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INDIVIDUAL ANNUITY PRODUCTS

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This session will provide an update of current topics relating to individual annuity products. The subjects to be covered are the marketing and product design of (1) variable annuities, (2) fixed interest rate annuities, including certificate of deposit (CD) and market-value adjusted (MVA) annuities and (3) immediate annuities with participation and liquidity features.

MR. DAN R. SPAFFORD: I think we're all aware that today's demographics would lead you to the conclusion that, for the next decade or so, the annuities will be a strong growth area. During this decade and the next, we'll have millions of Americans reaching their 50s and 60s, which will create a huge market for annuities. The question for insurers is, will this opportunity allow profitable growth in light of the competition that we're going to have from the banks and mutual fund companies? Can we create profitable products without all the risks that we've been hearing about over the past couple of days? Our speakers will discuss these issues in terms of what various companies are doing to create value in the marketplace through their product development work. After our speakers talk about deferred annuities, I'll have a few comments about immediate annuities. Our first speaker is Mitch Katcher. Mitch is a consultant with Tillinghast in New York City, where he helps his clients in many areas, particularly with product design questions and strategies dealing with separate accounts. Mitch was previously with Monarch Life, where he developed expertise in the area of variable life and annuity products. In his last job at Monarch, he was the senior vice president and chief actuary of the company's variable product subsidiary with broad responsibility for product pricing, design, profitability, and valuation work.

MR. MITCHELL R. KATCHER: I'll discuss trends in variable annuities. We'll start with a market overview. Variable annuity sales have dramatically increased over the past five years. We've seen an increase of 20% from 1990-91 and sales have continued to grow in the first quarter of 1992; they are double that of the first quarter of 1991. That's about a 40% rise over the fourth quarter of 1991. Six companies continue to dominate the variable annuity marketplace. They account for over 50% of all sales – Lincoln National, Nationwide, Equitable, IDS, Hartford, and Prudential. The market share of individual variable annuities has steadily risen over the past four years from 17% to 28% of total annuity sales.

Product design, investment management, distribution, and service are the four variables in the equation to success. Although product design is important, the top tier of variable annuities have similar product features. Investment management and name recognition are very important. Distribution is critical. Powerful distribution can overcome less than stellar investment performance. Service to not only the customer, but also the field is absolutely essential. You can't give people an excuse not to do business with you. You have to make them want to come back.

I'll start off by talking about some late-breaking regulatory issues that affect variable annuities. Two weeks ago, the SEC released its long-awaited report on the Investment Company Act of 1940. This 525-page report contained recommendations with respect to statutory and regulatory changes, some of which will affect variable products in general. Basically, the 1940 Act requires that sales loads do not exceed 9% of premium. If a company does charge greater than 9%, the first-year sales charge is capped at 50%, and it's subject to a stair-step provision and a sales-load-refund provision. Those provisions are generally more applicable to variable life than variable annuities. Administrative charges must be reasonable in relation to the services provided and companies are not allowed to profit from them.

There is no specific statutory limit on mortality and expense risk charges; rather, a defacto limit of 125 basis points has been imposed. Companies charge more than 125 basis points by adding either a 15 basis-point administrative charge that is subject to being reasonable with no profit margin, or a 15 basis-point distribution charge which would be included in the sales load. Investment expenses are subject to the fiduciary obligations imposed under the 1940 Act.

The report proposes to eliminate most of the current charge limits and replace them with a requirement that aggregate charges be reasonable in relation to the services provided, the risks assumed and the expenses expected to be incurred. There appears to be no current intention on the part of the SEC to develop regulations defining "reasonable." I'm sure you could well imagine that if excessive or abusive practices evolve, the SEC's position will change rather quickly.

Currently, variable annuity separate accounts are structured either as unit investment trusts or as managed separate accounts. The report recommends a new type of investment company -- a limited redemption investment company. This would be an open-end account that would provide for less liquid securities, and a limited right on the part of investors to redeem shares at net asset value. There are two forms proposed and we believe that the "interval company" will provide companies with an opportunity for innovation of new investment options under variable annuities. Under an interval company, shares can be redeemed monthly or quarterly, and a shareholder may be required to give a reasonable amount of advance notice. As such, these options might add an additional layer of complexity, but I think you can see that certain types of investment options, involving less-liquid securities, might have potential.

The report also recommends that mutual fund advertising not be limited to information contained in the prospectus. The intent is to lead to freer advertising, although my sense is that it will also lead to more creative advertising. Here, the key is that the advertising still needs to be fair and accurate, and that means truthful. If this recommendation is adopted, it may allow companies to significantly reduce the amount of material they currently have in their prospectuses. Although this proposal applies to mutual funds, it is hoped that it can be expanded to variable products.

Another mutual fund proposal is to allow "off the page" advertisements. If adopted, this would allow mutual funds to be purchased directly from advertisements with the prospectus being a delivery requirement. If the variable annuity application could be contained in such an advertisement, there might be an extension of this mutual fund recommendation to variable annuities. Again, the prospectus would become a delivery requirement. However, I caution that the level of disclosure and state issues still need to be explored.

The SEC is currently in the process of setting priorities with respect to these various recommendations and we'll see how they all fall out.

Now, before I move onto trends and product design, I'd like to discuss reserves. An NAIC actuarial task force met recently to discuss the proper level of reserves for variable annuities. Current industry practice is to take the account value, project the valuation interest rate reduced by the morality and expense charge, reflect surrender charges and free-outs (i.e., penalty-free withdrawals), and then discount the entire result back at the full valuation rate. This generally leads to the cash surrender value being held as the reserve. Some on the task force believe the account value is the appropriate level of reserve for a variable annuity.

The task force is currently working on a compromise that would allow the industry to continue to use its current practice, but would require the mortality and expense risk charge for the purposes of this projection to be reduced by an expense provision in the neighborhood of about 75 basis points. It's still being debated; there was no resolution, and the talks will go on.

Now we'll talk about trends in product design. In addition to the typical death benefit of the greater of (1) the account value, or (2) premiums paid less withdrawals, more and more companies are considering a stepped-up death benefit. The stepped-up death benefit takes one of two forms. The death benefit is equal to either the premiums accumulated at some interest rate, and usually capped at twice the initial premium, or the fund value every *x* years, where *x* is the length of the surrender charge period. There are some state concerns; California and North Carolina, in particular, will not allow such a death benefit.

A nursing home rider will waive surrender charges for hospital and nursing home confinement after a minimum of 30 days. It appears that companies are not currently pricing or reserving for this kind of rider. Another new rider is an unemployment benefits rider. This rider will waive all or some of the surrender charges for unemployment of at least 60 consecutive days. Again, it's not clear whether companies are pricing or reserving for this rider either.

Dollar-cost averaging is an investment technique applied to variable annuities. A level amount is transferred from the money market fund, usually, on a regular basis, monthly or quarterly, to selected options. Generally, companies do not allow policyholders to dollar-cost average from the fixed account. This is a particularly popular feature in the brokerage marketplace. My recommendation to a company considering adding this feature is to make sure you can administer it before you jump in.

Another enhancement is systematic withdrawals. This is popular with mutual funds. It provides a steady, level stream of income to the contractowner without having to annuitize the contract. This feature needs to be thoroughly discussed and understood by the field and by the client due to the tax implications, particularly if the owner is under 59½ years old. Companies are considering combination plans – a variable annuity with a MVA fixed option. The MVA fixed option has a number of very attractive advantages. It reduces the interest rate risk, reduces surplus strain, improves equity between persisting and terminating contractholders, allows for longer-term interest guarantees, and, depending on the design of the contract, may provide the safety of a separate account.

There are, though, several disadvantages. There are regulatory issues. The product may need to be registered with the SEC. From a state perspective, most contracts have to be filed on a group basis to avoid individual nonforfeiture issues. Only about six states have MVA regulations. The MVA fixed option tends to be more complex than a traditional fixed option. Generally, at the shorter end of the yield curve it provides lower interest guarantees. The combination plans we're aware of have one-year rates that are in the neighborhood of 3.75-4% right now with three-year rates in the neighborhood of 5.25-5.5%.

Form S-1 is used to register a combination plan. It has all of the typical disclosure requirements of a variable annuity as required in Form N-4 and then some. There needs to be a discussion of the interest crediting practices, a description of the insurer's lines of business and investment policies, a discussion of liability/reserves, compensation to key officers, and a management discussion of financial conditions and operating results. One thing we've seen is that the need to disclose compensation of key officers can very often be a major impediment to registration.

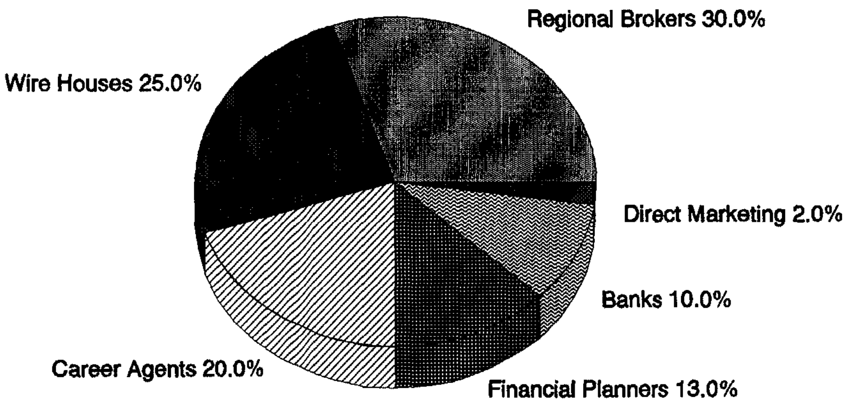
Now let's look at trends in investment options. International, global and overseas funds are very popular. International and overseas funds involve investing abroad only. Global funds include the United States. Managed funds and asset allocation funds are gaining in popularity as well. What's not hot? Zero coupon options are not particularly popular. Interest rates are just too low. Sector funds are also not popular. There are federal income tax implications for variable annuity and variable life investment options where the investment strategy is too narrowly defined. An investment option of purely gold stocks may be too narrow a definition, but gold stocks, as a subset of natural resources, may be broad enough.

What's innovative? A recognized fund manager, Marty Zweig is doing wonders for one small company's variable annuity sales. Limited offerings build up excitement and demand, and private placements are very popular in the corporate marketplace. What's interesting? More is not necessarily better. Our experience is that people get confused by too many choices, and you may be better served by carefully selecting a limited number of investment options.

I'll just briefly discuss distribution trends. Wire houses and regional brokers continued to dominate the market in 1991, accounting for over 50% of new sales (Chart 1). One item I would caution in this particular marketplace is to beware of market timers that can wreak havoc on your portfolio manager. Direct marketing sales have been limited to date but have been improving. Although banks are significant distributors of fixed annuities and mutual funds, variable annuities have not followed suit.

Let's take a look at the area of joint ventures. There continues to be a lot of activity in this area. We are continuing to be approached by both sides -- mutual fund groups and insurance companies -- to help find joint venture partners and to help establish the relationships. The mutual fund provides distribution and name recognition while the insurance company provides the expertise and the capital to establish the plan.

CHART 1
Variable Annuity New Premiums for 1991



From the mutual fund perspective, it's a source of additional assets under management, and it's another attractive product in their portfolio. From the insurance company's perspective, the mutual fund group can deliver added distribution and this can help the insurance company reach economies of scale much sooner. Some of the current variable annuity joint venture arrangements include Lincoln National and American Funds, NALAC and Franklin Funds, National Home and Vanguard, the Hartford and Putnam, and Phoenix Mutual and Templeton.

Now let's discuss service. As I said before, service is absolutely critical to the long-term success of any variable products program, and it's probably applicable to any program. You can't give people an excuse not to do business with you.

It's important that you support the field. We've seen companies with marketing service groups and more companies are moving to product managers. Customers must also be supported with good service and generally don't like to be passed around on the phone and don't like to wait on the phone for extended periods of time. We've seen an increasing use of voice response access equipment, to give customers the field annuity unit values and fund values. This can substantially reduce the number of telephone calls requiring service representatives.

We are seeing an increasing use of third-party administrators (TPAs), particularly by those variable annuity companies first entering the marketplace. Generally, this tends to be a cultural issue – control versus a fixed cost. You can control the systems, and you can control the administrative system, but can you also control the expenses? Many companies think they can control their expenses, and a few find out the hard way. Even though third-party administrators give you a contract and give you fixed expenses, but you certainly do give up an element of control.

Now let's discuss some pricing considerations. The surplus position of insurance companies has been under scrutiny for quite a while now. It's no longer enough to set target surplus levels based upon management's perception of the risk inherent in the product (Table 1). Rating agencies have requirements now, and the NAIC is developing its risk-based capital requirements. These all need to be reflected. It is worth noting that the MVA doesn't really eliminate the interest rate risk, but significantly reduces it. Of course, you still have the asset risk.

TABLE 1
Setting Target Surplus Levels

	Risk	VA	MVA	Fixed Option
C-1	Asset	No	Yes	Yes
C-2	Mortality/morbidity	Yes	Yes	Yes
C-3	Interest rate	No	No	Yes
C-4	Insurance expenses	Yes	Yes	Yes
Average	Percent reserve	0.5%	2.0%	5.0%

Now let's take a look at some typical pricing measures in Table 2. Generally, stock insurance companies look for a 12-15% return on their investment. Mutual companies, on average, look for something in the neighborhood of about 200 basis points less.

TABLE 2
Insurance Company Profit Measures

Return on investment (ROI)	
Stock companies	12-15%
Mutual companies	10-13%
Profit margin	
Pretax	2-4%
Aftertax	1-2.5%
Breakeven year	
SPVA	7-10 years
FPVA	10-15 years
Return on assets	
Pretax	30-40 basis points
Aftertax	20-25 basis points

Companies tend to look for a profit margin of about 2-4% of premium on a pretax basis and a 1-2.5% premium on an aftertax basis. Companies are looking for return on assets in a 30-40 basis-point neighborhood on a pretax basis and 20-25 basis points aftertax. From a breakeven perspective, companies generally are looking to break even by the end of the surrender charge period.

To enhance the financial dynamics of the variable annuity, there are a number of things at which companies are currently looking. One is avoiding costly features, such as principal guarantees. They are also looking at MVA fixed options versus traditional fixed options.

Companies are looking at ways to raise their average size. Pricing is very sensitive to average size. One item being considered is raising the initial premium. Companies are also increasingly looking at trail commissions as a way to enhance persistency and reduce surplus strain, although not companies licensed in New York. Companies are also looking at passing on traditional mutual fund expenses, series fund operating expenses to the funds underlying the variable annuities. Examples of these would be shareholder communications, shareholder servicing and transfer agent expenses. In addition, where insurance companies are working with outside fund groups, we are talking to companies about trying to retain the money market fund as a source of revenue.

What does the future look like for variable annuities? Some feel that variable annuities will become the dominant annuity product in the 1990s. There are opportunities for joint ventures. There are new distribution channels such as banks and direct marketing. The demographics of the retirement market will mean that there's more money for investing. There's a trend away from guaranteed liabilities and an increase in mutual fund assets. To us, this implies that people are getting used to nonguaranteed returns. Most people would probably agree that marginal tax rates are more likely to rise than drop, which will further enhance the appeal of variable annuities.

Obviously, a lot will depend on whether there's a tax law change. We firmly believe that it's not too soon for companies to start strategic planning around the whole issue of tax law changes so that they wouldn't get caught flat-footed, as I think most of us would have with the Bush (State of the Union Address) proposal.

Single premium variable life might be something to consider. The qualified market is another area where we've seen a lot of activity, particularly in the 401(k) marketplace where variable annuities might find a good reception, particularly for the small groups under 200 lives. Companies might consider variable immediate annuities. As an industry, we've been highly innovative in accumulating wealth. We've not been quite as innovative in paying it back to the contractowner. It appears that we have some time and companies should be using this time to plan for the future, and not wait until the time runs out.

MR. SPAFFORD: Mike Winterfield is a consultant and partner with Ernst and Young, but I know him much better from his days at Equitable. He had a career that spanned 12 years at the Equitable and he had many important jobs there, one of which was being in charge of the individual annuity business unit. I guess I'll think of Mike most prominently in his key role in developing the EQUI-VEST product at the Equitable. That's a little Equitable jargon, but EQUI-VEST is a flexible premium annuity product line that has both variable and fixed options. It has been a stellar success.

MR. MICHAEL R. WINTERFIELD: The title of my talk is "Individual Annuity Trends -- The Maturation of Product Design and Risk Management." I'll cover three topics.

First, I'll summarize the results of a very recent Ernst & Young survey of major trends in the individual annuity market. Second, I'd like to discuss two important products of recent years. The first one is the CD annuity, which is not doing very well, and the second is the MVA annuity, which is doing quite well. Third, I'll discuss the results of the joint Society of Actuaries and Life Insurance Marketing and Research Association (LIMRA) Single Premium Deferred Annuity (SPDA) Persistency Study.

Since the release of the preliminary report at the end of January, there's been quite a lot of tension with a number of pricing actuaries regarding lapse rates after the surrender charge expires. Thirty eight of 56 major writers responded to our survey. Almost all of the respondents were actuaries, so keep that in mind when we look at the results. There were three dominant themes in just about every one of the responses -- more asset/liability management, more MVA annuities and more variable annuities.

Let's begin with the marketing and distribution outlook. The estimated five-year annualized growth rate was about 12%. The individual company range went from 2.5% on the low side to 25% on the high side. In addition, one of the respondents indicated that his company was abandoning the business. Nontraditional distribution systems have been responsible for a significant amount of individual annuity business over the years. This movement is projected to continue, but a different set of players is beginning to emerge. In almost all cases, the savings and loans and banks were projected to have the most growth. This is in sharp contrast to the 1970s and the 1980s where we saw super growth within the stockbroker arena.

There seems to be a certain amount of disenchantment on both sides with regard to stockbroker distribution. Many of the stockbrokers felt very let down with the rash of company conservatorships in 1991. Also, from a company standpoint, there are a lot of concerns. The documented persistency experience is certainly showing some problems with the stockbroker distribution. Also, many of the companies had become irritated with the high rate requests from some of the major Wall Street firms. Mitch noted in his talk that there is a trend toward asset-based compensation. Of course, asset-based compensation is not currently allowed in New York.

Table 3 shows what I think are some major changes in the market. We asked the companies to project their major sellers in 1995. This table shows the top three sellers for the companies. Fourteen of the companies think that the traditional fixed contract will still be their major seller. If you combine the next four lines, we see a very, very powerful set of changes. Twenty-one of the companies look to either a variable annuity or a MVA annuity contract as the top seller in 1995. The combination variable annuity with MVA options is really the biggest story out there right now.

The Hartford began a revolution in the mid-1980s with the development of the stand-alone, MVA annuity contract. I believe that Sun Life of Canada with its Regatta Series has really moved it up a notch by combining the variable annuity with a whole host of MVA options. This seems to be the kind of contract that really appeals simultaneously to both chief marketing officers (CMOs) and chief financial officers (CFOs). That's a tough thing to do, but it's happening. The CMOs like the wide range of options. The CFOs like the protection level for the companies.

TABLE 3
Projected 1995 Sales Mix

	Top Contracts		
	1	2	3
Traditional Fixed	14	7	6
Combo VA/MVA	11	2	2
Combo VA/Fixed	6	9	--
MVA (Nonregistered)	3	6	3
MVA (Registered)	1	5	3
CD Annuity	--	2	4
Other Fixed	2	2	2
Immediate (Traditional)	--	2	9
Immediate (Cash-in Rights)	--	3	3

The stand-alone MVA contracts will also be prominent in the 1995 marketplace. A number of companies who are not presently in the separate account business, but who are writing a lot of SPDAs, are finding that a nonregistered MVA contract is an attractive way to go. The key in developing a nonregistered contract is to put some lid on the market-value adjustment. One common technique is to not allow the MVA adjustment to reduce the accumulated interest to less than a 3% level. Then the underlying surrender charge can be placed on top of that.

The CD annuity received a lot of attention a few years ago. It had been a hot product for a while. You can see that it really has lost a lot of favor. We'll be talking about that later. Some companies are doing quite well with other fixed designs. Two-tier annuities are contracts that have some kind of persistency bonus either up front or down the road. The immediate annuity is, of course, an important second or third seller for a number of companies. Dan Spafford will be talking about the new kid on the block -- the immediate annuity with cash-in rights. That's an interesting concept.

The actuaries felt good about the annuity market, by and large, with regards to the risk levels. Sixteen of the respondents thought that the business was becoming less risky. Ten thought it was becoming more risky. It seemed that there was a split based on the company profile. The companies who felt good about risk were companies who were working with an MVA or variable annuity (VA) design as the core. Or alternatively, they were AAA or AA companies who were working with fairly conservative SPDA pricing, but were doing well in the market because of the flight to quality. Most of the tension seemed to be concentrated at the medium quality companies who were continuing to hang in there with traditional SPDA design.

There are a few prominent reduced risk factors that were covered. First and foremost was better asset/liability management, and greater risk awareness. The switch to the MVA and the VA was highlighted by a number. Also, the flight to quality. There were a few increased risk factors that are worth noting. I think the biggest one is the concern about the current low interest rate environment with the consequent duration risk for companies who are writing SPDAs. I think most people would feel that if you're looking at a medium-term treasury rate that is around 7%, there's probably more risk over the next few years that the 7% treasury rate will go up to 10% rather than drop down to 4%.

Intense competition and thinner margins were also noted by a number of companies. Part of this is a reflection of a reduced-risk orientation, as companies dispense with their NAIC three-to-five or three-to-six investments and replace them with good investment grade quality. What happens in many cases is that the margin is safer, but it's not as big as it was before. Of course, there are continued concerns about some of the uninformed, newer companies.

Another topic is asset/liability management. The 1992 annual statement requirements will require all companies with over $500 million of assets to do an asset adequacy analysis, which is synonymous with cash-flow testing in most cases. A big question is whether companies will extend cash-flow testing to other areas, in particular, product development and pricing. About 80% of the respondents said that they would, in fact, use cash-flow testing for product development and pricing. A number have not done it to date but intend to do it this year. About 60% have altered their investment strategy through cash-flow testing. In most cases, there's been some fine tuning of the duration risk rather than major changes, but a couple of major changes were also noted.

There's obviously a lot of skepticism about cash-flow testing. I think the predominant feeling of a lot of companies is that everybody is doing it now. Everybody is becoming aware of it, but in how many cases will the awareness really translate into actual changes? I think the biggest one at this meeting was a theme that was mentioned by Richard Robertson during a capital management session. The publicity and the focus on the C-1 risk might have a detrimental effect on the bigger C-3 risk. The C-1 risk is the area that's gotten a lot of attention with the media. It's also the area that has been highlighted with the new risk-based capital (RBC) formulas.

I think there are real problems with the RBC formulas in the annuity area that are not going to be particularly helpful in getting companies to deal with the C-3 risk. I think there's a basic problem for a company that's offering one-year SPDA guarantees with a normal surrender charge structure. If that kind of contract is being backed up by a six-year or seven-year duration strategy, an RBC requirement of 1% of reserves is limited.

The companies, by and large, feel that a lot of progress is being made in setting realistic assumptions. There are a lot of positive trends here. A lot of concrete experience is accumulating. Companies are biting the bullet, in most cases, with some recognition of sharply higher lapse rates. There are many cases in the low interest rate environment. You really have to re-check those underlying guarantees.

In the competition area, and I think I alluded to this earlier, we're seeing the emergence of a two-tier market. It's a nice environment now for the AAA or the AA+ company. It's tough for the other ones. When I was involved with marketing a few years ago, I would find that you were lucky if you got anything more than 5-10 basis points and a sneer with your AAA or AA+ rating. But, I think this is the real thing and we'll see a recognition of quality here in the same way that we've seen recognition of it in the GIC market. Continuing concerns are the first-year teaser rates and general subsidizing of rates in a lower rate environment.

Profitability growth. There's a cautious optimism for a majority of the group. I think that the cautious optimism is well-founded. Companies have taken the tangible steps to achieve profitability. More often than not, the CMO isn't the person with the loudest voice during the interest rate crediting meetings. Many companies, despite their abilities to write tremendous amounts of annuity business, are also putting lids on the amounts of production in many cases and adjusting the interest rate accordingly to get the kind of profile that they want. Some concerns were mentioned. Some of the medium quality, smaller companies are concerned about risk-based capital if they're working with some of the more offbeat investments. Rating agency surplus requirements are a big concern.

A big change that most companies with sizeable in-force businesses are going to have to be aware of is that, by and large, the annuity writers have been able to get balloon profits from their in-force business. It's been easy for a company that has a lot of business on the books from the early 1980s and mid-1980s to reap the benefit of today's lower new money rates. If you have a portfolio of old business earning 10-11% and new money is at 8%, you can get some good margins on that old business. That phenomenon obviously is not going to continue forever.

Table 4 summarizes major concerns. Mitch mentioned the tax law concerns. Thirteen of the companies considered a change in the tax law, mainly a repeal of the inside build-up, as their major concern. The other categories that we noted received equal attention -- surplus adequacy, asset/liability mismatch. I was somewhat surprised that post-surrender charge lapse rates, which most people would feel is an important issue, though not a core one, is actually now as much of a concern as the other ones. Of course, competition is a problem. I should have added expenses as a category to the study. I didn't. Probably a few companies would have noted expenses.

TABLE 4
Major Concerns

	Level of Concern				
	1	2	3	4	5
Tax Law Changes	13	3	4	6	10
Surplus Adequacy	9	6	5	4	9
A/L Mismatch	7	10	6	8	5
Post Surrender Charge Lapse Rates	5	10	6	7	6
Competition	4	5	15	10	2
Other	1	2	1	--	3

Let's turn over to two of the products. I'll talk about the CD annuity, which I think is a product on the way out, and contrast that with the MVA annuity, a product on the way in. The CD annuity was good stuff in the mid-to-late 1980s. Marketing-wise, it was a nice, very simple and appealing structure to the bank CD holder, but it seems that just about everything is a problem from a financial standpoint with a CD annuity.

If you want to sell a one- to three-year CD annuity, there's a serious lack of investment product to back that up.

In the case of any of the CD annuity products – one year, three years, five years, six years – there's been very adverse persistency experience during the free windows. The policyholder has to think about holding onto the contract in the face of a resumption of a new surrender charge. This is a great opportunity for the agent to come in and look at examining all of the possible options. If you're working with the longer guarantees, there's often a lot of nontax deductible reserve strain, and, of course, there's a tremendous amount of C-3 risk.

Compare that with the MVA annuities that have a couple of great marketing advantages. You're able to offer the whole range of rates with one- to ten-year guarantees, as Mitch indicated. I've noted superior rates, and I'd like to explain that. The superior rates for the MVA annuities are with regard to the longer guarantees. When you're doing duration matching in today's steep yield curve, you get some very fine numbers when you're getting out to the five-, seven- and even the ten-year range. I think, as Mitch noted, if you want to have a good rate with a one-year or a three-year MVA, it's not going to happen. We have seen notable sale successes for both the nonregistered and the SEC registered designs.

Mitch noted the basic financial advantages and I'm not going to cover that again. I'd just add one to Mitch's list – rational pricing. I think since the onset of this contract we've seen a much more reasonable pricing environment for this kind of product. There are a few financial concerns. When the market-value accounting is used, there are problems with the synchronization of tax reserves and statutory reserves. I think this is causing some companies to try to use book-value accounting where they can. Although the MVA is very good in providing protection when rates rise, there are some problems in dealing with prepayments when rates fall. Expenses are, of course, a factor (SEC filings, administrative expenses, etc.).

Last, I want to go through the SPDA persistency study. This covered 1978-89 issues. I think most of the experience was for calendar year 1989, although some came in from earlier years. Twenty-four companies were in the study. The study covered both one-year and multiyear guarantee business. The experience was split between contracts within the surrender charge period and contracts outside the surrender charge period. The post-surrender charge experience was where the sobering results came up. It's noteworthy that there was only $600 million values in force that were covered by the study outside the surrender charge period. That is a problem in interpreting the results.

We looked at the composite experience (Table 5). For the one-year guarantee contracts, as almost everyone expected, there are rather low lapse rates during the surrender charge period, a 3% level. After the surrender charge is off, the rate was over 15%. The multiyear guarantee contract – three-year, five-year guarantees and others – had a worse picture. There was a 36% lapse rate during the post-surrender charge period.

TABLE 5
Composite Experience

	CV Withdrawal Rate	
One-Year Guarantee	Full	Partial
With Charge	3.1%	1.0%
Without Charge	15.6	2.1
Multiyear Guarantee	Full	Partial
With Charge	2.2%	0.5%
Without Charge	36.2	2.9

The experience under a five-year surrender charge product is shown in Table 6 for both one-year and five-year guarantees. If we look at the sixth year, we see a 14%-plus lapse for the one-year versus over 55% for the five-year guarantee.

TABLE 6
Five-Year Surrender Charge

	Full Lapse Rate	
Contract Year	One-Year Guarantee	Five-Year Guarantee
1	2.2%	1.1%
2	3.0	1.9
3	3.0	1.0
4	3.2	1.9
5	2.1	3.3
6	14.9*	55.8*
7		24.0

* Are the sixth-year differences an aberration?

What's happening here? How do we interpret this stuff? The total number of surrenders with these multiple guarantee contracts was actually less than 1,300; probably three or four companies were covered. A major problem in comparing the one-year and the multiyear guarantee experience seems to be that the one-year guarantee contracts were largely traditional contracts -- surrender charges in place five years, six years, seven years and then gone. In the case of the multiyear guarantee contracts, we were dealing with CD annuities in many cases. I think the lapse expectation for somebody who buys a five-year CD annuity and then has to look at continuing to pay another surrender charge really constitutes a totally different decision than the decision that's made to continue a contract without any ongoing surrender charge.

Companies also cited psychological reasons, which I think actually have some merit. The contracts that were included in the study from the early 1980s were all sold at double digit rates. Then a five-year guarantee that was renewed in 1989 would have been renewed at a much lower level. Somebody who started at a 13% rate, which was a good rate in 1984, is renewed at 8% in 1989, which might have been a good rate relative to the market, but they're still not very pleased with that. A lot of this business is also sold by stockbrokers and insurance brokers. Nevertheless, I think there's still a problem with a lot of the multiyear guarantees, but it's hard to know what the right numbers are.

Table 7 is instructive with regard to persistency differences by distribution system. The career agents came out very well in this study. There's a blip up in the surrender rates after the charge period is over, but it's not a block buster at 6%. Insurance brokers were the highest up at 22% and stockbrokers were at 18%. I don't think that companies should seize on persistency factors alone as a reason to go with one distribution system over another. I think all of the factors have to be weighed together. Years ago, everybody spoke about higher expenses with career agents. Today, companies might talk about higher lapse rates with stockbrokers. I think all of it has to be integrated.

TABLE 7
Full Withdrawal Rates
One-Year Guarantee

	With Charge	Without Charge
Career Agent	2.9%	6.3%
Bank/S&L	4.7	13.8
Insurance Broker	3.8	22.6
Stockbroker	2.3	18.6

I think the important message from this persistency study is really going to be what companies do about it. The double digit lapse rates after the surrender charge period are a reality. So, what should a company's response be? I would cite three things. First, companies should look at some lengthening of the liabilities. If you have a five-year surrender charge structure, you might want to get it up to six years or seven years to try to have a longer period to recover initial expenses. Asset-based compensation will be helpful for companies to even out expenses. Of course, companies are simply going to have to price more conservatively to build all of this in.

MR. SPAFFORD: Our speakers have covered a lot of information on what's happening with deferred annuities. I believe that there is, as they have implied, an increasing awareness that the traditional generic SPDA is quite a risky product and that may be a better path to the future would be the variable products and the MVA product.

I'm going to discuss immediate annuities. Not much is going on with immediate annuities currently, with the exception of one product that was introduced by Life of Virginia last year.

In his talk, Mitch posed a question: Why are insurers not doing a better job in the pay-out side of the business? We're doing a great job of capturing the premiums and accumulating the money in deferred annuities, but we're really not finding good ways to pay out the retirement benefits that people expect and that's in spite of the demographics that indicate immediate annuities should be becoming a hot market now. But, that's not happening and the conventional wisdom says that there are really two problems with immediate annuities.

One problem is that people are afraid of the inflation risk because most immediate annuities are sold with a level benefit stream. Also, there's the liquidity risk; if people have been saving for retirement over their entire life through various means, and they reach age 65 or 70, they have this pot of money, $100,000 or $200,000. They're very reluctant to turn over that nest egg to an insurer for the promise of a lifetime guaranteed income. So those are two problems that must be addressed.

The inflation risk is one problem area we have not really found a way to address. Variable annuities don't seem to be the right solution for this market. People in those upper age brackets are just very reluctant to take on the risk of a variable pay-out. However, insurers have found some ways to cover the liquidity risk. One thing that we're seeing a lot of today, as Mitch mentioned in his talk, is the systematic withdrawal options from annuities, including SPDAs. That's becoming quite a common feature. However, it suffers from two drawbacks. One drawback is that it's just a withdrawal from a fund, from the SPDA. There's no guarantee of lifetime income. The other problem is that there's no tax advantage because all withdrawals from the SPDA are currently taxable as long as there's gain in the contract.

That brings me to the contract that I wanted to talk about: the Life of Virginia contract, introduced last year called "Added Options." It's really, I believe, the first dramatic change in the immediate annuity marketplace in quite awhile. It combines the guaranteed pay-out of an immediate annuity with the account value of an SPDA. It overcomes that second major objection of the loss of liquidity, while at the same time providing tax advantaged income.

Lets discuss an example using a male 65 with $100,000. If that person bought the Added Options today, he would get, for the first policy year, a guaranteed pay-out of $760, and that's competitive with immediate annuity products offered today with a 15-year certain period. However, Life of Virginia can drop that pay-out rate after the first year to the minimum guaranteed pay-out rate of $677.

It has an account value. The net premium is placed into the account and interest is credited monthly. Subtracted from that account are the benefit payments and any withdrawals that take place.

If you bought the product, you'd get a current crediting rate for the first year of 5.25%, and as you would expect, that's a little bit lower than current SPDA rates. It has an interesting feature in that the underlying guaranteed rate is only 100 basis points less than the first-year rate. For this example, the underlying long-term guaranteed rate would be 4.25%. It has a five-year surrender charge structure. The surrender charge starts out at 7% in year one, declining to 3% in year five, and zero thereafter. The death benefit is the account value.

I had an opportunity to speak to Bruce Booker and Norlyn Dimmitt at Life of Virginia, the two actuaries who developed the product. They told me that they're somewhat disappointed with the sales results. The sales are not living up to their expectations. This is in spite of the fact that it does seem to answer one of the major objections with immediate annuities. However, it is a new idea and maybe it will just take a little while to catch on, or possibly it will need a little fine tuning. It does present the product actuary and the investment professional with an interesting investment dilemma. On the one hand, you have the long-term liability because there's a guaranteed pay-out for life, but on the other hand the company has to keep a certain amount of liquidity in case there's a run up in interest rates. If rates were to run up, you'd have to expect a certain amount of surrenders, particularly from contracts in their early durations.

MR. WALTER N. MILLER: I have a question for Mike on MVA. If that is really the hot oncoming product that you described, and I have no reason to doubt that, more companies are going to get into the market obviously. What then is the outlook for a continuation of rational pricing?

MR. WINTERFIELD: Could you say a little more about what you mean by rational pricing?

MR. MILLER: Whatever you described as rational pricing. Didn't you say that that seemed to be one of the advantages of this type of product so far?

MR. WINTERFIELD: Right, yes. I did say, in the case of the MVA, the rational pricing that I see is that the interest rates that are being set make sense. The interest rates on MVA guarantees seem to be totally consistent with investment grade earnings and duration matching. That's what I meant by the rational pricing.

MR. MILLER: Then just to repeat, I'm just wondering about your opinion as to the outlook for a continuation of that rational pricing. If the product proves to be more and more successful, more companies get into the market, and things presumably get a lot more competitive.

MR. WINTERFIELD: Yes. That's a judgment call. I'm hopeful that, since this market started out with rationality, it will continue that way. By contrast, the traditional market started out with a lot.

MR. ROBERT J. LALONDE: I have a question for Mike. I was struck by how high those lapse rates were for the CD annuities. There have to be some companies that are really hurting. I suppose that the actuaries for many of these CD annuities probably assumed that the renewals, when the termination of the CD period ended or the guarantee period ended, would just roll right on and that the termination rates would be very stable. What was happening with this 55%? Do we have a down interest rate? Are they happy to have the people leave because they would have to cash out and get a capital gain on the assets or did we have a large write-off of deferred acquisition cost (DAC) because of the assumptions? Can you give us any insight on that, please?

MR. WINTERFIELD: I think all of these things happened. Many companies that originally designed these CD annuities simply didn't look at the risks at renewal time. I think what happened in many cases is that a company that wrote a five-year CD annuity with a decent interest rate and an up-front commission would get to renewal time. The company, probably in most cases, wasn't expecting to pay out another full first-year commission because nobody could really price products effectively enough to pay a new first-year commission every five years. In many cases the customer and the agent would find another company that was paying a similar or better rate and the agent would get another commission at the same time. I think with this kind of experience a number of companies who were writing those CD annuities have either abandoned them or are in the process of doing so.

MR. MICHAEL E. DUBOIS: I have a question for Mitch. Do you ever expect the servicing aspect to be as easy for variable annuities as for mutual funds in light of the restrictions that the state regulators place on our servicing of variable annuities? A particular problem that we have run into is that some states will not allow us to do telephone transfers for our variable annuities.

MR. KATCHER: With respect to telephone transfers, I'm aware of one state that won't allow it in the application, but will allow you to do telephone transfers. I don't think that the servicing can ever be quite as simple as a mutual fund, because I view a variable annuity as a more complicated version of a mutual fund. I do think that there are ways to get it fairly efficient and streamlined to service the business.

MR. P. RANDALL LOWERY: I have a question with respect to the MVAs, the nonregistered versus registered versions. Reference was made to the way to avoid registration is to put a floor on the value. To what extent is that a settled issue? Is it a known fact that if you structure a product in a certain way that registration is not required, and the SEC is never going to bother you, or is it just somebody's opinion or guesswork as to what it takes to avoid registration? To what extent is there a risk that those products would, in fact, require it? They don't meet safe harbor, do they?

MR. KATCHER: I think if you don't violate principal or a minimum rate of interest, then the general view is that you don't need registration. I think if you violate interest and principal, it's clear you need to be registered. I think the gray area is if you violate interest but not principal. There is a fair amount of business judgment being taken right now.

MR. WINTERFIELD: When I looked at a couple of these, I think seven of the major SEC law firms feel that the nonregistered contract with a cap will qualify under Section 3(a)(8) of the 1933 Act, but not necessarily under Rule 151.

MR. THOMAS M. MARRA: Let me respond briefly to Walt Miller. Competition is heating up in the market-value adjusted area, and that's only natural when you find, as we have, that it's a winning story. I think folks are going to follow the lead of the early entrants, so competition is heating up and pricing of those products is naturally going to get tougher, just like it has already on the variable annuity side.

I'd just like to comment briefly, Mike, on your statement on what companies can do regarding the persistency issues. We should think realistically about persistency assumptions because in reality the money moves. I think you brought up some good points with the trail commissions which perhaps can lengthen the liability. Let me point out one other nonpricing issue. It's a company issue that hits on persistency -- treat those people like customers. Service them and service them hard. Communicate with them. Make them fully understand the value that you can provide to them, not only during the surrender charge period, but also above and beyond that. Communicate early, often and strongly about the things your company does for them.

There's that old catch-all that the intermediary is your customer. I think to a certain degree that is true, but in this instance I think you have to look at that next person, the person ultimately holding the policy, as someone you have a right to talk to directly. Our experience shows they really appreciate being talked to directly.

MR. DAVID M. WALCZAK: I'd like to address a quick, two-part question to Mike or Mitch. Number one, what about the 1035 exchange replacement risk after surrender charges are up, with a probable lack of brokerage or wire house loyalty to a carrier? Number two, what about regulation on the bonus annuities that we're seeing advertising 18% or 20% first-year yield rates and so forth? Do you think there's going to be an NAIC crack down on something like that happening soon?

MR. WINTERFIELD: I'll take at least the first part. With regard to 1035 exchanges, a lot of the post-surrender charge lapses are 1035 exchanges. In some cases, policyholders have gotten through a surrender period, and they cash in the chips. Perhaps in more cases than not, we're actually seeing 1035 exchanges. With regards to bonus annuities, I have some mixed feelings there. I think that some of the bonus programs that give some reasonable extra value for persistency are good programs. There are, of course, abuses where there are just incredible differences in the rates where few can ultimately obtain the difference. Then that kind of abuse has to be checked.

I'm supportive of the kinds of changes that are being proposed where two-tier annuities could still continue, but the difference between the annuitization rate and the cash-value rate is a reasonable one, not a 4% or 5% difference each year.