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PRODUCT UPDATE – INDIVIDUAL ANNUITIES

Moderator:	THOMAS M. MARRA
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	TIMOTHY C. PFEIFER
Recorder:	THOMAS M. MARRA

- Discussion of "current events"
- New products on the horizon
  - Market-value adjusted products
  - Income products
  - Variable products
- The importance of "due diligence"
- In-force annuity management

MR. THOMAS M. MARRA: My role was to recruit a knowledgeable, accomplished panel to discuss annuity issues in turbulent times. I think you'll agree this is indeed a very exciting, perhaps too exciting, period for our industry. Our focus from each of the panelists will be on emerging trends and issues as they relate to the current market environment. Obviously the challenges ahead of us as actuaries are significant. Creativity, awareness, involvement, and even corporate citizenship will be key factors as we move into the next few years.

Let me elaborate on that last point. Obviously in these turbulent times, one common area of interest is the public's perception of us as an industry and as annuity writers. As citizens of the life insurance industry, obviously we all need to regard this perception as fundamental to our long-term futures. And this will also require responsible marketing behavior, keeping the integrity of our industry clearly in focus. We'll focus more on this issue as the session progresses.

First, I'm going to ask Tim Pfeifer, a consulting actuary in Milliman & Robertson's Chicago office, to talk about emerging product trends. He will also touch on marketing and distribution issues, again focusing on issues in a turbulent economic and public confidence environment. Second, Doug Draeseke, a consulting actuary from Greenwich, Connecticut, will speak on distributor due diligence issues; Doug has worked very closely with many distribution houses, including regional and wire house broker dealer firms. I think you'll find his thoughts from the distributor side to be particularly interesting. Finally, Paul LeFevre, Senior Vice President and Chief Financial Officer at Keyport Life, will speak on profitability management issues, particularly as they relate to in-force business, something we all must pay careful attention to.

MR. TIMOTHY C. PFEIFER: My comments will focus on product design trends for individual annuities. Some of what I'll speak about pertains to contracts that are technically group annuities, but for a number of reasons are being sold to individuals and function similarly to an individual product.

There's been a lot in the financial press of late regarding both annuity carriers and annuity products. A tremendous amount of time is being spent on evaluation of the carriers – the whole due diligence process that Doug will be talking about later.

However, if you look at six-month annuity production figures put out by the Life Insurance Marketing and Research Association recently, sales of fixed annuity products increased by 15% in the first six months of 1991 over the comparable period in 1990. This compares to dramatic declines in variable life (both variable universal life and fixed premium variable life) and flat production for whole life and universal life.

You might ask why this is. A couple of the easy explanations are that demographics continue to work in the favor of the annuity line of business. It's a comparatively easy product to sell relative to life insurance. If you look at the current level of annuity-credited interest rates compared to rates on a one-year CD, the rates continue to look attractive. A recent *Wall Street Journal* indicated that one-year CD rates are averaging about 5.3 or 5.4%. Comparing that to a one-year rate guarantee on a Single Premium Deferred Annuity (SPDA), the annuities rates are much more attractive (7-7.5%).

The trends that we're seeing in annuity products are more in terms of the method than the product. By that, I'm referring to the way in which companies are going about designing their annuity products, which are much more sophisticated than in the past. It would be nice if we came to each annual meeting and unveiled the new line of automobile or the new fashion trend, but we don't do that. We can't say "this" is the 1991 annuity product. There are some design changes that we can talk about and I hope elaborate on some of them here.

I've divided my presentation into five main topic areas. Companies are designing products to manage the C-3 risk.

They are developing products in an attempt to control surplus strain. This, as much as anything, is because of the great emphasis being placed on professional rating agencies. But it also has to do with capacity concerns. In certain markets such as structured settlements or the bank annuity market, the question of how much capital and how much capacity a company controls is very important. In designing products, many companies make very serious attempts to keep the surplus drain to an absolute minimum.

One other product trend that counters the first two is an effort to enhance liquidity on certain types of products such as nonsurrenderable products. Companies are building in certain means by which the policyholder can always get access to at least a certain amount of money or at least get access to money under certain conditions.

The rise of immediate annuities is another area of interest. I don't mean to imply that there has been a groundswell of activity on the immediate annuity development front. But there are definite pockets of activity among certain companies that are becoming very active in the area of seeking immediate annuity business, such as in sales through bank trust departments. In the case of immediate annuities, the demographics are certainly in our favor in terms of making the product work.

Finally, I'm going to discuss briefly the new nonforfeiture proposal that has been put forth by the Howard Kayton committee. In the last year or so, an industry task force that reports to the NAIC Life and Health Actuarial Task Force has put together a revised nonforfeiture proposal that very soon may be exposed for comment. This proposal, over the long term, could very dramatically affect annuity product design in certain areas.

Let's first discuss managing C-3 risk and what companies have been doing in this area. The first main point in this topic is market-value adjusted products (MVAs). The number of companies interested in MVAs is rising dramatically. However, the number of companies that have actually developed products and are actively selling them has risen much more slowly. There are a number of reasons for that. The main one is probably the SEC registration requirements that some companies don't want to face.

A number of companies have come out with both registered and nonregistered versions of their MVAs. In either case, the typical MVA does not comply with the individual nonforfeiture law for deferred annuities. Therefore, most companies develop products that are technically group contracts, although for all intents and purposes, they're individual products in nature.

The whole area of whether an annuity must be registered is by no means a black and white issue. There are law firms in Washington that issue different opinions on registration of the exact same product. The criterion of whether a contract significantly passes investment risk to the customer is not a clear-cut issue. There is considerable legal interpretation that comes into play there. To be safe, many companies assume that their product has to be registered. The nature of the market-value adjustment is that it reflects changes in interest rates since issue. If interest rates as a whole have gone up since issue, the market-value adjustment is downward and vice versa. So far, we're unaware of any company that has developed a market-value adjusted annuity that reflects defaults in assets or any of the quality risks, which admittedly would be much more difficult. Certain companies have given this some thought in an attempt to make MVA formulas used in these products a little more applicable to what it really reflects.

In today's environment, with interest rates as low as they are, selling MVAs may be a difficult sale for customers who understand the product. Given that long-term rates will tend to rise from where they are today, agents may have difficulty convincing customers that if they want their money out early, they won't get hit with significant market-value adjustments. From our perspective as companies, this is the kind of protection that the MVA was designed for, but it does make for a difficult sales environment.

One other comment on MVAs is the fact that bank sales of MVAs have been rising, and I think this is a noteworthy point. For many years, the theory was that only fixed SPDAs could be sold in the bank market. But we are seeing signs now that some companies such as Tom's have been able to sell MVAs in the bank environment.

Let's turn to persistency bonuses and trailing commissions. Persistency bonuses in the life business have traditionally focused on life insurance more than annuities. One could make a very convincing argument that annuities are logical products on which to add some sort of persistency bonus. We design products that pay an upfront commission and give customers and agents all the incentive in the world to leave at some point.

With persistency bonuses, I'm not really talking about the contracts that pay an annuitization bonus, but rather the contracts that would enhance the interest rate after the policy was kept in force a certain number of years, or after the fund value reaches a certain level. There are precedents in other financial instruments such as CDs where a bonus interest rate is paid when the fund balance reaches a certain level. As an industry, we ought to give some thought to whether persistency bonuses could alleviate some of the C-3 risk by encouraging people to stick around for longer periods of time. There are questions as to how the Commissioners Annuity Reserve Valuation Method (CARVM) may apply to persistency bonuses in terms of whether they're guaranteed or not; nevertheless, I think it's a point worth consideration.

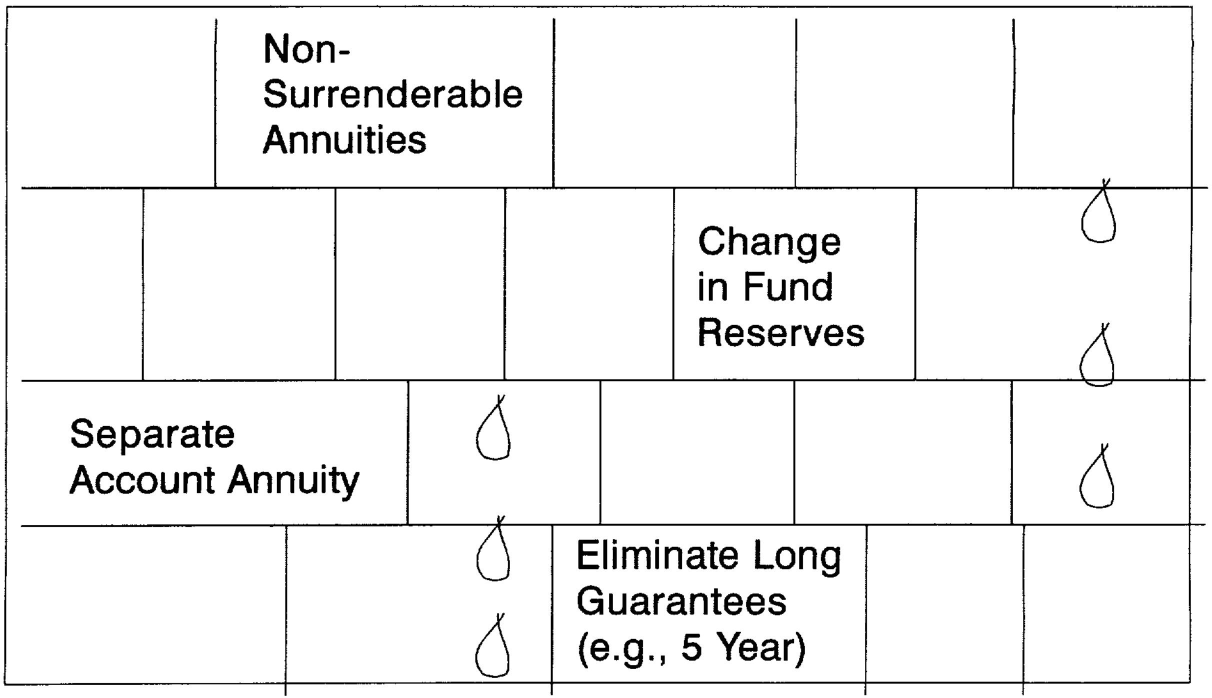
Payment of trailing commissions addresses a concern, given that the surplus drain on annuities is such a critical point. So far, most companies haven't been very successful in stripping away some of the front-end commissions and moving them to the back end. I think it's more of a cultural barrier than a practical barrier to overcome. In some markets, some companies have tried to structure the sale to the agent in such a way that they can be convinced that trailing commissions can be much more profitable for them in the long run.

With respect to using asset/liability analysis in pricing, the Actuarial Standards Board now requires that we, as actuaries, consider the appropriateness of asset/liability management and matching in many areas, with pricing definitely being one of them. I'm not going to touch in great detail on this point because I think it's been covered in significant detail in previous sessions of this meeting. I think it is noteworthy to observe that almost all companies we've dealt with, including small, medium, and large companies, are now very cognizant of the fact that asset/liability management is the key to successfully managing an annuity line. Pricing for a flat 200 basis point spread and running with it is not the way to go any more.

I've listed nonsurrenderable contracts as another way to manage the C-3 risk. These are contracts which guarantee an interest rate for a certain period of time. However, the contracts are nonsurrenderable until the end of that guarantee period. This design brings up the question of compliance with the individual nonforfeiture law. The answer is that it depends on which state you're filing the contract in. Most companies that have developed nonsurrenderable contracts have filed them as group contracts, because of certain states that interpret the individual standard nonforfeiture law to say that if you provide a cash surrender value at any point in time, you have to provide it at all points in time. Again, not all states agree with that, but most of these contracts are filed as group contracts. Most nonsurrenderable products out there have been able to manage the C-3 risk, because the disintermediation risk between the discrete cash surrender periods is lessened. It theoretically enables the company to invest in longer maturities and credit more attractive yields.

Product designs have been modified in an effort to control surplus strain (Chart 1). Nonsurrenderable annuities can provide a means to lower surplus strain, because by using nonsurrenderable products, companies can value them using either a type A or type B valuation rate. Most nonsurrenderable contracts use a type B valuation rate,

CONTROLLING SURPLUS DRAIN



as opposed to the type C valuation rate that most deferred annuities with ongoing book value cashouts use. The current type B valuation rate is 7.25%, compared to 6.75% for a type C product. If you designed a product that enabled you to utilize a type A valuation rate, which is the rate permitted if the product never allows lump sum cashouts, the rate would be 8.75%. Thus, there is quite a rate jump when you go to a type A product. Holding change in fund reserves may be another strategy. The provision to calculate reserves on the change in fund basis has been in the Standard Valuation Law for quite awhile. Most companies have dismissed it as being either too complicated or of little benefit. In today's environment, change in fund reserves seems to offer some potential advantages, if you adhere to the thought that over the long term, interest rates will rise from current levels. Not only do you get a reserve rate advantage with a lower initial first-year valuation rate (the change in fund valuation rate is 7% versus 6.75% on an issue year basis), but presumably if rates go up, the ongoing valuation rate under the change in fund method would increase as well. Thus, the change in fund method, over a period of time, could actually offer you some advantages. Although one must pay attention to the administrative requirements of the change in fund method, most commercial software can handle this method.

Separate account annuities include not only MVAs, for which surplus strain is lower due to the use of higher valuation rates, but also other types of separate account products. There's currently a product on the street that is a separate account annuity product that does not have a market-value adjustment. It has a declared interest rate and is taking advantage of the market-value adjusted valuation rates to keep reserves low.

In terms of product design, in addition to some of the obvious strategies like raising surrender charges, trying to lower or spread commissions, we've also seen companies eliminate their five-year rate guarantee products in favor of offering simply a one- and a three-year product. The surplus strain on a five-year versus a three-year rate guarantee product can be three to four times the level if the rates are fairly close. Another reason companies have eliminated their five-year rate guarantee is simply because with the current level of rates, a five-year rate guarantee would not be attractive.

Finally, a lot of companies have done away with bail-out clauses and cumulative free withdrawals, two other features which tend to drive up surplus requirements. On the one hand, we see companies taking away some of these liquidity features, but on the other hand, they are enhancing them as well. The development of liquidity options is driven by customers' concerns over the negative press regarding company ratings and their inability to get at their money.

Probably the most popular one that you've seen is the nursing home and hospital waiver of surrender charge provision, which specifies that if the individual is confined in a hospital or a nursing home for 60-90 consecutive days, the policyholder can withdraw their funds with no surrender penalty.

Some of the more recent variations of that same theme are companies looking at types of education waivers, if funds are used to fund some type of postsecondary education. Another is unemployment waivers. Obviously, you have to be careful about which market you offer these in because you might actually get significant claims on them if you choose the wrong market. The cost of these benefits tends to be fairly minor. For example, the nursing home and hospital benefit has been priced to cost about two basis points. Obviously, the cost depends on the specific product and provisions, but generally the consensus is that it is a fairly nominal cost.

Another liquidity feature is the use of policy loans. These have been found on tax-sheltered annuities for awhile, but they've also appeared on nonsurrenderable contracts as a means that policyholders can gain access to their money. Loan features do not typically require any additional CARVM reserves, so the company has less of a problem in offering that type of liquidity.

As far as the 10% free withdrawal provision, we've started seeing some variations on that provision also. I mentioned that many companies have shied away from the cumulative free partial withdrawals. We've seen companies design variations, such as a 20% free withdrawal for the first partial withdrawal, and then it drops to 10% after that.

In certain markets, return of principal guarantees are an essential type of liquidity feature. Bank-sold business in particular requires a return of principal guarantee or, in lieu of this, a one-year free look provision (either stated in the contract or not stated in the contract). Companies may or may not be reserving for a one-year free look in the same manner that they reserve for a return of principal guarantee. The exact treatment depends again on how rigorous the state insurance department treats that type of provision.

Just a few more comments on immediate annuities. Immediate annuities in the past have generally been income-only contracts. We have seen interest in immediate annuity contracts that allow a cash-value provision. You've probably read about the Life of Virginia Added Options contract that provides for a cash-value benefit. In addition, we've seen some companies look at immediates that would pay a commuted value of the remaining payments, subject to some type of market-value adjustment to ensure that the company is not getting killed on surrenders.

Variable payouts and inflation adjustments are related to the same issue. Variable payouts would relate to indexed immediate annuity benefits that are not fixed at issue but that are based on some standard financial index, although it could vary over a wide range. The inflation adjustments are more of a fixed increase in the income benefit, like the structured settlement annuity feature that adds 4% to the payment each year. Many more companies encourage the purchase of settlement options on annuities or life insurance by paying a fairly generous commission if the proceeds are rolled over into an immediate annuity.

Let me just touch on the new nonforfeiture proposal. This proposal started out with the committee looking at two-tiered annuities, the goal of which was to try to develop an equitable way of regulating differences between the values available on annuitization or on a lump sum surrender. This committee was chaired by Howard Kayton.

After the committee began their work, they realized that the issue was much broader than just two-tiered annuities. They began focusing on the more complete picture of cash surrender values and nonforfeiture for all annuities.

In mid-September, this committee released their initial report to the Life and Health Actuarial Task Force. I've highlighted a few of the main provisions of this suggested nonforfeiture proposal (Chart 2). The main one, in my opinion, is that it limits the difference between the account value and the cash surrender value to 10% on SPDAs. Thus, regardless of your commission or other product design features, the maximum initial surrender charge is 10%. If you have a front-end load, it is also limited to 10%. On flexible premium annuities, the limit is 20% on the first $5,000 of premium and 10% on the subsequent amounts. Thus, compared with the current nonforfeiture law, this would define a more restrictive surrender charge limit. It also prescribes that differences in the guaranteed credited rates cannot be bigger than 2% between any two years.

CHART 2
New Nonforfeiture Proposal

Proposal Draft	Difference in guaranteed credited rates $\leq$ 2% in consecutive years
Limits difference between account value and cash value to 10%/20%	Restricts cliff surrender charges
Permanent surrender charges acceptable	Withdraw guideline III

The committee was very concerned about persistency bonus features. They wanted to ensure that companies weren't designing products in which one day the customers get very little, while the next day they get a windfall. Several different provisions of the new nonforfeiture law have been designed to address persistency bonus provisions. The committee views cliff surrender charges as another form of persistency bonus. Therefore, the change in the surrender charge from one year to the next year cannot be greater than 2%. A surrender charge pattern like 5, 5, 5, 0% would not fly. A surrender charge pattern like 9, 6, 3, 0% would not fly, but a surrender charge pattern like 5, 4, 2, 1, 0% would fly. Again, the thinking there was maintaining equity more than anything and making sure that two similar policyholders get roughly equivalent amounts upon surrender.

The proposal also addressed permanent surrender charges and offered the opinion that permanent surrender charges are acceptable, provided that they meet all other provisions in the nonforfeiture proposal. Permanent surrender charges were viewed as nothing more than front-end loads. Contracts which do not have any lump-sum surrender ability were also viewed as acceptable provided that they meet all other provisions of the nonforfeiture proposal.

The proposal also went on to require a 3% minimum credited interest rate, as is now the requirement in the current nonforfeiture law. Until action is taken on this proposal, it was recommended that current Actuarial Guideline III be withdrawn. This is a guideline that has caused a lot of headaches if you've made annuity filings in Oregon or Washington. The Guideline refers to the definition of the maturity value of an annuity contract. Guideline III says it should be the cash value at maturity. That causes a lot of problems if you're filing a two-tiered product.

Just a few other miscellaneous points relative to products. The deferred acquisition cost (DAC) tax has received a lot of discussion at this meeting. The annuity line of business came away relatively unscathed compared to other lines of business. The DAC tax does not apply to qualified annuities, only to nonqualified annuities. And for those annuities, the percentage that's applied to annuity premium is 1.75%. Most of the analysis that we've seen and that we've done seems to indicate that the cost of the DAC tax is roughly five to ten basis points. Nobody wants to give away five to ten basis points, but compared to the way the DAC tax hit some other product lines, annuities came away in relatively good shape.

Just one other comment. A new valuation law is something that I think we're all going to be hearing more about within the next few months. A separate committee is addressing the clarification of CARVM principles relative to annuities. From what I understand in talking to some of the committee members, they're expecting that an initial report will be issued within the next month. Apparently, this proposal is on a very fast track. They're hoping to actually have something exposed and maybe even enacted by the end of this year or very early next year. The new industry-endorsed valuation law proposal would recommend that companies reserve for all significant contingent benefits in their annuity products, and it recommends a *curtate* interpretation of CARVM rather than the continuous interpretation of CARVM, which would increase reserves in most cases. Whether regulators will approve of this is another point entirely. But keep your ears open, I think you're going to hear something on valuation very soon.

MR. DOUGLAS G. DRAESEKE: I'm going to discuss due diligence in turbulent times. I've been involved with the due diligence process for a number of Wall Street member firms, regional firms, and banks over the last 10 years and have become quite adept at evaluating life insurance. In this presentation I will describe the due diligence as it applies to annuity companies, which I define to be companies whose annuity and GIC liabilities are more than three quarters of total actuarial liabilities. The presentation will be from the point of view of my clients, which are annuity marketing departments of fiduciary organizations such as the New York Stock Exchange (NYSE) member firms or banks. They are well aware of their due diligence responsibilities.

OVERVIEW

As a quick overview of what you're going to hear from me, I'm going to define some of the terms, or the words in the term due diligence, and how we apply them. I want to cover the phases of due diligence that we work our way through and then I'm going to close with some criteria that we apply in measuring the strength of annuity companies.

DEFINITIONS

The word "diligence" is defined to be attention and care by a person. It's the opposite of negligence. The word "due" means it's capable of satisfying an obligation, as something you must do, and it must be sufficient. So, "due diligence" is obligatory and sufficient care and attention to what exactly is happening. We maintain due diligence over the affairs of life insurance companies supplying insurance and annuity products through the member firm or the bank.

PHASES
There are four main phases we cover in evaluating a company. They are very quickly, a product evaluation phase, then a financial analysis phase, moving to a management analysis phase, and then finally the ongoing phase (probably the most important). Now I look on the due diligence process as being basically a filtering process which is much like the actuarial examinations. If you don't get through one phase, there really isn't much point in going on to the next.

The first phase, the product evaluation phase, is very straightforward. Nothing of any revelation here; reviewing contracts, illustrations, prospectuses, relevant history such as rate crediting, all very mundane and straightforward and very client specific and product specific. But again, if you don't get past this first hurdle, there's no use going on to the next.

Next, then, is the financial analysis phase, which is our quantitative review. The primary source of data for this phase is the NAIC's Statutory Annual Statement, which contains a wealth of information, if you have the patience to dig through it all. We also review GAAP statements, if there are any, basically combing the footnotes for interesting extra reserves we don't find on the statutory side. Often we can pick a few things out of various SEC filings.

The first part of the financial analysis phase concerns the capital strength of the company: it's capital and surplus. We've found we can't merely rely on what's published in the *Blue Book*. We have to make a series of adjustments. Let me share with you some of these adjustments, in no particular order.

1. Unstacking of Surplus. Many insurance organizations contain multiple insurance companies, often stacked one above the other. The result is that the Capital and Surplus of a subsidiary insurer is being counted in the Capital and Surplus of its parent. We believe that the Capital and Surplus is needed in the subsidiary company, otherwise it would be dividended up. We therefore unstack the Capital and Surplus in our analysis and do not double count a subsidiary's Capital and Surplus.

2. Loans to Affiliates. It's too often the case that an insurer in a fleet of companies will loan money to one of more affiliated companies, and these affiliates then default, bringing down the insurer. So after analysis we'll typically write down these loans to something which we consider more appropriate.

3. The Mandatory Securities Valuation Reserve (MSVR). It's not really an actuarial liability, it's an investment reserve. However, we don't blindly release that into capital and surplus. We look first at the market value short fall of the bond portfolio and if that is at all worrisome then we may not release any or all of the MSVR. We also adjust for GAAP default reserves. We've seen quite a few of those in the last year or so. Most insurers do not set these reserves up on their statutory books, because they don't have to. But of course, many of them have set them up on their GAAP books. So, we use

(as a starting point adjustment) the amount of that reserve to knock down the Adjusted Statutory Capital and Surplus.

4. Separate Accounts. It's often the case that the surplus requirement of a separate account is almost zero or very low. So, where appropriate, we will adjust assets and liabilities for the separate accounts.

5. Reinsurance. Another adjustment area is reinsurance which can be vastly complex, probably the most difficult, and the most often abused. Schedule S contains a wealth of information, but you really have to evaluate several years of Schedule S to get an idea of the true financial strength of the insurer.

6. Surplus Notes. We consider a surplus note to be a form of debt (rather than equity) in the life company and we therefore often adjust the capital and surplus for some portion, if not all, of the surplus note.

7. New Business. Finally, we don't use the current capital and surplus to measure the strength of the company just for its current block of business. The company must also be able to handle large blocks of new business, which our member firms can turn on very easily.

The second part of the financial review considers the quality of the invested assets. For most insurance companies we've reviewed there are two kinds of assets, namely bond holdings and mortgage loan holdings (and, unfortunately, these mortgage loan holdings are often turning into real estate due to mortgage loan defaults).

1. Bonds. Up until last year, it was a tedious process to make some real evaluations of the quality of the bond holdings since the old NAIC classifications weren't terribly useful. The new Schedule D, part 1A breakdown (which sort of follows the ratings agencies) has made the job a lot easier. We can now get a much better feel for the risks that the insurer is taking with the policyholders' monies.

2. Mortgage Loans. If you are familiar with the blue book, Schedule B has a wealth of information. Although not nearly as finely tuned as for Bonds, you can still analyze the performance of their mortgage loan portfolio.

   It's interesting to follow over time how a mortgage loan in good standing can move into the category of problem mortgage loan, into the category of mortgage loan in default, into yet another category of mortgage loan being foreclosed, into the category real estate acquired in satisfaction of debt, which moves the reporting to Schedule A. Of course, there is the final transaction of foreclosed real estate sold. Again, the information in the blue book is not that easy to follow, and there are insurers that obfuscate the details as between real estate acquired in satisfaction of debt and other investment real estate. It's often too difficult to complete your analysis without an on-site visit. Nevertheless, it's very enlightening to observe the progression of just where the companies take hits to capital and surplus on these five or six steps down through the classifications. Some companies are very realistic and take some write downs at the front end, while others in a capital conservation mode don't recognize any losses until they have finally sold the piece of real estate at something like 40 cents on the dollar.

Although bonds and mortgage loans are far and away the most usual assets we analyze, it is not always so. Recently, we analyzed an insurer whose statutory net worth was very large; capital and surplus looked very strong until we analyzed the asset holdings; 50% of the assets were in common stock holdings of five publicly traded companies; very unusual.

The next two financial analyses are related to each other, and not nearly as exact as some of the previous ones. We use these to give us an idea of where our analysis should go and where our questioning should be concentrated. These two are asset maturities and liability maturities. For bond maturities, we analyze the expanded Schedule D, Part 1A. We have to make adjustments for mortgage-backed bonds, like Government National Mortgage Associations and Federal National Mortgage Associations, because they are reported as maturing at the latest maturity mortgage in the pool. It's not difficult, although it does take some tedious arithmetic to get decent results.

Liability maturities can only be approximated and inferred from the annual statement data, and again I'm referring to companies with primarily annuity and GIC liabilities. The statutory breakdown of the withdrawal characteristics of the annuity actuarial reserves is between those that are (a) withdrawable at book value, (b) withdrawable at book value less some sort of surrender charge (which supplies some disincentive to withdraw), (c) withdrawable at market value or perhaps market value adjusted, and (d) not withdrawable at all. By looking at this spread of the liability maturities or liability liquidity you can get an idea (but only an idea) of a possible mismatch between assets and liabilities. But it gives us an overview with which to move to the next phase of the process, which is the management review. We interview the management of the company and get answers to questions brought up by our analysis. Now this is much more qualitative than quantitative, but it's by far the most important to this point in the due diligence process.

We interview the top executives of the insurer and their staffs. It helps to have people down a few levels who are actually doing the work and supplying the data that back various statements. We interview the chief financial officer, especially with questions raised in the previous analysis. The chief operating officer is questioned about the administrative capability of the company. A member firm can roll hundreds of millions of dollars of premiums very quickly; are you able to take this on administratively, let alone financially? We spend time with the chief actuary for specific product questions, questions on rate-setting philosophy, rate histories, cash-flow testing, asset/liability measurements. Sometimes we'll interview the chief counsel about legal opinions, or IRS opinion letters, or SEC matters. The chief investment officer is questioned about investment strategy and execution. Then of course, the chief executive officer is questioned about overall corporate goals and strategy, and how they will affect the products that are under review by us. Through this process, we also want to get a good understanding of "communication across the balance sheet." How are the liabilities (typically annuities) measured by the actuary and how are the assets managed by the investment department, and how do they communicate with each other? How do they tell each other what they're doing? Too often I've been in meetings where the actuary admits to infrequent discourse with the investment managers who are halfway across the country. Or the investment manager who claims that his daily telephone call from 200 miles away concerning today's investable cash is all he needs. Some of these interviews end up with a termination of the due diligence process. At that phase, notice one major omission from the list of interviews, the chief marketing officer. It's not meant to be an insult, it just tends to be a waste of time.

The fourth and probably the most important phase of the due diligence process is the ongoing phase. It's not a one-shot affair. We have to be continually diligent. The financial strengths of companies have changed very quickly, especially in the last few years. So, we review the financial statements of most companies quarterly and we visit their management as often as twice a year, especially if there are difficulties.

STANDARDS

When all this analysis is complete, we measure each insurer against a set of standards, a criterion. If a company misses a criterion there must be a good and compelling explanation as to why the shortfall might be acceptable.

Without going into great detail, here is a list of criteria and the kinds of measurements we make: (a) capital and surplus with adjustments, a minimum dollar amount, and a minimum percentage of actuarial liabilities; (b) investment quality criteria, and investment liquidity criteria, as well as a criterion for investment returns and how they relate to the interest rates credited; (c) minimum for financial results on both Statutory and GAAP; (d) product risks -- how well does the management of this company understand these risks and second how well do they manage those risks? and (e) the accounting stance -- how aggressive, or conservative, have they been in their liability measurements, as well in their asset valuations?

RATINGS AGENCIES

Also of importance are the ratings agencies, which include Best's and Standard & Poor's (S&P) and Moody's and the NAIC. Now we look at their reviews and ratings and they are useful. However, we believe they really have missed too much in the past; perhaps they are still in a learning phase; they've got some catching up to do. I really don't think they understand some of the nuances of our business. We have minimum ratings criteria, which, if missed, need explaining. We find that we cannot rely on these agencies. Notice that we included the NAIC in the above list of ratings agencies. Not because they claim to be, but because they've turned out to be through their so-called Insurance Regulatory Information System (IRIS) ratios. It contains a series of 10 or 12 measures which, if a company fails for a good or bad reason, gets some (usually) negative press. So we have taken the step of measuring all the IRIS ratings in advance when we look at a company, just so that we can be aware that there may be some negative publicity sometime in the future.

SUMMARY

So this has been an overview of the process we go through in due diligence, as it applies to insurance companies whose products are being distributed by banks and Wall Street firms.

MR. PAUL H. LEFEVRE: When Tom and I talked earlier on this subject, one of the things we discussed was renewal rates on traditional SPDAs. Then I looked back at what I'd been doing all year, and decided that what we'd really been doing all year at our company was dealing with the outside world. I thought I'd share with you some of the things we said and did. I'm not going to spend a lot of time on what the challenging times are. I think you know them.

Annuity company seizures: you know who they are and what went on.

Regulatory attention to solvency matters: I include the federal attention and the congressional attention, all of which has been picked up by the press. A lot of people who stay up and watch late-night TV have seen senators on TV talking with "great knowledge" about our industry.

Rating agency confusion: I call it confusion, because of the emergence of the Weiss organization, the S&P ratings versus the solvency ratings they did on all companies, and the downgrades that have been occurring. That's caused, from my perspective, a great deal of confusion among distributors, the public, and the press. I'm not referring to confusion in dealing with rating agencies, though that can be part of it as well.

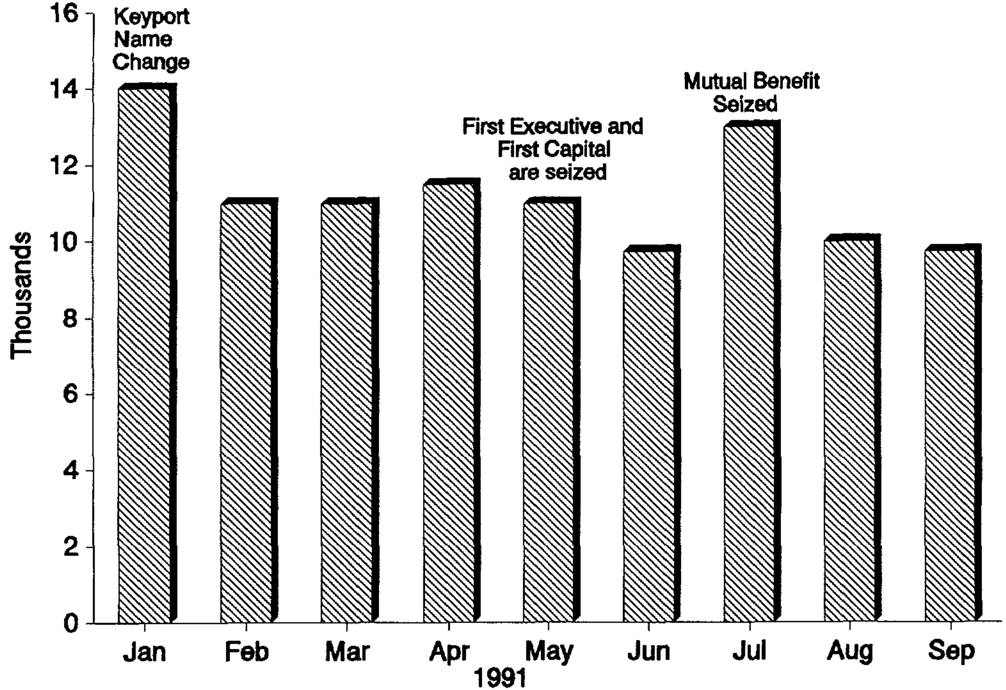
Media attention: TV, radio, magazines, they've had a field day with the insurance industry. There has been reaction from distributors. There's been reaction from policyholders. I think you've all experienced it.

Agent and distributor reactions: In our company we deal with many different distribution sources of business. So when I talk about distributor, I'm talking about a major firm or a bank or a marketing company. When I'm talking about agents, I'm talking about the person who actually has the contact with the policyholder at the point of sale, and maybe at the point of service. Let me get into a little bit of detail.

How do you know what's going on if you have diverse distribution? If you happen to have a captive field force or a narrow market, I think you have a better chance of knowing what's going on. I believe in this market, you've really got to take the pulse of your policyholders and your field force. The symptoms as well as the sources of information are telephone calls, surrender activity, and due diligence requests. You can learn from 1035 exchanges. You can learn about it from analyzing what's coming in on 1035 exchanges and also from what's going out. Let me zip through some of these.

Chart 3 is an example that we've used internally because we track our telephone calls. These are telephone calls to our service hot line for 1991. The level of telephone calls isn't what's important, it's the things that have caused the blips. Those of you who know me think I've changed companies; we just changed the name of the company. It used to be Keystone Provident. Now, it's Keyport Life. At the beginning of the year, we sent a letter to all our policyholders. We informed them that because of the sale of our company two years prior, we had an obligation to change the name of our company, because the owners of the Keystone name were no longer part of the organization. So we changed it.

Keyport Telephone Call Volume



We sent a letter to all our policyholders. Probably the first time we've communicated with all our policyholders in one mailing. It caused the greatest amount of telephone calls we've ever received. "We didn't know you were sold." "Are you in trouble because you're changing your name?" "Why didn't you change it to this?" "Have you ever been to Keyport, New Jersey?" Then things went along with a pretty good level of phone calls and we've marked two other events. One peak was when Executive Life and First Capital became real news, when they were seized by the insurance departments. The other peak occurred when Mutual Benefit was seized. For some reason, that one was higher. Then things tailed off. There were other minor peaks that showed in our weekly chart, when there was an article in *USA Today* or Mr. Weiss put out press releases.

Surrenders for the year seem to illustrate, at least to me, that with more and more media attention, people started saying enough is enough with this industry (Chart 4). Surrenders started building up. It peaked for us in August. Again, I'm not concerned with the level. The point is that in this year, there has been an increase in surrenders. The thing that we've noticed the most is that the increase in surrenders has really been as much policyholder driven as agent driven. They are not necessarily 1035 exchanges.

The people who are calling up don't even want to talk to anyone: "You're an insurance company, therefore you're bad, therefore my money should not be with you, can you Federal Express me a check?" There's a significant amount of that. In a sense, I think it has cleansed our in-force of the really nervous people. Our 1035 activity is very interesting. I've done this by putting the S&P ratings of the companies to where the business is going. I believe that this is a good illustration of what we call the quality flight. Triple A companies have been getting the bulk of our 1035 exchanges (Chart 5).

Agent Reaction

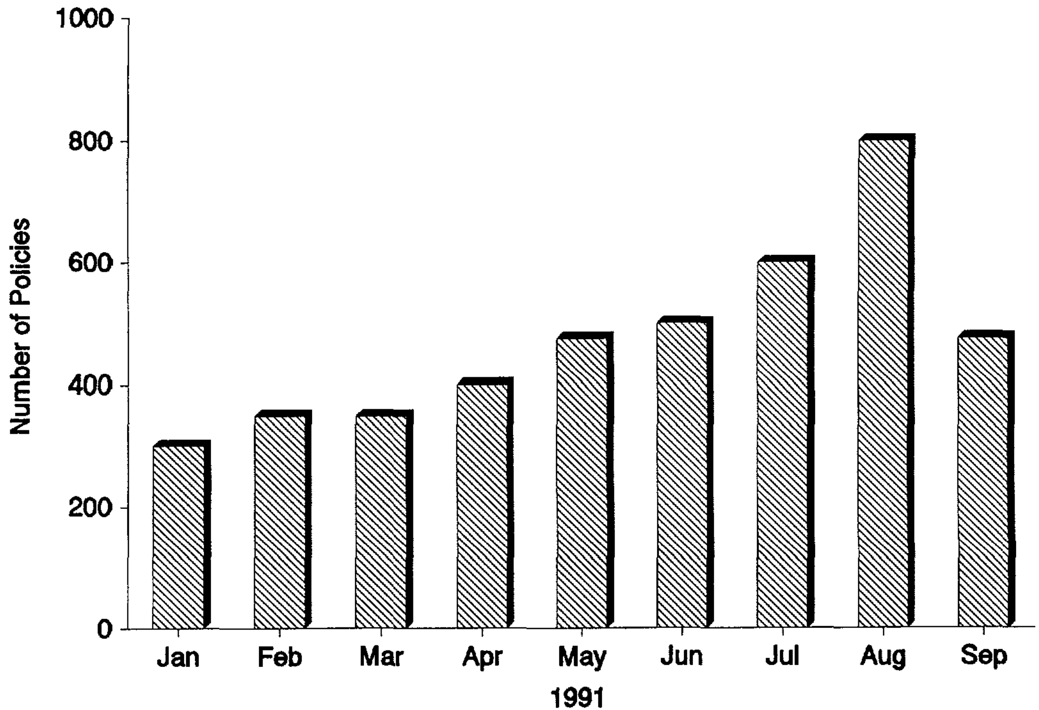
There are a couple of things I want to mention about agent reaction. The major NYSE firms contain brokers who are doing business with us. They've been through Baldwin United, First Capital, and Fidelity Bankers. They're a little edgy -- that's the best word I can use. So, we're finding two things: brokers are reluctant to write business. And they're much more concerned about where their customers are and about moving business.

Insurance commissioners in at least six states have put out bulletins. I'll read a couple of sentences from one of them. The subject is industry responsibility concerning public confidence and unfair trade practices. This happens to be from the Connecticut bulletin; some of the others are similar in wording, but the message is the same:

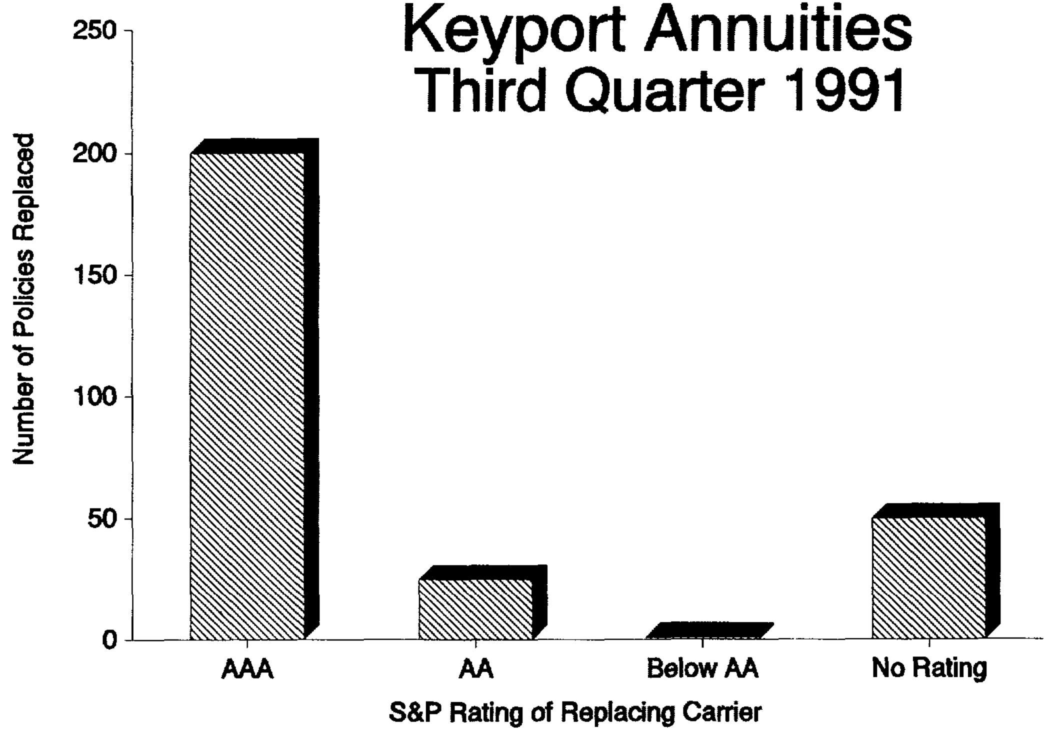
> While it is not inappropriate for companies and their representatives to tout their own financial strength, statements, implications or innuendos about financial condition or solvency of other companies and their representatives is likely to be unacceptable and a violation of Connecticut law. Particularly bad is replacement activity attempting to capitalize on heightened public concern over the financial condition of insurers.

CHART 4

Keyport 1991 Surrender Activity



S&P Ratings of Companies Replacing Keyport Annuities
Third Quarter 1991



This bulletin was pleading with insurance company management to individually and collectively take whatever positive steps you can take to promote public confidence. Some of the other bulletins were stronger. They required a copy of the bulletin to be sent to your agents in that state. We have complied with that but that leads to my last point.

We have a little bit of difficulty with our brokers because it's very hard to separate what I call "concern" from opportunism. In the most extreme cases of both, it is not difficult to determine. And we have dealt with at least five situations of blatant opportunism where brokers have sent letters to their policyholders -- our policyholders -- in which they wrote not only inflammatory statements, but untrue statements and innuendos about our company. In those cases, we have dealt quite firmly with those brokers. We have sent a copy of the information that they have used to the insurance commissioners of the states in which they're licensed and we've removed their license.

The one thing that we've missed doing, but have just started on, is sending information to the companies that are replacing the business. I believe these bulletins are addressed not to the companies that are being replaced but to the companies that are replacing. But then you have what I would call the concern. If brokers and their customers are reading about the industry, if they've been burnt before, there are agents who are, in a genuine way, acting to move business from A companies to AA companies. They're reading newspaper articles and Jane Bryant Quinntype articles in magazines that say they should deal only with AA and AAA writers. So, it's a tough choice, but I believe it's something that needs to be addressed. And we're being asked to address it.

Doug has covered due diligence very well. My belief is that we've had a lot of due diligence meetings as a reaction to media attention. You try to talk about all kinds of issues with these people and all they want to know is, "How many junk bonds do we have?" We've had the ones that are just seeking reassurance. We've seen some reliance on rating agencies. We've had situations where people in management of certain distribution forces have just said "We don't want to distribute your product because you're a single A+ S&P company." In general, there has been a great pick-up in due diligence this year. I would say that at least half of it has been extremely thorough, meeting Doug's definition. You learn something from it.

This is not meant to be an advertisement, but rather to show you what I call rating agency confusion (Chart 6). We are rated, and I'm including Weiss because, whether Weiss is legitimate or not, he has been legitimized. You turn on the TV, that's who you see. You read the paper, that's who you see. It doesn't do us any good as industry people to say to one another that the person doesn't know what he's doing or that he's not legitimate. It's what you're hearing. We are rated by four rating agencies. We have an A+ from Best's. We have a B– from Weiss, which was recently increased from a C+.

Some of our customers have received letters from their agents telling them that we have been downgraded to a B– from a C+. That was one of the ones we've caught. Look at the percentage of companies who have been rated by these agencies above us. The rating that stands out -- the A+ from Best's -- is a very good rating, but, as you all know, there are an awful lot of A+ Best's companies. The best rating we have is the Weiss rating of B–. It's the worst one from the standpoint that people are leaving us. It's the one we get most on the phone: "We're not going to do business with you because you're a B–."

CHART 6
Ratings

Keyport is rated:	
A+ by Best's	0% rated above Keyport
B– by Weiss	13% rated above Keyport
A1 by Moody's	56% rated above Keyport
A+ by S&P	78% rated above Keyport

Now, why does this happen? I believe there are two reasons. First, because B– sounds worse than A+. Second, because Weiss has a lot more attention. That's my only point there. People are confused. By people I mean the ultimate consumer as well as the distributor. They're confused by Weiss. They're confused by all the things I mentioned before. So what can you do? I'll tell you what we've tried to do. We've tried to learn more about our distributors and agents. We've tried to learn more about our policyholders and we've tried to understand what they need and what they know. And this is not easy.

Distributors: You need to know what they're selling, how much business they've put on the books with you, and how that business is behaving. You also need to know the level of service, once the business is sold, that the distributor is providing. Because, if the distributor isn't providing service, it is an opportunity for you to provide it. If the distributor is providing service, then it's an "opportunity" for you to cause confusion to provide service. On the in-force block, the obvious things are size and persistence. I have found that the more you know about the persistence of writing agents within distributors, the better off you are. That's because you have the distributors themselves who like to know who they're depending on – good apples or bad apples. How much control does the distributor have over the agents? You need to know that. In the relationship, how long do they stay with a certain distributor? How do they move around, and how do they relate to the policyholders? There is a big difference between the bank market and the stock brokerage market. There are some very basic differences in how the business is sold, the person who sells it, and their ongoing relationship with the policyholder.

Contractholders

We've gotten some good ideas about our contractholders. I'm going to give you some things we know and these are not exact, these are rough. Some of them are surprising. Forty-six percent are high school graduates or less. Twenty-four percent have had some college. Thirty percent graduated from college and might have had some graduate school experience. Sixty-four percent of our SPDA policyholders are retired. Eighty percent of them, and this is the most surprising to me (but may not be when you put it together with the fact that they're retired), have household incomes less than $75,000. The contract with the company is probably one of the best ways to really track what your policyholders are thinking and doing. Every Monday we get a list of the five top questions that were asked in the last week. It's a very instructive thing. "When am I going to get my check?" "What is your rating?" "You guys are doing a good job."

Here's something interesting we found out about our policyholders. I suspect a lot of you would find out the same thing. These are SPDA policyholders. Twenty percent of them don't even know they have an annuity. They know they have an investment. They know that they have a CD. They know that they have something. But they don't know that they have an annuity. Now we found that for a very high percentage of our policyholders, the bulk of their savings, other than their home, is in these annuities. Of the ones who knew they had an annuity, only one third of them knew they had it with an insurance firm. That's a little more easy to believe. They thought they had it with the bank or the distributor. When you find out something like this, you have to make a decision. The decision basically is, do you want to change this or is this good? Because if they don't know they have an annuity, they're not going to call you and say surrender my annuity.

This is what I came up with as the challenges that we've dealt with. We have to have our employees up to speed on current issues. This was the year in our company where the policyholder service employees, the people on our phones, learned more about our company overall than the people in the actuarial department, the people in the accounting department, or the people in the legal department. Because these people are on the phones talking about junk bonds, talking about surplus, talking about ratings, and talking about rating agencies.

How have we dealt with this? The bulk of our employees dealing directly with customers are college graduates. Second, they are cross trained across all kinds of jobs. Third, every morning they know about almost any article that came out in a paper or magazine in the previous day that has anything to do with our business or might have mentioned our company. So if somebody calls from Los Angeles with regard to an article in the *Los Angeles Times*, they know something and can discuss it.

You have to have a computer system that can track things. It can track phone calls. It can track what's going on. That's the way you learn. Companies must determine what information they will disclose to the various publics. I don't mean keeping secrets. I mean voluntarily, aggressively, and actively disclosing. I don't mean getting a phone call and getting a question and saying I'm not at liberty to tell you that.

I've got a couple of examples that are near and dear to me; they have positive and negative sides. One is renewal rate history. We have been a company that has made its renewal rate history available to any distributor or anybody who wants to know it. What's good about that is it gives you some credibility. What's bad about that is the world changes, times change, and people draw inferences from your renewal rate history that might not be applicable in today's world.

Another example is the quality distribution of your portfolio. A lot of people were caught off guard by the change in the NAIC definitions of bond classes. Thus, they had to deal with the appearance that below investment grade bond or junk holdings had increased, when nothing had changed. We got in the habit of sending our distribution of bond quality out on a monthly basis. I wish we hadn't, because then you have to deal with downgrades and changes. But it's a tough decision.

The last one is a real tough one. Especially for a company that distributes all over the place. You need to determine the degree of control that you can exert with the distributors. By that I mean with respect to the policyholder. Obviously, stock brokers think they're their clients, and they are. The firms also think they're their clients. With respect to the banks, they're bank customers. But they're also the insurance company's customer. When things get shaky, they look to the insurance company, sometimes through the distributors, sometimes directly. These are all very challenging issues, and you need information to deal with them. That's the point of what I'm trying to say.

MR. A. MICHAEL MCMAHON: Tim, you mentioned people paying commission on settlement options. What have you seen for the level of commission? Is it the same as immediates, much lower?

MR. PFEIFER: It's usually much lower than the 3-4% you normally see on a stand-alone immediate annuity, usually 1-2%. It's sort of a token commission, but it's at least some incentive to keep the business on the books.

One last point that I wanted to bring up is the level of minimum guaranteed credited rates. A few years back, companies put 5%, 5.5%, or 6% lifetime rate guarantees into their annuities, thinking that this isn't really going to cost us anything from a reserve perspective or anything else. You might want to keep that in mind when you're developing products today, because some of those companies are pretty scared right now with today's lower interest rates.

MR. MARRA: Okay, any other questions?

FROM THE FLOOR: Tim Pfeifer mentioned companies were filing a lot of the contracts with MVAs as group contracts, because they don't always comply with individual states. Our legal department says that all the states are catching on to that, and they don't allow that anymore. I'm wondering if the panel or any participants here have that experience or if they still feel they file group or what's happening?

MR. MARRA: I will answer that, since we're the leading seller of that product. There are several states now that have adopted the modified guaranteed annuity (MGA) regulation. We're hoping that more will. In fact, I'm chairing a new NAIC committee to try to modify the current NAIC model MGA regulation. In particular, our group will be working on amending the regulation to provide for both general and separate account funding of MGAs.

The group contract approach, now being employed by many MVA companies, is what I believe you're referring to. It is true that some states have taken issue with this approach. Obviously each company needs to make its own determination of how it should proceed on this issue. Nevertheless, I think the emphasis of the industry needs to be to continue to move the regulation through, and I hope we can get a lot of support to get this really moving at the state level.