RECORD OF SOCIETY OF ACTUARIES
1988 VOL. 14 NO. 2

Vol. 14, No. 2 May 1988

RECORD

TRENDS IN ANNUITY PRODUCT DESIGN

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- o Single premium deferred annuities
- o Single premium immediate annuities
- o Modified guaranteed annuities, market value adjustments, certificates of annuity
- o Flexible premium deferred annuities

MR. DAN R. SPAFFORD: We're fortunate to have with us three speakers who have great depth and experience in the annuity field. Michael Winterfield will address the ways in which insurers can position themselves in today's annuity marketplace. Don Sondergeld will describe his company's unique and ground breaking approach to the risks inherent in the fixed annuity. Grant Somerville will discuss marketing of annuity products through the stock brokerage channel.

The speakers certainly represent great depth in terms of annuity product design, but to increase the breadth of our panel we designed a questionnaire which was sent to 35 people that we identified as experts in the field of annuities. They were 17 actuaries, 4 attorneys, 14 marketers and Nancy Reagan's astrologer. On the questionnaire, we listed eight products, which varied from a generic type product, like the SPDA (single premium deferred annuity) and the variable deferred annuity, to more exotic designs like the combination annuity, which Mike Winterfield will talk about, and the market value adjusted annuity, which Don Sondergeld will address.

The questionnaire covered three main areas. The first area was, which products will experience the greatest growth in sales over the near term? The second area was, what products will undergo the greatest design changes in the next few years? And the third area was, how adequate is the product design and pricing in terms of covering the risks inherent in the product?

If there is one overriding conclusion that I came to, upon my review of the 23 forms that were returned, it's that, in spite of all the talk, and of all the seminars by Tillinghast, Milliman & Robertson (M&R) and others, and in spite of

* Mr. Somerville, not a member of the Society, is Vice President of Marketing with Dean Witter Insurance Services in New York, New York.

the regulatory concern on the subject, in the view of these experts, the insurance industry is still not doing a good job in managing the interest rate risk inherent in the fixed annuity product.

I'd like to present a tree top summary of the results of this questionnaire.

I have five graphs to share with you. The first (Graph A) compiles the responses of the experts in terms of which product will realize the greatest growth in sales over the next few years. The experts picked the SPDA product. It was mentioned on 44% of the responses as likely to have the greatest increase in sales. The reasons for this were; the ending of the IRA market, people coming from IRAs and buying SPDAs, the flight from equities into the fixed product, and the concern about the single premium life insurance product because of possible tax changes. There was also a feeling, with respect to the SPDAs, that there would be increasing use of new distribution channels such as banks and savings and loans.

The next product that got a lot of attention in terms of increasing sales was the variable annuity. This appeared on 35% of the questionnaires. The reason for this was, in spite of the October 1987 stock market crash, the experts felt that this product would be attractive because equities will continue to be attractive in the future. Also, because of the narrowing of the IRA market, the experts felt that we would see movement into the variable annuities.

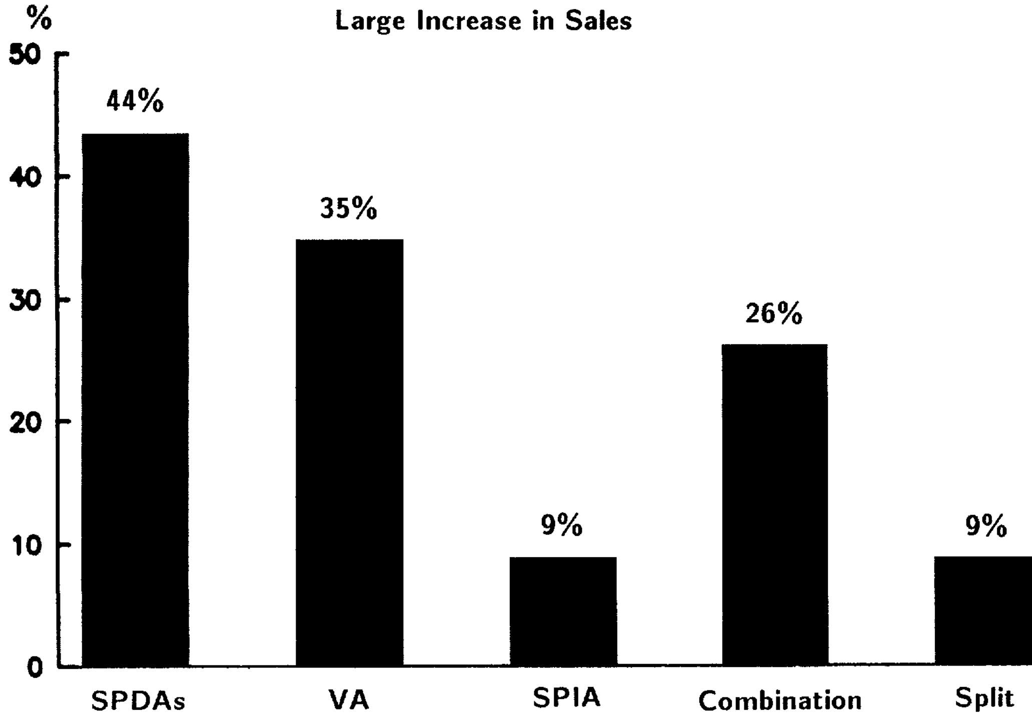
The third product that got some attention was the combination annuity, the combination of a fixed bucket in a variable annuity. According to the experts, this product combines the best of both worlds.

Graph B shows the extent of expected product changes. The products that were considered to be changing the most were the variable annuity and the combination annuity, the variable type products. Seventy-eight percent and 82% of the experts, respectively felt there would be significant changes for these two products. The response was polarized into two factions. On the one hand you had the marketers and the actuaries feeling that there would be considerable marketing improvement with these products, for example, additional separate accounts, separate accounts designed to look like fixed accounts, greater facility for transferring between accounts and a possibility of a check writing facility. On the other hand, the attorneys felt that there would be, because of the concern of the federal regulators, restrictions thrown on these products, such as, restrictions on movements between funds and increased diversification requirements.

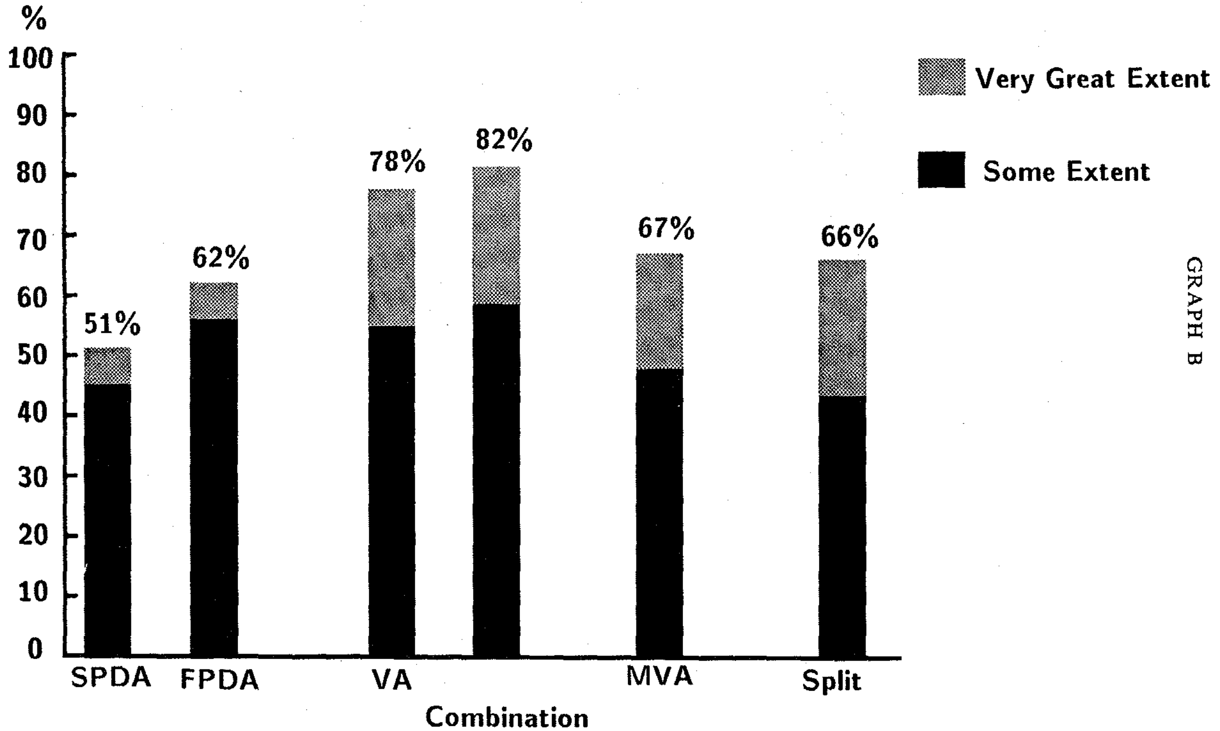
The market value annuity, or the modified guaranteed annuity was chosen as undergoing change over the next few years also. The primary reason was the feeling, of some experts, that it would likely be required to be registered by the SEC as an investment product. Also, as more and more states approve the product, we will see changes due to their regulatory concerns.

The next group, the SPDA, and its sister product, the flexible premium fixed deferred annuity (FPFDA) were seen as undergoing changes over the next few years because of insurer concerns about their profitability and inherent risks. The types of changes the experts felt would come about were lower compensation levels, higher surrender charges, longer surrender charges, and things of that nature.

GRAPH A



GRAPH B



Graph C shows the results of the adequacy of various products in terms of providing risk margins to insurers. Four products did well on this particular question. The variable annuities were felt by 78% of the experts to provide adequate risk margins for insurers. This was their split between the people who felt that it did "well" in that regard and the people who felt that it did "very well." The next two products, the market value adjusted annuity and the combination annuity, were also felt to do well. The market value adjusted annuity had a 62% positive response on this question while 38% of the people said they didn't understand the product. So, none of the respondents said that it didn't provide adequate risk margins for insurers.

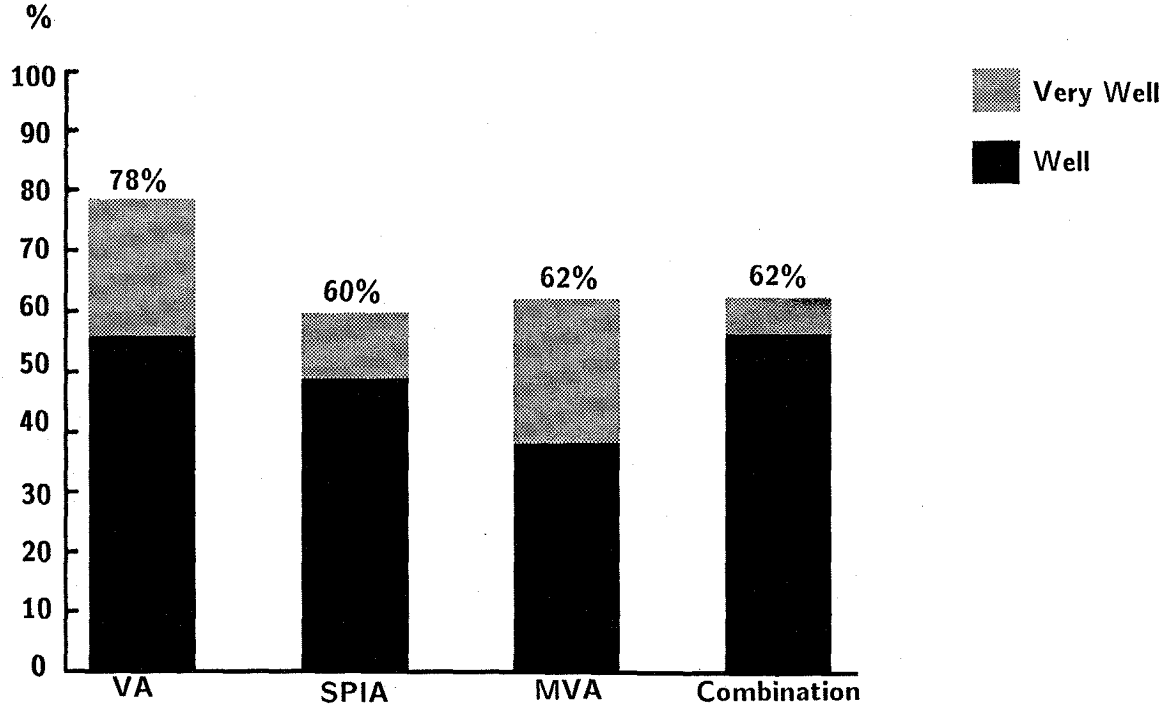
Graph D is the flip side of Graph C and shows the products that were named as not doing well in providing adequate risk margins. The single premium deferred annuity came out on top. Forty percent of the responses said it does "not well" in this category and 30% responded it does "not well at all," the most severe category. So, there is much concern about the SPDA. Again, the fixed flexible premium deferred annuity also registered a high level of concern in this regard. Structured settlements were mentioned on 40% of the questionnaires, but 40% also said that structured settlements did provide adequate risk margins, so there was a wash on that product.

Graph E shows the ranking by types of risk. The clear winner for greatest risk was asset/liability mismatch. Eighty-seven percent of the respondents felt that that risk was covered "not very well" or "not well at all" in the product design and pricing. Only 9% of the respondents felt that it was covered "well." The next three risk categories, the risk of asset default, the expense risk, and the persistency risk, all came out about the same, in the low 40s. On the other hand, about 40% of the respondents felt that they were covered well. So they were about a wash too. The respondents felt most comfortable with the mortality risk. Twenty-four percent of the people felt that it was covered "not well." About the complement of that felt it was covered well, 76%.

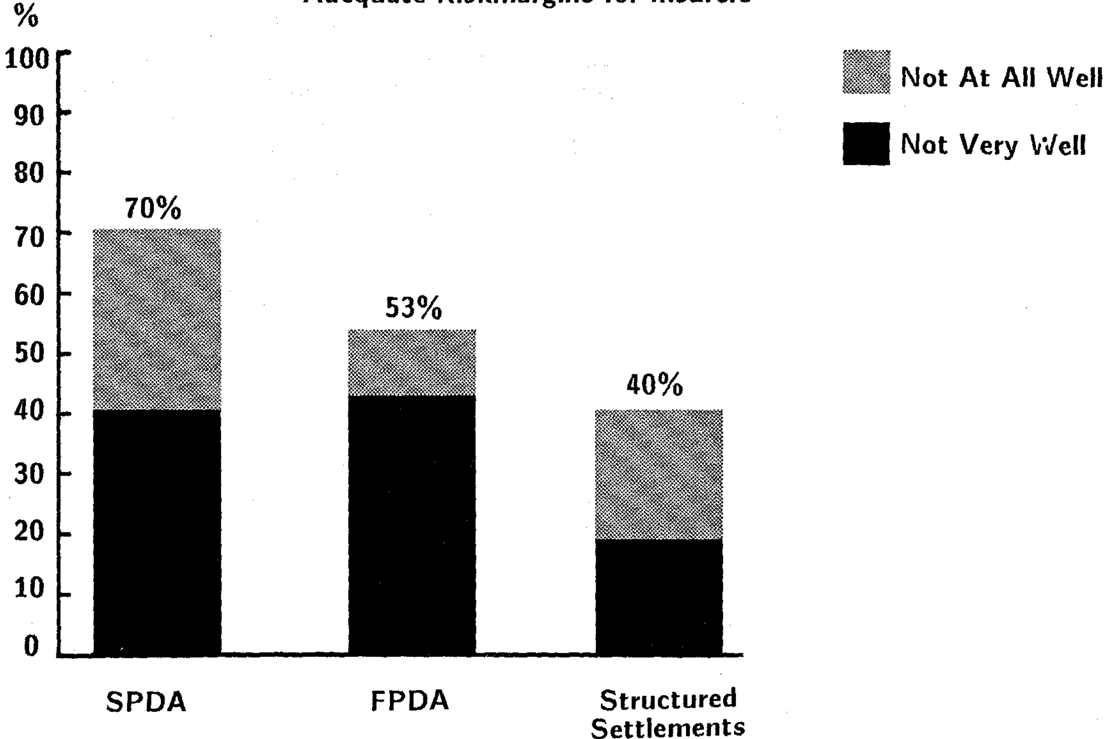
MR. MICHAEL WINTERFIELD: Consulting actuaries like to talk a lot about balance, and we really try pretty hard to have a little something for everyone. I have accordingly labeled my talk, "The 1988 Individual Annuity World. Balancing Unprecedented Sales Opportunities (Up to $20 Billion Premium) with Financial Risk Tolerance." I will speak from my vantage point, as a consulting actuary, who is working with insurance companies which want to actively participate in the annuity market within a set of prudent risk parameters. These clients don't necessarily want to bet the ranch on their annuity business but they are prepared, in most cases, to accept some risk of a real loss. This will distinguish my orientation from Don Sondergeld, who will talk about the product approach, where the company feels that it is necessary to work with something closer to a bullet-proof risk orientation.

I'd like to begin with the current consumer and distribution driving forces. The logical place to start is last October with the twin bombshells that occurred then. The first of these was obviously Stark-Gradison. The Stark-Gradison proposals would impose the annuity distribution rules on life insurance. This necessarily led to a rather extreme shift from life insurance sales to annuity sales. Twelve days later, on October 19, we had the 508 point Dow Jones collapse which created an additional emphasis to sell the fixed annuity over the variable annuity.

GRAPH C



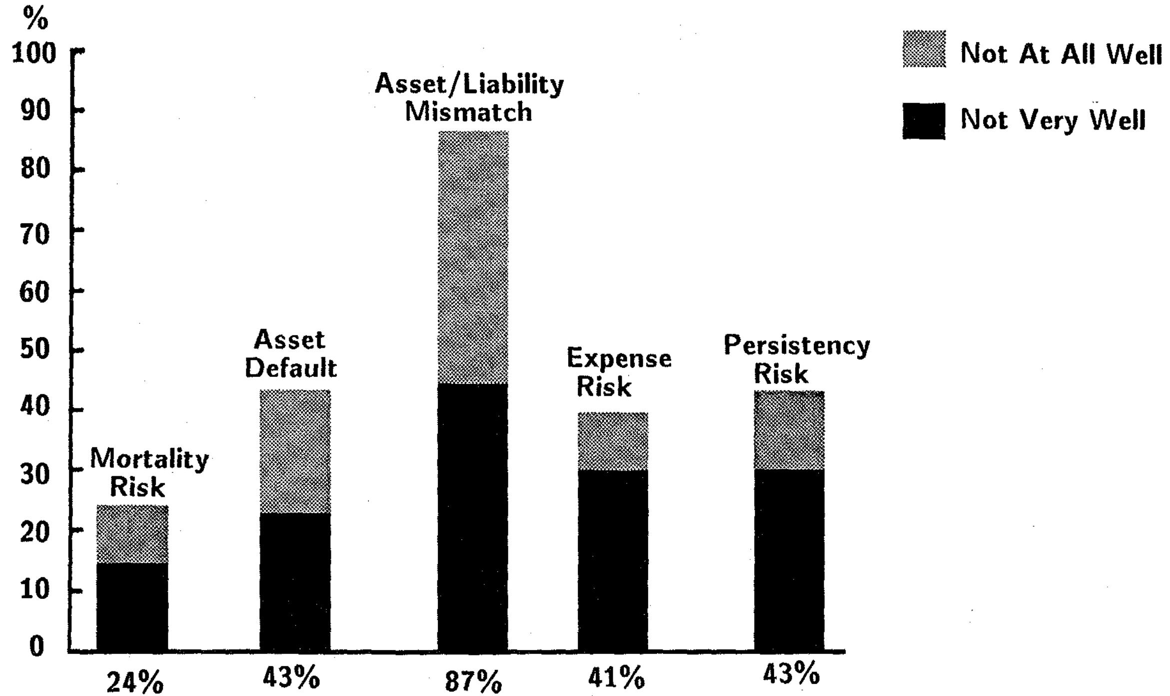
GRAPH D



GRAPH E

Adequacy of Providing for Selected Risks

in Product Design and Pricing



Our estimated sales figures will be quite consistent with the two driving forces previously mentioned. We are estimating that SPDA premiums increased by approximately 50% in 1987 to slightly over $10 billion. We are looking for another 40 to 50% increase in 1988, to the $15 billion range. Our other catch-all category is the variable annuity and the combination fixed and variable annuity contract. We saw a pretty healthy increase in 1987 to the $3.6 billion range, most of which occurred prior to the stock market collapse. Our projection for 1988 is very speculative, in the $2.5 billion range. We think it would be a lot lower than $2.5 billion if not for the moderating impact of the fixed portion of the combination fixed and variable annuity contracts.

The main phenomenon that we're looking at is the action within the SPDA area, where we see the $15 billion of projected activity. The safe zone, where companies would prefer to be financially, is in the $2.5 billion area, where variable annuities and the combinations are.

Let's talk a little about the company's financial concerns in the SPDA area. First, we're looking at some significant initial surplus requirements in two areas. There's reserve strain and assigned capital to cover the risks for these products. We've been dealing, over the years, with some very severe interest rate competition. It's been awfully difficult for companies to achieve their target margins. Of course, we have the specter of investment antiselection which Don will be talking about. What happens when interest rates go through the ceiling, as they sometimes do?

All of this leads to certain alternative company tactical strategies. The first of these is to find a financially acceptable SPDA product design. Essentially, the feeling with this $15 billion market is that it's just too big to ignore. You've got to find a way to work with it. The second strategic response is to try to build up the $2.5 billion area. Increase the marketability of the variable product. The third one is to try to get the best of both worlds. Combine the fixed and variable contracts. One very important note, when we're looking at the necessary strategic response, is don't lose sight of the buyer's insecurity. My point is that we simply can't afford to kid ourselves. Because of our desire to minimize company risk, we can easily create a lot of rationalizations for products that shift the investment risk to the buyer. We can talk a lot about long term performance, about the ability to find better value in the current market, but the sometimes consumer won't buy it.

In the business section of yesterday's *New York Times*, there was a sobering reminder of consumer realities. I'd like to quote a few pieces from this article. First, "In a survey this month by Sindlinger & Company, only 3% of the households queried said they planned to buy stocks, down from 33% who said they would do so after the market panic in October. The figure is the lowest in the 34 years the firm has polled consumers. They're more frightened than they were in October and November." Another quote, "The most common explanation for what ails the market is investors' fear of being whip-sawed by program trading or playing in a 'rigged' game." A couple of other quotes: John Bogle, chairman of the Vanguard Group, "You are probably looking at four or five years of withdrawals from the market," and David Williams, chairman of Alliance Capital, "Only time will restore confidence."

Let's turn to the specific product responses to satisfying the company and customer needs simultaneously. We will talk about, first of all, SPDAs with a better marketing and financial balance. The market is there, let's fit it into a

better financial framework. We have as a second response, what I call, the modified SPDAs, the modified guaranteed annuity and the certificate of annuity approach. The feature is that there is a book value only at the maturity date. The third area is the combination fixed and variable annuities; the fourth, variable annuities with multiple pockets and an asset allocation service. I mentioned earlier about people feeling that the ball game was rigged against them. The asset allocation service is an opportunity for the customer to feel that he can participate in that bigger ball game.

Let's return to the SPDA financial changes. In the current environment we are fortunately looking at more realistic pricing. It's not easy to price today, but it is a lot easier than it was 12-18 months ago. There have been some very significant changes in the interest crediting policies to carry companies through both the first year and the renewal years. In some cases companies have perhaps been a little bit over zealous, with regards to their renewal settings.

I would encourage many of you, if you haven't done so already, to read the April article of *Money* magazine on annuities, "How to Cut Through the Flim-Flam."

There is a better asset/liability fit, not bullet-proof, but a much better fit, and products are becoming more persistency oriented. In order to reduce the initial statutory losses, and in order to encourage persistency on the part of the agent and the customer, companies are increasingly diverting a little bit of the initial compensation into an asset based pattern. Here, the reduced initial allowance, plus the trail compensation, would have the same equivalent present value, if the underlying persistency assumptions are realized.

I'd like to provide an example of the improvement in the pricing trends. Back on July 15, 1986, seven-year treasuries were barely over 7%. One-year interest guarantees were over a percent higher, and averaged about 8.25%, and five-year guarantees ran about 25 points lower. If we look at July and December 1987 and May 1988, and we then compare the May 1988 figures with July 1986, we'll see that the one-year guaranteed interest rate went up by a negligible eight basis points whereas, the seven-year treasury went up by 161 points.

Let's get more specific about some of the SPDA product changes. There is definitely more diversity within the company portfolios. Many companies are offering a number of products simultaneously. Very often now, we different products for different distribution systems. For example, companies which are selling through both agents and financial institutions often have a simpler, but slightly less competitive, product for the banks. The bank product, for example, can be issued right at the bank. But the interest rates and the termination charges might be a little less glamorous.

We are seeing some very big changes with the longer term interest guarantees. They are very commonly offered by companies, but you might have to settle for a significantly lower rate than what you'd get on a one-year guarantee. Companies are building in the cost of capital to put up the nondeductible excess reserve. The nondeductible amount includes guaranteed interest, in excess of the dynamic valuation rate, and additional nondeductible amounts, that arise from discounting the guaranteed values at the federal interest rate (7.77% for 1988). With respect to the surrender charge area, again we're seeing some very substantial changes. We are seeing both higher and longer charges.

As a totally different approach to products, Grant Somerville will discuss the product which has renewable interest guarantees and termination charges. For example, a product which has an initial five-year interest guarantee with a five-year termination charge. At the end of five years, the client has an opportunity, within about a 30-day window, to get out of the contract without any penalty. After that time, a new five-year guarantee is declared and a new termination charge is imposed. One of the very nice advantages of this, financially, is that the insurer's exposure is greatly limited in the renewal period. The insurer is only exposed at the end of each one of these initial guarantee periods, for a limited 30-day period. Again, in order to reduce some investment exposure, and to substantially reduce initial reserve and statutory losses, there is a definite movement towards the nonbailout design.

Let's turn to index options. Indexed products are enjoying a bit of a rejuvenation. There are two different approaches here. The first approach, which has been around for a while, largely centers around one-year underlying guarantees, where an index is provided as a floor. The policyholder is given a guarantee that the individual one-year guarantees will never go below the index. The second type of index, which has become very popular, is to provide an upward index under a longer interest guarantee. The approach, typically under a five-year type guarantee, is to add a clause stating that if market rates go above a certain index, the policyholder will get the higher rate. This kind of index has done much better than the first one because the buyer really feels that he or she can't lose. If rates drop, you have a very nice five-year guarantee. If rates go up, there's some upside participation. Split funding is another hot area that Grant will be covering.

As sort of a sleeper, I'd like to mention the certificate of annuity approach. This product is simpler, but more restrictive than the modified guaranteed annuity. Technically, it's not quite as good a product but the simplicity seems to matter. This product provides a single guaranteed interest rate to the maturity date. There are no withdrawals allowed, or there might be a design which would allow interest only to be withdrawn prior to the maturity date. The appeal is that there are opportunities to provide a higher rate for the liquidity give-up. There are some very nice opportunities to tie this product into a split funding framework, where interest can be tax efficiently withdrawn under an installment income.

I'd like to comment on a conceptual framework which some of our clients find is a good way to approach the SPDA market, when there is a desire to introduce products that provide more protection for the company. The concept is to offer a family of products, in which different product features can be compared. Under this framework, a company, for the sake of having something like everyone else, will offer a fairly traditional product with a limited termination charge. At the same time, the company can simultaneously look at a product with a more significant termination charge, or lapse deterrent, with the client getting a higher interest rate. Within the same framework it would also be possible to look at the modified guaranteed annuity and the certificate of annuity as being an approach whereby the client can get an absolutely superior interest rate, in exchange for the company not having to accept quite as much risk.

Lastly, I would like to comment on the combination fixed and variable annuity. There's a quote in the April 4 *National Underwriter* from one of the new entrants in this market, "it's a product for all seasons." This product offers a wide range of variable fund choices. It offers a one-year guaranteed fixed account.

It will be less aggressive than the SPDA account but the rate on this will be more attractive than what the customer would be looking for in a money market account -- generally somewhere in the middle between a money market rate and your full SPDA rate. There is another advantage in this kind of product. There normally is some nice incentive for the seller. We generally see slightly higher compensation than in the case of the SPDA.

MR. DONALD R. SONDERGELD: About 150 years ago, in 1833, an obscure English mathematician named William Lloyd Forster described the threat of overpopulation in terms that might equally characterize the dangers posed by many guaranteed-return life insurance and annuity products today.[1]

Forster used the analogy of a common grazing area to point up the hazards of pitting private gain against collective risk. Suppose that a village commons was open to all herdsmen to graze their cattle, he argued. Each herdsman would naturally seek to maximize his gain by adding more animals to his own herd. In the absence of any regulations governing use of the commons, the self-interest of the herdsmen would lead to overgrazing, according to Forster. Why? If unregulated, the individual incentive for gain would outweigh the collective risk of overgrazing. Each herdsman would realize the full benefit of adding an animal to his own herd, whereas the incremental risk posed by adding another animal would be spread among all the herdsmen grazing on the commons.

In 1968, the writer, Garrett Hardin used the term "tragedy of the commons" to describe the latter-day equivalent of "overgrazing" seen in the environmental problems of a modern industrial economy.[2] Indeed, the analogy has broad application in a society that has grown steadily more complex and interdependent since Forster's day.

How does this tragedy of the commons relate to life insurance? The proliferation of certain interest-sensitive financial products sold by life insurance companies is a case in point.

Life insurers traditionally emphasized long-term, low-interest products whose cash values were essentially a by-product of their level-premium pricing structures. The viability of such products was severely tested by the high inflation and high interest rates of the 1970s. In order to appeal to more sophisticated buyers, insurance companies began offering a competitive rate of return on cash-value products, notably SPDAs and single-premium life insurance, as well as such interest-sensitive products as universal life.

The new products became directly competitive with other types of financial instruments by offering a guaranteed return at current market rates in combination with tax deferral of cash-value buildup. Liquidity was preserved by allowing buyers to withdraw their money at book value, regardless of fluctuations in the market value of underlying assets. In effect, cash values were guaranteed from inception to maturity, apart from modest deductions to cover company expenses in the event of early withdrawal.

[1] W. F. Lloyd, Two Lectures on the Checks to Population, Oxford University Press (Oxford, England, 1833).

[2] Garrett Hardin, "The Tragedy of the Commons," *Science* (Vol. 162, December 13, 1968), p. 1243 ff.

Buyers enjoyed the benefits of a long-term return while retaining a short-term surrender option, which virtually insulated them against market risk. The separation of risk from reward, which made such products so attractive to investors, also created the potential for a "tragedy of the commons."

It is a basic tenet of investment theory that the greater the risk, the greater the reward. Investing in a long-term security at a fixed rate is considered riskier than a short-term investment because the buyer can't take advantage of higher returns if interest rates subsequently rise. Conversely, of course, the buyer would benefit from a decline in interest rates because of his higher long-term fixed return. The variability of the outcome is the key to risk. The greater the potential for a rise or fall in rates, the greater the risk and the higher the return that must be paid to attract investors.

Risk-and-return considerations normally act as a curb on speculative excess. The hope of higher gain is balanced by a proportional fear of financial loss. But with most interest-sensitive products, the buyer reaps the benefits of long-term yields, while the insurer assumes the interest-rate risk. Ostensibly, at least, the products appear to offer a high return with little or no risk.

No problem exists as long as interest rates are stable or declining, because buyers have no incentive to withdraw their money. However, a sharp rise in rates can cause investors to withdraw their cash in search of higher yielding investment alternatives. A large number of such surrenders will result in severe losses or even insolvencies for insurance companies by forcing them to sell fixed-income assets at market values that are substantially below the book values guaranteed to buyers. The reason, of course, is that the market value of debt securities rises or falls inversely with interest rates so that their effective yield always approximates the prevailing market rate. That, of course, means insurers will realize losses if assets bought at lower interest rates must be sold after interest rates have risen.

Consider the example of an annuity guaranteeing an 8% rate for ten years. The insurer might invest in 9% fixed-income securities to cover expenses and profit. The securities will mature in ten years if asset and liability cash flows are matched. Now suppose that new annuity guarantees rise to 12% after two years. Surrender charges, if any, would rarely be high enough to offset the reward of a 50% increase in yield to buyers who cashed in their 8% annuities in favor of 12% annuities. If the insurer's cash reserves aren't adequate to cover surrenders, the company will be forced to absorb a 20% loss in the market value of 9% securities sold when prevailing market rates have risen to 13%. If the insurer mismatched assets and liabilities by purchasing longer-term securities, the effect on its surplus would be even more devastating in the event of wholesale withdrawals.

For insurers selling interest-sensitive products, the danger of "overgrazing" is greatest when the grass is greenest -- which is to say, when interest rates are high and guarantees are most attractive to potential buyers. High rates are typically a by-product of inflation, which tends to depress stock market performance and make fixed-interest investments all the more alluring. Furthermore, in emphasizing competitive market rates, the new insurance products attract a more opportunistic type of investor. A short-term investment orientation inevitably exacerbates the tendency toward disintermediation when interest rates spike.

What is the likelihood that unwary insurance companies will once again be caught by double-digit interest rates in combination with extreme market volatility? In fact, although inflation has remained relatively low in recent years, market volatility has persisted, and real rates (the difference between nominal rates and inflation) have remained relatively high. Indeed, since the Federal Reserve stopped pegging interest rates in 1979, volatility may have become a permanent market fixture, with deregulation of the banking system and the globalization of capital flows also playing major roles.

Two other developments contribute to a potentially perilous financial situation for marketers of interest-sensitive products.

The first is passage of the Tax Reform Act of 1986, which retained the tax advantages of life insurance and annuities while eliminating numerous other tax shelters. In effect, by standing still, the interest-sensitive products sold by life insurers had substantially improved their competitive position in the tax-favored investment market.

Even before enactment of the tax reform measure, growth in premium income from single-premium annuities and life insurance had been substantial. Annuity sales increased 29% in 1986 (the most recent year for which industry data is available), following a 23% gain the prior year.[3] Growth in sales of single-premium life was even more impressive, rising 75% in 1986 after an 87% gain the year before.[4] Indications are that 1987 was another banner year for single-premium products, spurred on no doubt by tax reform and a concurrent rise in interest rates.

A second worrisome development was precipitated by the 508-point drop in the Dow Jones Industrial Average in October 1987. Whatever its long-term economic impact, the crash ended one of the longest sustained bull markets in modern history -- and with it any illusion that common stocks provide high returns with relatively little risk. Indeed, the marketers of fixed-interest investments wasted little time in launching new advertising campaigns that emphasized their guaranteed returns.

The guarantees that make interest-sensitive life insurance and annuity products so appealing in unstable markets are precisely the features that should be of greatest concern to insurance regulators and insurance company management. By guaranteeing cash values, insurers have merely transferred the market risk from individual buyers to themselves, thereby setting up a potential "tragedy of the commons." In the event of an insolvency, the cash-value guarantee disappears, since investors have no access at all to their money. Their eventual reimbursement -- at less than 100 cents on the dollar -- must then depend on assessments levied against other insurance companies through the various state insolvency funds.

A number of safeguards have been proposed, including higher surrender charges, shorter guarantee periods or even a ban on cash withdrawals prior to

[3] Data supplied by Life Insurance Marketing and Research Association, Inc., Hartford, Connecticut.

[4] "Single-Premium Life: The Story Continues," Life Insurance Marketing and Research Association, Inc., Hartford, Connecticut, September 15, 1987.

maturity. Any or all of these might be justified, given the potential magnitude of the problem. But none could be implemented without severely compromising the products' viability in the marketplace.

However, the most compelling features of interest-sensitive life insurance and annuities can be retained without creating unacceptable risks to the insurer. This can be accomplished through the simple remedy of paying the buyer the market value rather than the book value if he cashes out prior to maturity.

Some market-value adjustments are already a standard feature of many group annuity and pension products.

I'm sure some of you have read the feature article in the December, 1985 *Best's Review* on new product profitability. It was titled, "A Tale of Two Countries," and was written by Fred Richardson, FSA, former President of the Hartford Life Insurance Companies. That article compares the historical development of cash value products in the United States and in the United Kingdom, and indicates the lessons that can be learned from our British relatives. The major ones are the need for market adjusted cash values and the use of cash flow matching.

During the early 1970s in the United Kingdom, a number of life companies offered SPDAs with attractive interest guarantees. As interest rates rose to unexpectedly high levels, a number of companies found themselves in serious trouble in meeting their withdrawal guarantees. This crisis resulted in a number of rescues of small companies by the industry, and in one bankruptcy. This event caused great distress to policyholders and, of course, was of great concern to the industry and to the regulators.

Through a company we previously owned (Abbey Life in the U.K.), the Hartford has had extensive experience with SPDAs in a period of high inflation and volatile interest rates. Abbey Life wrote an individual annuity that had surrender values based upon a market value adjustment formula. That contract was very popular and, by its nature, avoids the inherent risks of the traditional SPDA by having surrender values related to market values. As a result of this experience, Hartford Life decided to launch a similar product in the U.S.

We wanted to market a "safe single premium annuity" to individuals. That is, an annuity with a guarantee of principal at a stated maturity date, an attractive interest guarantee during that period, but with a surrender value that is equitable to both the policyholder, and to the company. The surrender value is adjusted upward or downward, based on market conditions at the time of surrender. We began offering this product in May of 1984, using an SEC registered group annuity product.

Our product is sold to customers of four broker dealers that are affiliated with The Hartford. It is sold to individuals who are issued certificates under these group annuity contracts issued to a Rhode Island Trust. We currently offer this product in only 42 states, as these are not legal "groups" in the other states.

The certificate holder initially selects either a three, five, seven, eight or ten-year guarantee period. We provide a simple interest guarantee over that period. However, we just recently came out with a product containing a compound interest guarantee. Under the simple interest product, the interest is either paid out each year or treated as a new single premium containing the original maturity date, but with an interest guarantee appropriate to market

conditions at that time. At the end of the guarantee period, the individual can choose a new guarantee period or take the principal. Our experience has been that 95% of the policyholders just let their money ride every time the interest is credited as opposed to just taking it out.

If any certificate holder chooses to surrender during a guarantee period, he or she is given a surrender value based on a market-value adjustment formula. The formula is designed to closely approximate the market value of assets needed to back the guarantee. This modification is why the product is called a modified guaranteed annuity. Our formula includes such factors as the period remaining in the guarantee period, the aggregate rate of interest being credited on the date of surrender, and the rate currently being guaranteed by the company on contracts with the same guarantee period remaining. This formula can obviously produce a result that is larger, or smaller, than book value. It is, however, fair, and removes the antiselection that the company would otherwise be subjected to when the market value of the assets was less than a book value surrender value. A rear-end load is also taken on surrender.

We would prefer to sell an individual policy, but our product does not satisfy the individual annuity nonforfeiture laws (due to its market value adjustment formula), or the variable annuity regulation (which relates to separate accounts having unit values). Therefore, in 1984, Hartford Life began working with the NAIC Actuarial Task Force and the ACLI. Our efforts resulted in an NAIC model regulation on Modified Guaranteed Annuities, which was adopted by the NAIC in June of 1985.

That same year, Hartford Life again worked with the NAIC Actuarial Task Force, and the ACLI, on a similar NAIC model regulation, which would permit use of a market value adjustment in determining cash values on individual life insurance policies. The NAIC at its June 1986 meeting adopted a companion model regulation on Modified Guaranteed Life Insurance. We are especially interested in including this "guaranteed option" within a variable universal life insurance policy.

An important feature of both of these NAIC model regulations is that the assets must be placed in a separate account and valued at market. I believe this discipline is essential to proper management of assets supporting the liabilities.

Also, New York has developed regulations that are used to implement 1985 legislation applicable to annuities, which permits utilization of a market value adjustment formula to be used in calculating cash values on individual annuity contracts. In New York you have the option of placing the assets in a separate account or in a general account. Similar legislation, in New York, applicable to life insurance, was adopted in 1986.

Although Connecticut is the only state that has adopted these NAIC model regulations -- the situation should change this year as a result of a change in ACLI policy. Last November the ACLI Board changed its policy, which in effect was passive support to one of active involvement. I was quite disappointed to see John Booth sitting here, in the front of the room, because I thought he was going to spend every waking moment working on getting these regulations adopted. With so-called "modified guaranteed" annuities (and life insurance), interest and principal are guaranteed to maturity, as with existing products. Buyers are also able to withdraw cash prior to maturity without paying prohibitive surrender charges.

However, surrender values will reflect any changes in the market value of underlying assets due to fluctuations in interest rates. If current interest rates are higher than the guaranteed rate, the surrender value declines according to a formula contained in the contract. By the same token, if interest rates are lower, the surrender value increases. The settlement is fair to both buyer and company, and the threat of disintermediation is virtually eliminated. Mike Winterfield's bullet-proof comment.

In the absence of such regulations, insurers are prevented by existing nonforfeiture laws from applying a market-value adjustment to cash surrenders. Nonforfeiture laws were enacted at the turn of the century to protect policyholders against abuses by some insurers who withheld cash values at surrender. The application of such laws to interest-sensitive products has the perverse effect of benefitting policyholders who withdraw their money at the expense of those who remain and thereby are exposed to a greater risk of company insolvency.

A market-value withdrawal adjustment actually provides better protection to buyers of interest-sensitive products than the traditional nonforfeiture laws. A company that is mindful of its interest-rate risk can never prudently offer investors a long-term guaranteed return that is high enough to protect the buyer against inflation, since inflation and interest rates go hand in hand. On the other hand, if competitive pressures force the company to guarantee an unrealistically high rate, the buyer unknowingly assumes the added risk of company insolvency.

As mentioned earlier, the assets backing "modified guaranteed" products are held in a separate account. Both assets and liabilities in the separate account are valued at market, which enables regulators to determine quickly the true financial soundness of interest-sensitive products. By contrast, when assets are placed in a general account and valued at amortized cost, the insurer might be able to satisfy all reserve and surplus requirements and still be vulnerable to financially damaging disintermediation.

While the market-value adjustment feature may serve as a disincentive to investors seeking short-term gains, it is worth recalling that these products are intended to provide long-term savings for old age and retirement. Indeed, their tax advantages presumably derive from the public-policy benefit of encouraging long-term savings. Life insurers serve a vital public interest in turn by providing a major source of long-term financing to the economy. Accordingly, the market-value adjustment feature constitutes a significant advance in preserving the long-term character of life insurance and annuity products.

With the availability of the NAIC model regulation, and the ACLI now actively seeking adoption of the regulations, state insurance departments can move to authorize products that are safer, easier to supervise and better for the consumers. The lesson of Forster's "tragedy of the commons" is that individual gain and collective risk are a disastrous combination in the absence of careful regulation. Surely we need not risk a large-scale insolvency to drive that lesson home.

MR. SPAFFORD: We'll leave it for the follow-up workshop sessions, to decide who the "mother of modified guaranteed annuities" is.

PANEL DISCUSSION

MR. GRANT A. SOMERVILLE: When Dan first asked me to speak with you, I was sitting on top of the world. Dean Witter Insurance Services was coming off a fantastic year producing over $850 million of insurance and annuity sales in 1987 versus $500 million in 1986 and $350 million in 1985. This overall production led Dean Witter to the No. 3 spot among brokerage firms behind my former employer Merrill Lynch and the now merged E. F. Hutton. As a matter of fact, the top 20 brokerage firms in 1987 saw life insurance sales of $3.9 billion and annuity sales of $5.6 billion.

Dean Witter had just introduced a new and innovative product to the marketplace. On October 19 we announced to the world the Dean Witter "Growth and Income," three contract, split funded annuity. Many of you may also remember what else happened on October 19. We will not take any blame. We know that it's a popular product, but I don't think everyone ran out to buy it that day. That wasn't the cause of the market crash.

I am unemployed now and it is a very strange feeling. I could say that I am a consultant since I am out of town and carry a briefcase. However, I will soon be starting my new position as Managing Director of Smith Barney, where I will face a whole new set of challenges and opportunities.

I am a very fortunate person, in many respects. Twelve years ago when I left Xerox Corporation and started as an account executive with Merrill Lynch in Chattanooga, Tennessee, Merrill Lynch was just beginning to implement the results of a very extensive McKinsey study that was done for the firm. McKinsey suggested that, for the brokerage firms to survive in the financial services industry of the 1980s and beyond, they must find a more stable source of income to support the unpredictable stock trading business -- a very long range view at the time. And we see right now the results of that. McKinsey recommended that Merrill Lynch use its account executives to sell insurance to its very large client base. In 1978, after two frustrating years trying to make a living selling stocks, bonds and options, having that new house and a new child, I discovered the variable annuity. I had been frustrated in trying to sell mutual funds. In concept, I thought they were excellent, but my customers would go out and buy my concept through firms like Fidelity that offered no load. With the variable annuity, I was able to offer them no load, a guaranteed death benefit, and most importantly, tax deferral. Ultimately, I discovered the fixed annuity. Both these products made a lot of sense to me as a broker because they made so much sense for the clients.

In April of 1983, I was asked to move to New York to take over the annuity department at Merrill. Shortly after taking this assignment, Merrill Lynch was faced with the very harsh realities of Baldwin United. It was during this period that I got quite an extensive education from consulting actuaries about the insurance company side of insurance products. It was also during this time, that Merrill Lynch discovered the problems insurance companies have with capacity limitations. A firm the size of Merrill, then with about ten thousand account executives, posed a very significant risk to the surplus that major insurance companies were willing to commit to fixed annuities.

Based on what we felt, however, was a significant need in the marketplace, and an ideal marketing opportunity, Merrill Lynch came up with a product design that was initially called the "ideal annuity." We showed this plan to several insurance carriers but they were unwilling to build such a product. Finally, as an outgrowth of the Charter problems, Merrill Lynch and The Equitable decided

to form a joint venture called Tandem. Touche Ross was hired as the consultant and the "ideal annuity" finally hit the streets in February of 1986 under the names "Alternative I" and "Alternative II." Tandem sold over $600 million in 1986 and over $1 billion in 1987.

The relationship of the brokerage firm and the insurance company -- Why was it necessary for Merrill Lynch to go the joint venture route versus taking an existing product from a quality carrier? One of the reasons was product design. Account executives experience frustrations in having to learn a new language before they can sell an insurance product. *Insurancese* is not something that either the account executive or the client really understand. My goal in developing insurance products is to attempt to speak the language that the customer does understand. For example, "A surrender charge equal to the last six-months interest, interest earned may be withdrawn at any time without charge," (the Tandem concept), versus, "a declining surrender charge based on the accumulated value with the ability to access 10% of the money without charge once per contract year." This is not something that the customer would necessarily be used to. We want to speak in language that the broker and the customer can understand.

Another important area is capacity and consistent capacity and I emphasize both the words, "consistent" and "capacity." It's an important double four letter word, "capacity." Several carriers wanted to work with Merrill but would only allocate a certain amount of surplus and would put a cap on the amount of business that could be written. We certainly understood that. But, it created many problems. It is tough enough to turn account executives on to selling an insurance product. But, try to find a way to tell them that they had to quit selling because the insurance company was out of surplus. The perception in the minds of the brokers would be a real problem. Another problem in dealing with big brokerage firms is that you have no idea just how much product can be sold by a large brokerage firm's sales force. We saw that in Dean Witter last year when for the first four or five months of the year we were averaging $43 million in sales and in December we hit $163 million. It's a little hard to plan ahead.

CAPACITY AND QUALITY SERVICE

Account executives and clients expect quality service. There is no quicker way to turn off the sales force then to cause an AE (account executive) to have to give back a hard earned commission because someone in operations screwed up or didn't get a contract issued properly or on time. Within a brokerage firm the account executives have too many other products they can present to their clients. They will go for the easier sale -- the one that they feel confident they won't lose. The partnership of understanding and trust between the brokerage firm and the insurance company is very important. There has to be good communications between the two companies so that there is a proper understanding. That is enhanced by working together in product development. Listen to the brokers. Focus groups can be useful also.

DISTRIBUTION WITHIN THE BROKERAGE FIRMS

How do we get that product from the insurance company or brokerage firm's marketing department to the account executive in the field? Many firms use outside wholesalers. Some firms have internal wholesalers. Merrill Lynch chose the "territorial insurance specialist" route. Those are all important elements in getting the word out there to the broker to get him to sell the product.

SYSTEMS
It's important that the proper systems are in place to support the product once it's there. We don't like surprises. When brokers get customer statements that they don't understand, they call us, and we find out that the computer has glitched. Brokers and customers lose confidence fairly quickly.

THE CUSTOMER, WHAT THEY WANT, WHAT THEY NEED, WHAT THEY'LL BUY
About a year ago, *USA Today* ran a survey and asked its customers why they save. Seventy-nine percent of those people said retirement was a principle reason for saving; 44% said children's education; and 23% said inheritance for children. Since the 1986 tax bill, each one of those objectives is best served by an insurance product. Children's education, depending upon what happens with Stark-Gradison, may be best served by single premium whole life. But each one of these goals is best served currently by an insurance product.

Americans are savers. They need to accumulate as much money as possible in order to provide for their own retirement. They want what our products have to offer, safety, tax-deferred accumulation and competitive interest rates. They will buy an annuity or single premium whole life product if we can get the account executive to suggest it and present it in a way that clients can understand. One of the things I find interesting to note is, in the brokerage firms only about 40% of the brokers actually sell insurance products on a consistent basis. I don't know why that is because in my estimation every one of the brokers have clients and could be doing a significant amount of insurance business. We have to do a better job in getting to all of the brokers to sell the products. But if we do, will the capacity be there in the insurance companies to support it? If the clients are not shown the annuity, they will continue to pour their money into the banks and not have the advantages of tax deferred accumulations and triple compounding, earning interest on interest, interest on principal and interest on money that would otherwise go to pay Uncle Sam. They will have less money than they could at retirement. We owe it to the clients to show them the annuity products.

THE ACCOUNT EXECUTIVES AND AGAIN WHAT THEY NEED
The account executive needs quality products that can be understood and presented to the clients in language they can understand. The more AEs have to learn about a product, the less likely they will be to present it. The more they have to stop and explain something to the client, the less likely sale will be made. AEs fear the client is going to ask a question that they can't answer, and not only will a sale not be made, but the client will lose confidence in them which will result in the loss of a client for their other business.

Account executives also want a choice of quality products but, what we've noticed is that in giving them the choice, they will generally sell the proprietary product or the featured product offered by the firm. Account executives also need someone to teach them about the product and the market and how to sell annuity and insurance products.

Wholesalers, either internal or external, are used to distribute insurance products to the account executives. Some brokerage firms use only internal wholesalers while the majority rely on outside wholesalers. We have outside wholesalers which are independent and represent a number of different companies. Of course, many brokerage firms have their own wholesale distribution force.

THE BROKERAGE FIRMS

They need quality products with plenty of capacity and innovation. Brokerage firms that have proprietary products of sister companies are very, very fortunate. I had that at Dean Witter and I certainly am very thankful for the relationship between Dean Witter, part of the Sears Financial family, Allstate Life and its subsidiary Northbrook. This arrangement worked very well at Dean Witter where annuity and insurance products were underwritten by Northbrook Life. These firms, such as Dean Witter and Merrill Lynch, Pru-Bache and E. F. Hutton, do have important input into the product design and are generally responsible for all the literature and sales material. Both at Dean Witter and at Merrill Lynch, we used focus groups of account executives before the product design was finalized.

Other firms, such as my new employer, Smith Barney, must rely on outside carriers to provide an adequate supply of quality products. At these firms, it's important to make sure that they have relationships with several insurance companies in order to avoid the problems many firms experienced in the past and especially late last year. The capacity shortage in the industry and a dropping of the interest rates to below current market levels caused some firms to fall short of their potential market. There is also a risk that an insurance company, which a brokerage firm is relying on, may be sold or decide to drop out of the business. That happened with Smith Barney and Integrity.

CURRENT PRODUCTS

There are several new and relatively new annuity products on the market. In the relatively new category; there are few people in the industry who have not heard about the success of the joint venture between Merrill Lynch and The Equitable and the "Alternative One" and "Alternative Two" annuities. This was the first annuity to combine the simple to understand six-month interest surrender charge with an easy to explain index based on the one-year CD rate as reported by the *Wall Street Journal.* This product was also the first, to my knowledge, to promise the account executive a renewal commission at the end of the guarantee period. This renewal is paid only if the customer elects a new five-year option and the surrender charge would then continue. The sales process was simplified, and it gave the customer a choice of a five-year guarantee or a five-year guaranteed base rate contract with an index 200 basis points below the one-year CD rate. Several other companies have now copied many of the Tandem features.

The renewal commission helps the customer, the insurance company, the account executive and the brokerage firm. I was very anxious to build a renewal commission into the Tandem product to prevent what I call the "Orphan Customer Syndrome." Account executives often times feel that once his client makes a purchase of an annuity contract, he will never again see that money because the customer probably doesn't have any more money or is not an investor. Many good annuity clients end up in the dead file.

A couple of years ago the Life Insurance Marketing and Research Association (LIMRA) did a survey on annuity purchasers and found that 80% of them were very well satisfied with their annuity. Over 70% said they would purchase another annuity, but very sadly only 2% had ever been offered the opportunity to do so. The account executive, who knows that there is opportunity for additional commission, will hold on to that annuity client, will provide better service and may even suggest that additional client dollars be put into an annuity or insurance contract. The average client stays with a brokerage firm

only 3.8 years. Clients that own packaged products, such as insurance, tend to stay with the firm much longer. The insurance company benefits from long term relationships with the customers just as the brokerage firms do.

There are several companies that have gone even further than Tandem to simplify their annuity products. At least two companies that I am aware of, have started offering a one-year annuity at a very competitive interest rate that allows the client to surrender the entire contract at the end of each year without incurring a surrender penalty. Basically, clients are guaranteed a competitive rate, upon renewal, because if they don't like the rate being offered by the insurance company, they can move the money via a 1035 exchange or surrender and pay the taxes.

I have a very personal concern about this type of product in that the insurance companies may be tempted, and I don't see any other way that they can do it, to mismatch the assets in order to provide a competitive interest rate. This could lead to problems down the road. I'm very concerned about mismatching assets.

Another problem I have with this type of product is the way it is sold. My understanding, in talking to some of the brokers that have come to us from other firms, is that a fair amount was being sold to corporations because of the guarantee of no market fluctuation, and most importantly, the higher interest rate that was being offered versus other competitive products. As you all know, corporations are not eligible for tax-deferral and insurance companies must issue a year-end tax statement for these corporate accounts. The concern I have is that, if the only reason the corporation is purchasing the annuity is for its investment features, then the status of the annuity might be in jeopardy under SEC Rule 151. These guidelines provide that for an annuity to qualify under the "safe harbor" and exempt from registration, the annuity cannot be promoted on its investment features.

On the variable side, there have been a number of changes. Trail commissions were introduced a little over a year ago, 10 or 20 basis point trails paid on the accumulated value in the contract. There are some companies, such as Sun Life/MFS (Massachusetts Financial Services) which has just introduced an escalating guaranteed death benefit that steps up at the end of every seven years. An example of that would be: a client puts in $100,000 and has a guaranteed death benefit of $100,000. Five or seven years later that account may be worth $160,000. The guaranteed death benefit would not provide a lot of attraction to the client but, it would provide attraction to the account executive to move that money to another variable annuity to step-up the death benefit. So Sun Life/MFS has now put an escalating death benefit in to keep the money in the contract to prevent it from moving to another VA (variable annuity). It is an interesting feature. They did not put an additional commission in the escalator clause, so I don't know if it's going to do everything they wanted it to do, but they did put a trail commission and are offering the brokerage firms the opportunity of either a higher up-front commission or a 20 basis point trail. I don't know how the brokerage firms will react to the option of taking the trail versus the option of a higher up-front commission.

Another thing that's happening with variable annuities is the more attractive interest rates on the fixed account within the variable annuity. There are, however, I'm noticing, some new restrictions on movement back and forth between the variable and fixed account. Also we're seeing within the variable

annuity new fund options. The multiple strategy, or asset allocation funds, were the real buzz words 18 months ago, a year ago, and Merrill Lynch put $1.5 billion in its multiple strategy bucket in Prime Plan. Unfortunately, on October 19 it was not quite at the right asset allocation. I understand that this caused a few problems. What we're seeing now, within the variable annuities, are companies talking about international investments. I think that's the current wave of new funds within the variable annuity.

The Dean Witter "Growth and Income Annuity," issued by Northbrook Life, was the first packaging of a three contract split funded annuity. These three contracts are used in order to allow the policyholder to continue monthly income, after the end of the fifth year, when the initial immediate annuity runs out. The multiple contract approach is necessary because the IRS has stated that any monies withdrawn from an annuity contract, even to purchase another annuity, will be immediately taxable and subject to penalty if the policyholder is younger than 59 1/2. Dean Witter has been extremely pleased with the sales since the introduction on October 19. Over $60 million was sold by the end of last year, in a little over two months, and so far sales, year to date, have almost reached the $100 million level budgeted for the full year 1988.

One of the unexpected benefits of the Dean Witter "Growth and Income Annuity" is that more account executives are starting to present the annuity product to a wider group of clients. The account executive and the client have a choice now of tax-deferred savings with or without current income. Sales of our regular annuity, the Dean Witter SPDA 1&5 took off concurrently with the introduction of the Dean Witter "Growth and Income Annuity."

With all due respect to Don Sondergeld, I need to say a few words about the market value adjusted SPDA. While I certainly understand, and totally agree with, the attractiveness of having the insurance company protected, I do have to ask an important question about the client's acceptance of this product and more importantly the account executives' acceptance. Will they sell it? I don't know. I really don't, but it's one that is certainly a challenge for the future. My guess is that there would have to be a substantial premium on the initial interest rate before this could happen.

On the topic of single premium life and what is happening in Washington, I will only speculate that something will be done to restrict the loan provisions, but I firmly believe that the product will survive. Variable annuities came back after revenue ruling 81-225. Fixed annuities survived DEFRA and TEFRA. The creative minds in this room, along with the marketing people in your own firms, as well as, the brokerage community, will design attractive single premium life products for sale post Stark-Gradison.

I am very enthusiastic about the future. People would rather save on a tax-deferred basis than on a currently taxable basis. The overwhelming success of the IRA, with a $2,000 a year limit, clearly shows the concern people have about saving for their own retirement and taxes. There is a slide I have used that shows a little boy sitting on his father's lap reading Grimm's Fairy Tales. The caption says that they all lived happily ever after on their IRAs. We know that $2,000 a year IRAs are not necessarily going to provide the fairy tale ending, but one of the things I used to say about annuities was that annuities are IRAs funded with after-tax dollars.

Now, as we all know, an IRA is an IRA funded with after tax dollars, for most of our clients. An annuity is an IRA with unlimited contributions. I think there is a tremendous market. People do want to save for their retirement. I think the opportunity to save tax-deferred in an annuity product is excellent. It is our challenge to work together to build the products that will be attractive for the clients to purchase, easy for the broker to sell, and most importantly, profitable for the insurance companies to offer.

The distribution channels are getting much more cloudy. Certainly the banks are coming into our business. The brokerage firms have gotten into the insurance business. I'm not so sure how many insurance people are happy about that. I know I am. It is a murky world out there when it comes to distributing financial service products to the ultimate customer. And, it probably will get murkier; but it does create tremendous opportunity and awareness of the customer, and an awareness on the part of the customer of the available insurance products.

MR. RICHARD J. TUCKER: Mike, you mentioned that some companies are creating distinct products for different distribution channels. To what degree do you have problems getting state approval of distinct contract forms that are of the same generic type?

MR. WINTERFIELD: Companies that we have dealt with feel that there's a tangible difference in the markets that they are dealing with. For example, I mentioned bank products that are simpler but a little more restrictive. One of the rationales for going a different route is that the average bank premium is a lot smaller. The average seems to run $15,000 to $17,000 as compared to, perhaps, $35,000 for an average stock brokerage sale.

MR. BRUCE E. BOOKER: Mike, could you discuss the certificate of annuity a little bit more. They are group products; they don't look like they would fit with individual nonforfeiture regulations.

MR. WINTERFIELD: Right, you are correct in that. What we have seen so far is a group approach.

MS. BARBARA J. LAUTZENHEISER: As Mr. Somerville indicated, 79% of the savers, from the USA Today report, are on the retirement side. Is there any creativity being done on the pay-out side as opposed to the pay-in side?

MR. SOMERVILLE: Well, I certainly hope so. The Dean Witter "Growth and Income" goes on the pay-out side. The first contract, "Alternative One," pays a five-year income. That has been very popular. I noticed, also, some other firms packaging the immediate annuity. That is a concern I've had for a number of years, and I question why there hasn't been more packaging of the immediate annuity, especially with the IRA market. At Dean Witter we worked with Northbrook. The immediate annuity is simply pending some system's enhancements before it is released. It's at Dean Witter in a package form. Pru-Bache introduced their packaging of the immediate annuity in February. I think it's a tremendous market. With the emphasis on retirement pay-out the "Growth and Income" type of split funded annuity will lead the way as far as the account executives learning more about the income market. They will use it independently once it is available.

MS. LAUTZENHEISER: The majority of the effort that is being done is more on the side of packaging of the annuity as opposed to any change in the way annuities are paid, increasing annuities, flexible annuities on pay-out, and so forth. Is that correct?

MR. SOMERVILLE: Packaging is the end I have been the most familiar with.

MR. WINTERFIELD: As one postscript, I would note that some companies are trying to enhance the pay-out side by providing for additional compensation. There is a recognition that it's one sale to get the customer to begin to accumulate, and it's an entirely different sale when the customer reaches the retirement point. Then you're looking at purchasing a life income. You need an agent there. In order to get the agent it makes sense to provide another commission at that time.

MS. LAUTZENHEISER: A single commission as opposed to a renewable type of commission?

MR. WINTERFIELD: Yes.

MR. JOHN O. MONTGOMERY: We've been studying funding of long-term care insurance. One of the means by which this could be done is through the funding arrangements that are similar to what you have with annuities. Is any work being done on that?

MR. SOMERVILLE: I will say that we had a number of brokers that have come to us at Dean Witter and asked us to market the product. We looked at it. There were relatively few companies that offered it, and none were really anxious to do business in the brokerage community.

MR. MONTGOMERY: We're trying to set-up legislation in California to make that more possible. And, this is something, I'm pretty sure, the NAIC is going to be considering.

MR. SOMERVILLE: Mike, have you worked with any companies that have?

MR. WINTERFIELD: No, I haven't but I like the idea.

MR. SPAFFORD: We're seeing a number of companies adding a long-term care rider to life insurance contracts. I think some of them actually pay out part of the death benefit. It would seem that there would be some significant problems with IRC Section 7702, on the definition of life insurance, if you had that kind of benefit.

MR. MONTGOMERY: There is also a need to change some of the valuation and nonforfeiture laws too.

MR. ALDEN L. HEAD: Mike, maybe I misunderstood what you just said, but when you talked about a renewal commission on an investment I assume that this was with no premium paid. How can you work this into a New York company considering Section 213 or 4228?

MR. WINTERFIELD: You were referring to the trail commission that I mentioned in the talk?

MR. HEAD: Yes. The question in back of this is we've had discussions with the New York Department about renewal commissions with no premium paid. We've lost on the issue.

MR. WINTERFIELD: The trail commissions have been offered outside of New York. During our discussion last night, Grant mentioned some new territory perhaps he can elaborate or that now.

MR. SOMERVILLE: I'm wondering if I should turn this over to Ed Turner, since he is working very closely with the New York Commissioner and I understand some breakthroughs have been made.

MR. EDWARD A. TURNER: I have nothing definite to say at this point. We're negotiating with the Department trying to get something but it will probably be different than what we are paying in the rest of the country.

MR. LAWRENCE A. SELLER: Grant, it has been clear to us for a long time how important simplicity in a product is. A lot of complicated product features are put in so that companies can try to do a better job of meeting their profit targets in a world that has become so competitive on interest sensitive products. My question is, do you feel brokerage companies will accept perhaps slightly lower commissions in return for greater salability and simplicity of product?

MR. SOMERVILLE: Yes. And I think there is evidence of that happening now with the product that I didn't particularly care for, which was the one-year product being offered by First Capital Holding.

That one-year product pays a lower than usual first-year commission and a low renewal commission every time that it renews. That has received a fair amount of acceptance from the brokers. If you combine a lower front end commission with something else, such as, a renewal commission or a trail commission, I think that a lower front end will work.

MR. SPAFFORD: I have a question for Don Sondergeld. In the United Kingdom the asset-linked products are very popular, in spite of the fact that the fixed products can be offered just as readily under law as the market value adjusted type products. What is it going to take, in the United States, for these market value adjusted products to gain the acceptance of the insurance companies and the distribution systems?

MR. SONDERGELD: First of all, the people who are selling life and annuity products in the United States are changing. We used to have a career agent who I think is going to be a person of the past. We now have stock brokers selling life and annuity products, a huge distribution system. The stock brokerage community, which sells our products at Hartford, has no problem selling a market value adjusted product. It's just like a bond. The surrender value, if you will, varies inversely with the direction of interest rates. So there are changes that are going on in the United States. The problems we have, in my opinion, of getting the NAIC model regulations adopted in the various states relate to inertia. There are a lot of insurance companies that do not have NASD (National Association of Security Dealers) registered sales representatives so their agents can not sell a fully market value adjusted product. However, insurance companies have been selling market value adjusted products for years. *Look at the GIC market. Has anybody ever heard of a GIC?* That's a market value adjusted product.

We're selling billions and billions of dollars of market value adjusted products in the states. We're not talking about a new product. We're talking about a new product in the individual marketplace. That's the only area that's new. Of course, variable annuities have been sold for years. So, we're really not talking about anything new. We are talking about a modification of something that's been sold in the United States for years. We think that once the regulations are adopted in the various states, we're going to see more and more companies selling the product. As Grant mentioned earlier, a challenge is to design products which are easy for brokers to sell and also profitable to insurers. I submit that is a challenge. And there are a lot of companies today which are not making money in selling interest sensitive products. We have an old-fashioned rule at my company and that is if you can't price a product, don't sell it; if you can't quantify a risk, don't take it. I don't know how many people can predict what inflation is going to be three, five, or seven years from now, but I certainly don't know how to do it. We like the safety, if you will, of offering a market value adjusted product that is both fair to the buyer and the seller.

MR. SPAFFORD: I think a lot of companies wish their GICs were more market value adjusted.