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## ANNUITY PRODUCT DEVELOPMENTS

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MR. PAUL LEFEVRE: In the past two years, annuities, particularly fixed single premium deferred annuities (SPDAs), have been selling in large numbers. Sales have been quite strong in the New York Stock Exchange market, and sales have been increasing steadily in what I would refer to as the institutional market: mostly in savings and loan institutions. In my opinion, many factors have contributed to what I would call a resurgence in the annuities market. I say resurgence because back when the taxation was changed on annuities by TEFRA a lot of people felt that there was going to be quite a decline in sales. One of the major events, in our perspective at least, that changed and picked up the sales in the stock brokerage end of the business was the October 1987 decline in the stock market. When that occurred, two things happened. One was that the individual investor was looking for a place to put his money that at least he perceived to be safer, that was not subject to the types of losses in the equity markets. And, the other was that the stockbrokers were looking for something they could sell to replace the income that they were losing by lack of ability to sell equity products. So in late 1987 there was a lot of press that suggested that annuities are a place to put your money. You get good return, it's an insurance company, and your money is safe. Another factor was that the Baldwin-United situation was, in a sense, finally settled. A lot of the major firms that had been involved in that were now in a position where the customers whose money had been tied up for so long needed to make decisions. Brokers were getting questions that made them realize that annuities were still around. Much of the money stayed where it was and some of it moved. But the brokerage community was reacquainted with annuities, and I think the combination of the two elements got the brokers back into annuities. Another factor was that the thrift industry, which has been having a lot of problems, either started discovering, or was taught by opportunistic third-party marketers, that had quite a customer base and that the selling of annuities to that customer base or through that customer base provided income to its institutions that was not high-risk income. It did not require a large investment on the third-party marketer's part, and it was not the type of income that was involved with any risks, such as the actual managing of assets themselves and selling CDs.

In the variable annuity market, the situation has been quite different. The events in October 1987, in a sense, took people away from variable annuities, and it's only until recently that we've seen some successes in the industry. Recently we've started seeing what I would call a resurgence of at least an interest in the marketplace. There are a lot of new products being announced. There are product innovations occurring in the variable annuity marketplace. It appears that most companies that are successful, or attempting to be successful, in the nonqualified variable annuity marketplace are finding that they have to deal in some way with the concept of fixed accounts in the variable annuities. Also, they have been looking at redefining death benefits. Some of these things will be addressed by the panel.

So in this period there have been some innovations. You wonder what you can do to an annuity. We will talk about some of the things. One of the things that has been happening on the product side is a greater interest in longer term guarantees in annuities. Some of this occurred toward the end of 1988 when a lot of the major firms were pushing bonds. They were predicting that interest

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rates would decline, and in their annuity selling, they were looking to companies to provide longer-term guarantees; sometimes as long as ten years. This interest in longer-term guarantees results, from the company's standpoint, in two major effects. First, you have to look at the investment risks. You're forced to look at them a lot more than you are with a one-year guarantee, especially the risks associated with call provisions. The other problem revolves around the surplus strain that occurs when you write traditional fixed book-value-type products with long-term guarantees. This created an opportunity for companies to begin to market and sell modified guaranteed annuities (market value adjusted annuities) that had been around for a while, but had trouble gaining any market acceptance against the book value products. The other thing that I've noticed, a lot more recently, is a great deal more interest in the receiving of income from annuities. This is occurring in a manner that is not in the traditional manner, which is via annuitization or the use of settlement options. It's manifesting itself in a manner that is through utilization of partial surrender provisions. This was somewhat aggravated recently by the aggregation rule in the latest tax law, which is still not fully understood, but once you deal with the aggregation rule, such things as selling an immediate annuity combined with a deferred annuity could lose its appeal from a tax standpoint. And thus, the marketers, the people selling the annuities would just as soon have the flexibility of dealing with partial surrenders. This leads to some interesting pricing questions and investment questions if we start seeing a lot of the money going out. I have seen a lot of demands for what you could call a systematic withdrawal out of an annuity -- "Send me a check a month," "Send me a check a year," "Send me a check a quarter," "I don't care if I have to pay taxes on it." And this, to me at least, has a lot of administrative implications and certainly some pricing and investment implications. Another factor which is contributing to this withdrawal syndrome, as I'll call it, is the way that the people are latching onto the IRA minimum distributions, which don't really lend themselves to a definitive form of annuitization. The other factor, which has manifested itself in the last six months or so in the annuity market and has created some interesting products as well as some confusion, is the way the yield curve in the United States has been inverted. Certain products have taken advantage of that which has changed some of the thinking relative to deferred annuity products.

Our first speaker is Doug Draeseke. Doug Draeseke is a consultant in product development. He does computer system consulting mostly in areas revolving around annuities and interest-sensitive products, variable annuity product administration, annuity benefits administration, and asset liability management systems. I felt Doug would be a good person to lead off our panel as part of his consulting practice is doing due diligence work for major New York Stock Exchange firms. In this process, he is retained by the company to look at the products and the companies that manufacture the annuities that they would be selling. In that process, Doug comes across many things that are going on in the industry, so I've asked him to share his observations. So he'll give an overview of the annuity marketplace and what he's seen from that perspective.

**MR. DOUGLAS G. DRAESEKE:** As Paul said, I work with New York Stock Exchange member firms in their due diligence reviews of life insurance companies. Sometimes, to the chagrin of some insurers, I've gotten a little too nosy and a little too close to what they're doing. Nevertheless, we feel it's very important to get right inside a life company and its products to see whether they are strong enough and able enough to withstand the onslaught of business from a member firm when it does get turned on to a product.

### **FIXED ANNUITIES**

In my first section, I'm going to review various insurance products, and make a few comments on them. First of all, the fixed annuity products. As Paul mentioned, the single premium deferred annuity (SPDA) is currently the dominant product. Single premium immediate annuities had a very hot time about a year ago and, of course, the IRS came along with the so-called aggregation rules and knocked the marketing scheme out from under the insurers who were just getting into it. Mr. Larson is going to have a few more comments on that later. In considering annuities, Paul asked the question, "What can be done to design a product as simple as an SPDA?" There are very few pure SPDAs sold. Those with built-in options are much more popular: 1) The "bail-out" option is where if your renewal rate is too low by some measure or formula, you can "bail-out" of your annuity; the cash value is available without a surrender charge. The measure may be a comparison to then current declared rates on the same product, or to your original declared rate. 2) An "indexed" declared rate is where the declared rate is tied to an internal or external index. The inclusion of these options has, of course, some pricing implications. An external index would be a publicly available interest rate, usually published in financial journals. An internal index

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might be the current "new money" declared rate. I wonder sometimes if these options are priced at all, when reviewing SPDAs currently in the marketplace.

Some other product features we've seen lately are what I call fixed products with windows. I define a window product as being one which has a temporary suspension of the surrender charge; for example, for 30 days after the end of each policy year. There are window products that have various guarantee periods with various guaranteed interest rates. There is currently a window product called the CD annuity. This is a hot product in the NYSE member firm community right now. It's nothing more than a one-year SPDA. It has what appears to be a permanent surrender charge. However, a window opens up at the end of the year for something like 30 days, and you can get out no matter what the renewal interest rate may be. You simply have the option to cash out whole at the end of the year. The name CD annuity, of course, is alluding to a certificate of deposit offered by banks and savings and loans. New York Stock Exchange member firms are selling CDs themselves for banks and S&Ls and earning paltry commissions; around .375%. CD annuities, on the other hand, pay annual commissions of about 1%. The combination of higher commissions, and the possibility of deferral of income taxes on the interest credited, makes the CD annuity competitive with bank CDs.

A third kind of interesting example of the window annuity is a group annuity with no cash value whatsoever, except at the window. And, again, this one has been offered with a series of interest rate guarantee periods and different interest rates. And, again, the companies are alluding to a certificate of deposit in their marketing. It's very interesting that investors are willing to plunk their money down knowing there's absolutely no cash value, that there's no way out until the end of the guarantee period.

### VARIABLE ANNUITIES

I'd like to move now to the variable annuities (VAs), which have had their ups and downs over the last few years. Variable annuities are usually offered as a flexible premium product (to simplify administrative needs), but they're sold primarily on a single premium basis. The hallmark of this product, of course, is the fact that the risks and the rewards of the investments are passed back to the policyholder. The latest observations of variable annuities include an absolute proliferation of investment options available under a VA separate account; a vast range of separate investment subaccounts: real estate mutual funds, mortgage funds, junk bond funds or, euphemistically, high-yield bond funds, global bond funds and global equity funds. The global funds are presenting a new problem; the pricing of the fund's net asset value (NAV) tends to be difficult, delayed and often imprecise. The task of redoing accumulation unit value calculations, then having to reverse and reprocess days or even weeks of transactions, can be a nightmare.

Another major development has been "asset allocation." As originally offered, the asset allocation manager (either inside the life company's investment department, or an outside investment manager) will periodically reallocate all the investor's funds among the investment options, usually being common stocks, bonds, and money market funds. The allocations may differ by risk level, with such descriptions as aggressive, balanced, moderate, conservative. Administratively, it's rather a bit of an enigma, because units of coverage at the variable annuity level must be reallocated, implying voluminous recordkeeping by the insurance company. So the next step is to design specific asset allocation mutual funds which will buy and sell bonds, equities and money market instruments inside the mutual fund and save all the recordkeeping. The NAV of the mutual fund will pass the value through to the units of coverage, and there is nothing to be altered at the insurance company detail policyholder level.

### COMBINATION ANNUITIES

A third product area, after the fixed and the variable I would call the combination products: a mix of the previous two coming from either direction, from the variable side or from the fixed side. And then, of course, there is the modified guaranteed annuity, which has elements of a fixed annuity, but has a market value adjustment feature built right into it and therefore passes some of the investment risk back to the policyholder.

Coming from the variable annuity side of things, as Paul mentioned, there are variable annuities with fixed subaccounts. In fact, many people buy variable annuities but then put all their money into fixed subaccounts. They really haven't bought a variable annuity, but they've come in via that route. These products are offered with varying guarantee periods and varying guaranteed interest rate of (say) 8.5% isn't honored and your surrender penalty is structured such that you

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really just fall back to the underlying (say) 5.25% savings rate; it is just like a CD. And, interestingly, there are fixed annuities with market value adjustments introduced through the back door, introducing variable features into fixed products. One I reviewed has a market value adjustment provision on the insert page, not preprinted in the contract.

As an overview then, there is a great diversity of annuity products in the marketplace that cover quite a spectrum of choice for the buyer, allowing him to choose the level of risk and, of course, the commensurate reward that comes with it.

### MARKETING ANNUITIES

Now, my next major topic is the marketing of annuities. They're being marketed in many different ways with many levels of success. As I said before, I do a lot of work with New York Stock Exchange member firms. From the NYSE member firm perspective, let me share a couple of thoughts about how a member firm would evaluate a life company, what qualities it's looking for to qualify it to be a part of their distribution network. First of all, the annual statements are reviewed for the financial strength of the life company: its ability to bear the risks of these products, and its ability to afford to finance major amounts of new business. Financial strength doesn't just refer to the statutory capital and surplus or an A+ Best's rating or a Moody's Aaa rating. An evaluation is made of the asset and liability portfolios, and a determination is made of the ability of a company to withstand various future events. One of the areas to pay close attention to in this evaluation is reinsurance. Some reinsurance deals have resulted in reinsurance reserves disappearing into other countries' more favorable valuation laws.

Another major item in a life company with investment-oriented products is its communication across the balance sheet. I am referring to the communication between the chief investment officer and the chief actuary. How are they running a company with significant disintermediation risk? How are they investing their assets? What's the portfolio of the liabilities? How are they telling each other what they're doing? And do they understand the implications of what they're doing? In fact, on occasion, you have to ask the question, do you really understand what you're doing? How does the marketing department influence decisions, especially to the disadvantage of the existing policyholders? And what risks are understood and managed and which ones are simply ignored?

A third item of somewhat less importance, but nevertheless not to be ignored, is the administrative side. Is the company able to handle hundreds of new licensed agents and thousands of applications for millions of dollars of premium if it gets tuned into the network? So, that's a view of insurance companies from the brokerage community.

A more recent event in the marketing of annuities is the entry of the banking community, in which I include the Savings and Loans. Even if S&Ls do have a somewhat tarnished image these days, they are producing significant writings of single premium deferred annuities. They are becoming quite successful. I do have a couple of concerns, and I'm going to make two comments. One of them is we have watched over the last 20 years the Savings and Loans industry basically wipe out its own net worth by, among other things, borrowing short to lend long in this rather volatile interest rate environment. Now the S&Ls seem to feel, or some do, that there's more to be gained just by earning a commission selling an SPDA and passing that risk on to the insurance company. So now the insurers are borrowing short to invest long in a volatile interest rate environment. *Deja vu* all over again? Is the net worth of the insurers at risk just like the net worth of the S&Ls has been? And the answer is, of course. Is it entirely at risk? Probably for some companies, but which ones?

My second comment is that the barriers between financial institutions are, as we all know, rather artificial. And it seems they are crumbling or at least are about to crumble. And my question is, will the insurers keep the insurance monopoly? Especially for these kinds of interest-sensitive products? In many ways an SPDA is just a banking product with some options built in; mostly options against the insurance company. An interesting example of the crumbling barriers appeared in a corner of *The Wall Street Journal* recently, where the largest bank in France and the largest insurance company in France asked the government if they could merge and form a single corporation. Apparently, the bureaucracy decided they couldn't do that, but it allowed them to buy stock in each other's organizations. I don't know what difference that really makes, but to me the walls are starting to crumble, and the definitional differences of financial intermediaries are going down.

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A final comment when it comes to marketing of annuities. Of late, it's not the least bit unusual to have the topic of reinsurance arise when setting up new marketing deals; either the marketing intermediary or the financial institution wants a piece of the action. They see or perceive profitability in which they would like to participate, and have found out that it can be accomplished through reinsurance. It makes the negotiations rather complex. Explaining life insurance products and accounting to a banker can get a little tedious. Nevertheless, it's happening. There are some positives to this. First, the overall risk to the insurer can be reduced by the very existence of this reinsurance. There's just no incentive for a financial intermediary to take his *block of business and roll it somewhere else if he's got capital tied up in it*. Second, these other entities can get into the insurance business in really quite a controlled and cost-effective manner by setting up a reinsurance company and letting the direct writer do all the administration for it. And even for financial institutions which are currently barred from the insurance business, there is the concept of "synthetic reinsurance," which operates as if there were a reinsurance agreement, but without executing reinsurance treaties between insurance companies. So the SPDA arena, and especially the one involving financial institutions, now includes reinsurance.

### ANNUITY RISKS

My final topic is that of risks and rewards. Now, all business ventures involve risks and rewards, and the insurance industry has its own unique set, including mortality, interest, withdrawal and expense risks. In some parts of our business these risks offset one another, but the annuity subset of our business, and in particular the SPDA subset, has an unusual concentration of the interest risk increased (rather than diminished) by the fact that the withdrawal risk on these interest-sensitive products tends to worsen rather than offset the interest rate risks. To cover the risks involved, there are many investment strategies. In fact, there are about as many strategies as there are companies manufacturing these products. Some of them are taking terrific risks, and others are understanding and taking lesser risks. Some of the strategies include: funds with junk bonds; foreign bonds without even covering their foreign exchange rate risk; real estate (liquidity risk); active hedging of long-term bonds using futures contracts; holding of public utility preferred stocks; leveraged buyout paper, so-called increasers where the interest rate goes up 1% a month; bankers' acceptances; mortgage loan pools; and all sorts of assets backing the SPDA liabilities. Now, some companies strive to be matched, trying to line up the duration of the assets and liabilities in some manner. I happen to be one of those people who believe you're never truly matched. Even if you think you're matched, by tomorrow you're not matched. Something has changed and you're no longer matched. I believe that the rational thing to do is to measure where you are and how close you are to being matched and manage towards being matched if that is your goal, but don't be under the delusion that come Friday you'll be matched. On the other hand, there are companies which deliberately mismatch and recognize the risk and look for some reward' from that risk. Others manage for a total return over interest rate cycles, which will hopefully give some reward. Another focus that some companies take is to strive to diversify their annuity portfolio so as to include not just fixed, but fixed and variable, and a full spectrum of products in between, the combination products referred to earlier. The challenge is to design a portfolio of annuity products in the spectrum which will be attractive to the public, won't unduly jeopardize the whole insurance enterprise and, of course, will produce a profit.

MR. LEFEVRE: The modified guaranteed annuity is a product which has been getting a lot more attention, as I mentioned. Tom Marra, Assistant Vice-President and Actuary of the Hartford Life Insurance Company has been quite involved in that company's product. In his job, he is involved with product development, implementation, financial recording, and forecasting valuations. He's been a frequent speaker at other sessions on the market value adjusted (MVA) product and has served on some industry advisory groups in New York relative to the valuation of this product. Tom and his colleagues at Hartford have been quite active in the regulatory side of this as well.

MR. THOMAS M. MARRA: I would like to discuss some of my company's experiences with market value adjusted annuities, and also describe the current regulatory environment for these products, and how we, as an industry, need to be proactive in clearing some of these regulatory hurdles.

The Life Insurance Marketing and Research Association's (LIMRA's) 1988 annuity survey showed that fixed annuity deposits were up 42% from 1987 with total deposits exceeding \$15 billion (also note that some rather large players were absent from LIMRA's survey). While market value adjusted products have begun to get noticed in the last couple of years, still the vast majority of

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this fixed annuity business is in traditional book value products; that is, products whose cash values remain fixed regardless of changes in market interest rates.

In analyzing the profitability of these book value products, a key consideration involves the strong disintermediation or C-3 risk inherent in these products. In a significant and rapidly rising interest rate environment, we know well that underlying market values can decline substantially and, in fact, can become insufficient to meet the fixed cash value benefits. Furthermore, since these products are generally marketed through relatively astute and efficient distribution channels, the antiselection potential in a rising interest rate environment cannot be underestimated. Money can and does move fast in these channels, especially when there are opportunities for financial arbitrage.

When my own company analyzed the C-3 risk present in single premium fixed annuities, we tried to consider this risk as we would the pricing of any other risk. This analysis really comes down to a two-part question: 1) is the risk understandable and predictable enough so that an appropriate price may be determined, and 2) assuming that an appropriate price can be determined, will the market allow the company a commensurate reward for taking on the risk?

As we applied the first question regarding the price-ability of the C-3 risk, we knew that this was a debatable issue. We were aware of option pricing studies that assigned a "value" on the book-value put-option at over 100 basis points annually. We had also done extensive scenario testing ourselves and again concluded that a significant risk surcharge would be needed to cover the C-3 risk. Ultimately, we concluded that while it may be debatable whether the C-3 risk is a priceable risk, we did agree that if we could establish such a price, it would be an expensive one.

We then moved on to the second question; that is, will the market provide a company sufficient reward for assuming the C-3 risk? Our analysis here was a bit easier. As we saw it, there didn't seem to be much room for a significant risk surcharge, and certainly nothing on the order of 100 basis points. Our conclusion was that at least in regards to the single premium fixed annuities, we were unwilling to accept the C-3 risk under these market conditions.

As an alternative to the book value approach, we began to look at the market value adjusted annuity, a product which has been sold quite successfully by an affiliate of ours in England. Quite simply, the market value adjusted annuity will provide fully guaranteed cash values at specified maturity dates, but will appropriately adjust interim surrender values using a market value adjustment formula. When the MVA formula operates in conjunction with a strategy of matching assets to liabilities, the C-3 risk can be greatly reduced or perhaps eliminated. We saw this as a tremendous pricing advantage, and felt that this could be a winning approach for all parties -- the company, our distributors, and our policyholders. We felt that the market would accept the MVA concept and the protection it affords the company, and that the advantages of the MVA approach would be worth pursuing.

The results of the early entrants in the market value adjusted annuity marketplace have been quite successful. I believe that there are five key advantages to the MVA approach which underscore the reasons for such early success:

1. Safety -- More and more, policyholders, distributors, regulators, and industry rating agencies are becoming concerned with the investment risks that companies assume, and how these risks can affect a company's ability to meet its contractual guarantees. In a rapidly rising interest rate environment, company solvency can become threatened under the book-value approach, and as a result (and as Mr. Draeseke has mentioned) distributor due diligence often centers around these investment risks. Obviously, the MVA approach (recognizing its ability to greatly reduce or eliminate the C-3 risk) will stack up quite well to such due diligence scrutiny.
2. Price Benefits -- The pricing advantages of the MVA approach, in recognition of its reduced risk, are more than simply theoretical. For one thing, an immediate pricing advantage of the MVA approach is that, assuming assets and liabilities are closely matched, the MVA product's reserve strain will be significantly lower than that for book-value products.

But even beyond these reserving advantages, the reduced risk levels of the MVA product should lead to higher credited rates. Clearly an actuary simultaneously pricing both a

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book-value and a market value adjusted annuity would, all other things being equal, arrive at a considerably higher credited rate under the market value adjusted annuity. Of course, this actuary will not be able to control or perhaps even influence the actions of his book-value competitors and, therefore, doesn't expect market value adjusted annuities to always lead in the marketplace. However, over time I believe we will see a noticeable and consistent price advantage under the MVA approach.

3. **Attractive Guarantees** -- This goes beyond the pricing benefits just mentioned. Due to the insulation against the C-3 risk, the market value adjusted annuity will allow the company to offer much longer guarantees than can its book-value competitors. It is very common to see market value adjusted annuity guarantees extend up to ten years. Book-value interest guarantees, on the other hand, must be kept relatively short to avoid a heightened C-3 risk, and also to avoid the substantial additional reserve strain for such long-term guarantees.

Also, in this area of guarantees, the market value adjusted annuity distinguishes itself from variable annuities. Unlike a variable annuity, the MVA company fully guarantees cash values at the specified maturity dates, and of course, the MVA company also fully assumes the asset default (C-1) risk.

4. **Surplus Strain** -- This is usually an attention-getter and, in fact, is probably a major reason for some of the increased activity that MVA products are now getting. The regulations governing these products specifically recognize the company's ability to greatly reduce or eliminate the C-3 risk. As a result, assuming assets and liabilities are also closely matched, required reserves under the MVA products can be significantly lower than their book value counterparts. Companies with limited or highly leveraged surplus levels are beginning to take careful notice of this advantage of the MVA approach.
5. **Equity** -- Equity is indeed the hallmark of the MVA concept. I believe that the MVA approach is fair to all parties -- persisting policyholders, terminating policyholders, and, of course, the company. Both the NAIC Model modified guaranteed annuity (MGA) Regulation and New York's Regulation 127 require that the MVA formula operate similarly on both an upward and downward basis. In fact, both regulations require a qualified actuary to submit an opinion and demonstration (including numerical examples) that the MVA formula is equitable in both an upward and downward interest rate environment. These regulations also require that full disclosure of the operation of the MVA formula be made in all offering material and, of course, in the contract itself.

Next I would like to spend some time on the MVA formulas themselves and on some of the variations currently being used. As I have stated, the market value adjusted annuity provides fully guaranteed cash values on the specified benefit dates, and only interim surrenders will be subject to the MVA. These products are generally sold on a yield-to-maturity basis, and guarantee periods are commonly offered between 1 and 10 years (beyond 10 years it may become difficult to find assets to appropriately match these longer liabilities, and it should also be noted that the New York Regulation requires that unadjusted values be available at least once every ten years).

The contract may allow for unadjusted values at certain other times; for instance, on the death of the owner or annuitant. Also, I have seen death benefit provisions that pay the greater of market or book value on death and still others that pay market value with a minimum guarantee of return-of-premium (i.e., similar to the guaranteed death benefit commonly found in variable annuity contracts).

Another point where a company might provide unadjusted values is in the limited partial withdrawal provisions commonly found in fixed-interest annuities. For instance, a company might allow a one-time withdrawal of prior year's interest without a surrender charge and without application of the MVA formula. A variation of this also being utilized is to allow a partial withdrawal without surrender charges but with application of the MVA formula.

The MVA formula may also be capped to not exceed certain specified limits, though again, in the interest of equity, the regulations require that this capping mechanism operate similarly on both an upward and downward basis.

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Regarding the specific types of formulas being utilized, the regulations permit both internal and external formula structures. The internal index approach utilizes the company's own guaranteed interest rates for its formula components, while the external index approach will use a suitable index of publicly traded debt securities (e.g., zero coupon Treasury yields). To date, all products I have seen have used the internal index approach.

Two alternative approaches to the MVA approach have also been utilized by some companies. These alternatives are also aimed at minimizing the C-3 risk and, therefore, may also warrant consideration in product design.

1. **One-Way MVA Formula** -- These formulas operate on a downward-only basis; that is, they will adjust cash values downward in an increasing interest rate environment, but they do not adjust cash values upward in a decreasing rate environment. Keep in mind that due to this downward-only design, these formulas do not meet the requirements of the MGA regulation and, therefore, are really a form of additional contingent surrender charge. As a result, these formulas must be specifically capped to not exceed the maximum charges of the individual annuity nonforfeiture laws.
2. **No Cash Surrender Products** -- These products simply allow no cash surrenders prior to the specified maturity dates. As a result, there is again the ability to virtually eliminate the C-3 risk, and since there are no interim surrender values to adjust, these products should also avoid SEC registration. I regard this design as a real option if a pricing goal is to avoid the C-3 risk; however, the marketing implications of absolutely no interim liquidity provisions do need to be carefully considered.

Finally, I would like to talk about the regulatory issues facing these products. On the SEC front, obviously each company will need to do its own analysis of the facts and circumstances tests and safe harbors of Rule 151. Most of the MVA products I've seen have been registered under the 1933 (not the 1940) Investment Company Act, and also comply with the disclosure and distribution requirements of the 1934 Act.

Regarding state regulation, the presence of the MVA formula results in failure to meet requirements of the individual annuity standard nonforfeiture law, and as such, regulatory action will be necessary in order for these products to be offered on an individual contract basis. In 1985, the NAIC adopted a model (MGA) regulation; however, state adoption of this regulation has been disappointingly slow. In 1988, the ACLI changed its position regarding state adoption from "supportive" to "actively supportive"; however, actual adoption activity continues to move very slowly.

At this point, the product may be sold on an individual contract basis only in Connecticut and New York; in Connecticut under its MGA regulation (which very closely follows the NAIC Model), and in New York under an amended individual annuity nonforfeiture law and its clarifying regulation, Regulation 127.

As a result of these slow state adoptions, companies have been utilizing a "meantime" approach of selling these products on a group contract basis, with contracts typically issued to a group trust. This group approach will not work in certain states due to "group" definitional issues, and as a result, there are several states where market value adjusted annuities may not be marketed at all.

Please understand that this "meantime" group approach should not be considered as either an acceptable or a permanent solution. These products do provide a real social value, and they do make sense on an individual contract basis. Many more companies are now very interested in this product, and in fact, several new MVA products will hit the streets during 1989. With the many advantages of this product design that I have mentioned, I expect that interest in MVA products will continue to grow.

For those of you who are interested in this product, I urge you to become proactive in helping get the NAIC regulation adopted in more states. In your state of domicile, push to get your insurance department to sponsor and adopt this regulation. Also, let your ACLI representatives know of your keen interest in this product and in your interest in furthering state adoptions. Until the state insurance departments begin to see a more unified and intense industry approach, I guarantee that these state adoptions will continue to move very slowly.

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MR. LEFEVRE: Ryan Larson is Vice President, Annuity and Group Product Development, at IDS. IDS has been quite successful in the annuity business with over \$8 billion of annuities in force and expected sales of \$1.5 billion in 1989. Ryan has been a frequent speaker and panelist at Society meetings and seminars. He will discuss recent variable annuity developments and the aggregation rule.

MR. RYAN R. LARSON: A discussion of variable annuities which might have taken place say 18 months ago would have been very different than this one. The environment surrounding the product at that time was significantly different. Equity and bond markets were on a bull run that had lasted roughly five years. Market indices recorded all time highs almost on a weekly basis.

Investors were euphoric, deaf to any mention of risk or downside. Interest rates were at a low point for the decade. This situation frustrated conservative investors who normally look for safe, guaranteed investments and were used to high interest rates on those investments.

Add to all this the recent passage of the 1986 Tax Act which isolated annuities -- including variable annuities -- as one of the "last remaining tax shelters." These products were increasingly offered by brokers and financial planners who are quite comfortable with the regulatory hurdles of selling securities-oriented business. Together, these factors combined to produce a huge increase in variable annuity sales.

Product features weren't really important. Investment performance didn't seem to matter. Everything did well. If the product said "variable" and included the word "annuity" it sold and sold well.

Then came October 19, 1987. Everything not nailed down tumbled out of bed. The investments backing variable annuity funds dropped in about the same manner as other mutual funds. Suddenly the word *risk* was reintroduced to the investing public.

Overnight, annuity investors -- who tend to be a conservative lot anyway -- became paranoid. The term *variable* became a dirty word regardless of the product association. Unless the product had a fixed side, its sales dropped to almost zero. Products with a fixed option saw cash flow revert almost entirely to that pocket.

Meanwhile, the public's aversion to volatile investments and an increase in interest rates combined for a flood of money into fixed rate products, including annuities. While this partially compensated for the loss in variable business, many insurance companies had gotten used to the idea of attracting money into these products which expose them to somewhat less risk. This was a problem -- and as often happens in this industry -- when problems are present, lots of bright people set about to make lots of innovative changes to their products in an effort to wrest every precious investment dollar from reluctant annuity clients. We can see some of the results of those efforts.

Variable annuities have sprouted several novel new product features. They're all aimed at making products a little bit more friendly to cautious annuity investors. The changes that are cropping up include the following:

1. **Guaranteed Death Benefit** -- For years a common feature of variable annuities was that the benefit at death would be no less than premium initially paid, regardless of fluctuation of the account value. Many carriers are now enhancing this guarantee by increasing the death benefit at various stages throughout the contract owner's lifetime. For example, a product might guarantee a death benefit of contract value, say, every five years, if that's greater than the premium. That value then becomes the new floor. The death benefit ratchets up throughout the life of the annuity. Another variation gradually increases the death benefit by some low interest rate like 4%, providing a guarantee similar to that underlying fixed annuity products.
2. **Fixed Options** -- Many variable products have a fixed guarantee investment option. A common enhancement recently has been to have multiple fixed options, perhaps with different length guarantees or different transfer features. These combine some of the attractive aspects of fixed annuities with the variable investment flexibility.

## PANEL DISCUSSION

3. **Transferability -- Advantages of VAs --** Some companies are offering an automated transfer feature which acts like an internal dollar cost averaging method. A periodic transfer is made from the fixed pocket to any of the variable investment options with the aim of systematically purchasing variable investments with a lower average cost. From a marketing standpoint, the goal is to attract lump sum dollars now and perform the investment over time.
4. **Asset Allocation --** A popular investment orientation product feature is asset allocation. Under this approach the annuity investor might choose between one of three investment profiles, say conservative, middle of the road, or aggressive. Then, within that profile, a manager -- either an active human being or perhaps a computer model -- would allocate his or her investment dollars between investments under a mix conforming to the risk profile. This would allow the investor to participate in some of the advantages of variable performance without having to make periodic decisions as to investment direction.
5. **Investment Options --** Many of the product innovations have included new and different investment options. In addition to the standard stock, bond and money market offerings, it is possible to find virtually any investment that is available on the street also under an annuity wrapper. Examples are as follows: junk bond funds, speculative growth stock funds, global bond funds, socially conscious funds, funds tied to popular indices, such as the S&P, real estate funds, precious metal funds, and the list goes on.

Of course, where the rubber meets the road from the client's perspective is how these various funds perform. Variable annuities have gained the reputation of underperforming street mutual funds. An article in the March 22, 1989 *Wall Street Journal* documented this trailing performance. "Less than Stellar" read the headline. One reason given for the lower returns was that annuity funds -- particularly stock funds -- are managed more conservatively because of the retirement focus of annuity investors.

They can therefore be expected to produce a lower but somewhat more stable return. Nevertheless, the issue has pushed many companies to attempt to improve their variable fund performance. One approach has been to turn to dedicated mutual funds offered by investment houses. The annuity products of many companies may participate in one of these dedicated funds. The advantage to insurers is that in return for giving up the management of assets, they have access to a popular name with supposedly a strong track record. This translates into client recognition.

In summary, it appears that variable annuities have a much stronger position in the product offering portfolios of insurance companies than they did a few years ago. The level of product innovation and investment that carriers are making on these products are indications of their financial and marketing attractiveness.

### **SINGLE PREMIUM DEFERRED ANNUITIES**

Since SPDAs have been a workhorse of the industry for 10 years or more, one might think that the whole product idea has reached maturity. However, people are still finding ways to create new and different product features and make their product look less and less like a commodity. Expectedly, many of these new and different features have to do with the interest rate paid to the clients. In the past, the initial rate at time of purchase was some indication of future performance of the contract. This is not as true. Many carriers offer a high teaser rate and openly admit it up front. This come-on presumably attracts rate-wary investors who can't resist the lure of double digit returns even though they know that rates in later years will drop dramatically.

Other product innovations have focused on the underlying guarantees provided by the product.

In contrast to earlier versions which guaranteed low returns such as 4% for the life of the contract, new products often offer guarantees in early years which are closer to the current rate at the time of sale. They can grade down gradually over a number of years. For example, a carrier which pays 9% in the first year on a SPDA might guarantee 6% in the first couple years grading down by .5% or so a year. These guarantees seldom come into play, but they provide some assurance to the customer against a low-ball sales practice.

The length of interest rate guarantee is also a center of product variation. Many carriers offer a range of guarantees, perhaps three, five, seven, or even ten years. It is interesting to note that there is significant disagreement on the pricing for these guarantees. On a theoretical basis, the

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additional cost of capital to offer long-term guarantees should cause returns to decrease as the length of guarantee increases.

This is the case with many carriers. However, for other carriers the returns actually increase with the guarantee. Who ever said pricing was a science?

The bailout feature is one of the common variations offered in products in the marketplace. There is always pressure to reduce a corridor for triggering the bailout. And the price of the bailout seems to vary with market conditions.

An interesting twist on interest rate guarantees is a forward rate commitment or annuity purchase option. Under this concept the purchaser of an annuity at a given rate is offered the option of purchasing another annuity at the same rate at some point in the future, regardless of the behavior of interest rates. For that privilege the purchaser pays a premium, similar to the premium on a securities option. If in the future interest rates decline, the purchaser can exercise the option and buy a second annuity at the same rate as the first one. The success of this feature would seem to be dependent upon the view of near term interest rate movement by the investment public.

### AGGREGATION RULE

Paul referred to the aggregation rules perhaps more commonly known as antiabuse rules which are changes to Section 72(e) of the Internal Revenue Code. These may more properly be known as aggravation rules. I assume that most of you are familiar with the issue so I won't go into great detail. In addition, John Palmer wrote a very concise summary of the issue in the April edition of the newsletter of the Product Development section.

The general scope is that the IRS has been given authority by Congress to develop new regulations covering the purchase of multiple annuities. The Service has indicated that it intends to use that authority to the fullest extent of its ability. The general issue is that annuity contracts issued by the same insurer to the same policyholder during any 12-month period will be treated as one contract for withdrawal purposes. Since the issue first surfaced, interested carriers have raised a number of concerns. Some of these are as follows: What would be the treatment of split annuities, those situations in which a deferred annuity and an immediate annuity are purchased at the same time? What is the treatment of purchases by members of a policyholder's family? How can a 12-month time frame be defined to be manageable from a carrier's standpoint? How would annuity sales to the same client by other companies be treated? On most of these issues, the IRS is taking the worst possible stance from the industry standpoint. The one bright spot is that it seems to agree that the rule should not cover qualified annuities.

In part due to significant response from the insurance industry, the release of this regulation has been delayed and is not expected in the near future. In place it leaves the specter of indecision, and carriers are forced to operate in an environment of uncertainty. The main focus of industry efforts at this point is to assure that whatever rules are adopted, whenever they are adopted, are prospective in nature and not applied to business written previous to the effective date of the rules.

