factors.

The SEC also issued a report and it's somewhere in the middle of the Brady Commission and the CFTC. The SEC says that the decline immediately preceding October 19th was triggered by changes in investor perceptions regarding economic fundamentals. With those changes as a trigger, the SEC says that institutional stock selling was the largest single factor on October 19th. The increasing concentration of stock holdings in institutional hands, including pension funds and mutual funds, is cited as a major factor in the market drop. Program trading, index arbitrage, portfolio insurance are also cited by the SEC as being significant factors. Also, the SEC does agree with the Brady Commission that there was a market overhang effect from portfolio insurance. The fact that everyone was expecting that they would have to sell a lot more futures or a lot more stocks in order to follow their model had an inhibiting effect on would-be purchases of stock.

Despite the differing viewpoints of the regulators, there have been a number of actions that have been taken to revise the regulations in response to the market drop. They haven't been coordinated at all, however. The New York Stock Exchange, as you probably know, prohibited the use of its stock system for index arbitrage on days when the DOW moved 50 points or more. If you read the newspaper, you see that there's some criticism of that approach, that it may not only be ineffective, it may be damaging. If you say that they can't use the DOT system and there's still a discount in the futures market to the stock market, then people can use more brokers to sell stocks. This apparently is what happened yesterday, or they could not buy the futures at all, which will lead to a bigger discount in the futures price which is probably more dangerous. The futures exchanges have also made a few changes in instituting large daily price limits. Those only come into play when there's something like a 150-point change in the DOW. They've also raised the margin requirements.

Many more regulatory changes are under consideration, including transferring the regulatory authority over stock index futures to the SEC, raising margin requirements very dramatically to dampen the leverage in the futures market, revising clearing systems. One of the most interesting developments wasn't really triggered by the break because it was in the planning stages well before October. That is the proposed introduction by the Philadelphia Stock Exchange of a new way to trade the stock market generally without either the transactions costs involved in actually buying the baskets of securities themselves and without the leverage associated with the futures market. They've come up with a new instrument called a Cash Index Participation Contract, or CIP, which is currently pending approval at the SEC. If an active market develops in these CIPs, that may be an attractive investment for people interested in index funds and that sort of thing, as pension funds often are.

The ultimate political and regulatory fallout from the October crash is likely to be affected by how well or poorly the market behaves. There hasn't been much of a rush to enact any legislation because the market has been pretty well behaved since October. Competition among the various exchanges and the various regulators within their own turf ensures that Congress hears all sides of the story, but also makes it difficult for any legislative changes to be enacted. The administration doesn't have a consistent position on this to try to resolve the differences. My view is that there couldn't be any turning back the clock. Stock index futures are here to stay, they perform valuable functions particularly for institutional investors, and it is important to improve the communication between the stock and the futures market. For example, on October 20th, the futures exchanges closed trading for a while in stock index futures in response to an incorrect report from people on the SEC staff that the New York Stock Exchange was about to close. Things like that really shouldn't happen.

There are a number of regulations that need to be assessed and margins that need to be looked at. In my view, the case for wholesale regulatory changes really hasn't been made yet. Portfolio insurance, I think, should not and probably could not be banned. Based on the reports that I've read, it appears that portfolio insurance did contribute significantly to the market drop, but that it was only one source of selling pressure. Moreover I think it's also true that the hedging opportunities provided by the futures market in general and the portfolio insurance strategies in particular were a factor in the prior rise of the stock market to was now appear to be overvalued levels. It's hard to say that portfolio insurance was the primary cause of the drop. Equity markets where portfolio insurance was not used, such as the smaller stocks and the non U.S. markets, were hit just as hard as the major U.S. stocks where portfolio insurance is a factor. Moreover, because portfolio insurance strategies are trend following, if the market goes up, they buy, if the market goes down, they sell. It's hard to say that portfolio insurance is an initial cause of the drop rather than simply an exacerbating factor. Moreover, as I say, I don't know how you would go about prohibiting portfolio insurance, it's really a way of thinking. You could sell to a portfolio insurance model without the DOT system or even without the futures market. The cost would be higher and perhaps make it sufficiently inefficient to sell. Then you could effectively eliminate portfolio insurance.

A task force established by the Chicago Mercantile Exchange made the good point that the continuous and smooth exit prices by the theory are not really available when everyone tries to get out of stocks and futures at the same time. Alan Greenspan said that he thinks that Congress and the regulators need not worry quite so much about portfolio insurance's contribution to market volatility because there'll be less of it for business reasons.

One salutary thing arising out of October seems to be that vendors of portfolio insurance should now experience pressure to market their services on the basis of how they did in the turmoil of that period instead of simply showing you some simulations. Before the crash the advent of FAS 87 seemed likely to create further use of portfolio insurance by pension plans. Portfolio insurance appeared to provide sponsors with a way to achieve much of the favorable returns from equities in a rising market while minimizing the adverse income statement effects if a sponsor's plan is heavily invested and the market drops. After the crash plan sponsors may feel they have a starker choice between, on the one hand, seeking the higher returns available in equities at the expense of volatility and reported income, or taking a more conservative strategy and

emphasizing fixed income investments. On the other hand, if there are portfolio insurers who can point to a reasonable success in last year's volatile market, then they may be able to convince some plans that portfolio insurance continues to provide an alternative to that hard choice.

MR. MICHAEL MELNICK: I have one question that's directed to Tony. Generally a settlement of retired or inactive liabilities is also viewed as a way of reducing the PBGC premium, which is more interesting now with the effects of OBRA 87. With regard to the issue of the level of participation in the contract, does that also affect the issue of whether or not there would still be a PBGC premium? I'd like your comment on that. And, secondly, I wonder about the message that FAS 88 is creating a way for financial officers to use the pension plan to manage their bottom line. How widely dispersed is that message at this point? Is most of the FAS 88 activity you're seeing on settlements coming from events like mergers or acquisitions, or are you seeing a lot of FAS 88 settlements purely on the basis of managing the bottom line?

MR. AMODEO: I would answer the second question first and say that definitely the latter -- managing the bottom line. The FAS settlement opportunity is right now being perceived not in the merger and acquisition market so much as by financial institutions. Those are the ones who really have been availing themselves, banks for the most part, at the same time as they write up their loan losses, they exercise an FAS 88 settlement. Because the financial institutions have always concentrated on the financial results of their entire operations, the fact that the pension plans now have been pulled in is merely another thing that they concentrate on. But no, we haven't seen it so much in industrial organizations. In answer to the other one, the participating question in the PBGC, this was tackled under the joint guidelines for terminations. I remember going down to a meeting in Washington not long after the joint guidelines, around the end of 1984. At that point the people at the PBGC were upset about par annuities because they thought that par meant the individuals were going to get a differing benefit depending on the financial experience of the contract. Once it became clear, the PBGC went along with par first and then the IRS followed. The PBGC went along pretty quickly once they realized that the liability for these participants had indeed been pulled into the private sector. I've not heard any backing away from that position because of FAS settlements.