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HAVE YOU LOOKED AT YOUR ANNUITY PRODUCTS LATELY?

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Panelists: THOMAS F. STREIFF*
Recorder: TIMOTHY C. PFEIFER

A panel of experts from annuity companies (major players) will discuss important issues relating to annuity products. Some important issues to be discussed include product design, regulatory, marketplace, compensation, and pricing issues. The moderator will do the questioning and seek responses from the floor.

MR. TIMOTHY C. PFEIFER: I've structured this session as an annuity news conference. Tom Streiff and I will give a short presentation, and then open the session to questions from the floor. We'd like to encourage you to ask questions on anything related to individual annuities.

Let me start off by introducing my copresenter. Tom Streiff is president of the NFC Consulting Group in Chicago. Tom spoke about various distribution systems at another session on marketing. NFC is a Chicago-based consulting firm that specializes in technical training, product design and general marketing consulting with a definite focus on annuities. Prior to NFC, Tom was a senior vice president of marketing operations with NACOLAH in Chicago. He may be best known to some of you as the coauthor, along with his partner, David Shapiro, of a regular feature on annuity issues in the *National Underwriter.* Tom and David are also coauthors of an award-winning book on annuities that some of you may have seen. Tom is going to cover various issues, and then I'm going to supplement his comments, and then we'll take questions.

MR. THOMAS F. STREIFF: We won't talk much about distribution because we're going to focus a little bit more on the product and market side of annuities. I'm the marketing guy and Tim's the actuary, although we trade those positions from time to time.

Probably the best place to start is with an overview of the market. It's very, very difficult to get production numbers that we all can agree upon, so please bear with me and some of my definitions of what these numbers represent. Chart 1 represents estimated growth in fixed and variable individual annuities. There are probably some group annuities in these numbers, but we tried as best we could to filter out the more traditional group annuities. Of the production numbers that we get from industry sources, the most reliable numbers come from the variable side, and the worst numbers come on the fixed side. It's always very difficult to know what's happening in the fixed annuity marketplace in a very specific way, but as you can see, we have experienced some good growth over the last couple of years.

The variable annuity marketplace was responsible for a great deal of annuity growth for a few reasons. Number one is the great performance of the stock and bond markets, and number two is very low and falling interest rates. Those two things

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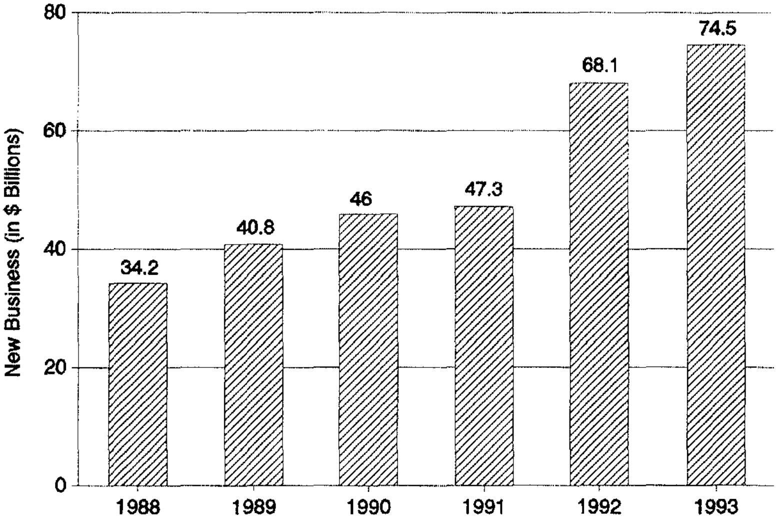
came together to add a great deal of fuel to the fire in the growth of variable annuities. Is that changing? Of course. We've seen a softness in the stock market, at least a great deal of volatility, and we've seen a substantial weakening in the bond market. We've also seen higher interest rates, and those two obviously go together. So times are changing. By the way, if I were to add my prediction for 1994 variable annuities sales (and it's hard to do this because we don't know exactly where some of the markets are headed this year), I would estimate that the variable annuity marketplace will be close to $60 billion this year. That would once again represent some fairly significant growth (50% growth) this year.

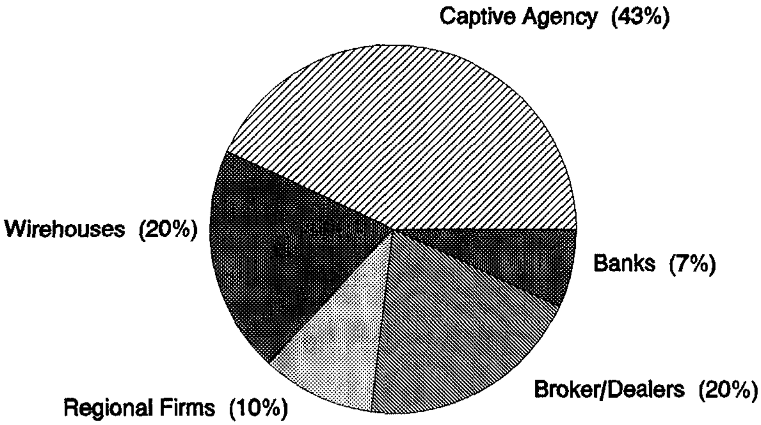
CHART 1
TOTAL ANNUITY GROWTH



Many things can change that, and we certainly have seen a trend over the last few months toward fixed annuities and away from variable annuities. However, these distribution systems that have been turned on to variable annuities are so well indoctrinated now and so energetic in their approach to marketing variable annuities, that there is an inertia and a momentum that isn't going to be slowing down even with some softness in the markets.

Let's look at who's responsible for this and touch on distribution systems (Chart 2). The captive agencies are still responsible for a great deal of variable annuity distribution, while wirehouses have been steady in their distribution of variable annuities. At the bottom of the chart, you can see broker/dealer distribution showing growth, particularly independent broker/dealers. I'd also like to add that bank distribution of variable annuities is growing as well.

CHART 2
VARIABLE ANNUITY DISTRIBUTION



Let me make one comment as it relates to banks. Those of you that attended the session where I ranked distribution systems by those that are most sought after, know that there is no doubt the distribution most sought after today by insurers is financial institutions. In many ways, they are almost single handedly responsible for the growth that we experienced in fixed annuities. If we set aside financial institutions, fixed annuities over the last couple of years have been a fairly stagnant marketplace. I don't think we will see exactly the same rate of growth with financial institutions in annuity distribution on the variable side, but we will see some significant growth in variable annuities with these institutions.

If I were to show the same chart next year, the financial institutions' section would be somewhat bigger, eating into the market share of some of these other distribution systems, probably the market share of captive agencies.

We certainly have seen some new innovation in annuity products. Those of you who attended the previous investment session certainly could tell that some of the underlying reasons for some of the questions that were asked were not just for portfolio protection; they were also aimed at how a company can use new, exciting investment opportunities to create new products. There are interesting new products, such as interest-index and equity-index products, and we'll see more and more of these.

There are some changes occurring in the commission marketplace. Somebody said to me, is the trend towards higher commissions or lower commissions in annuities? My answer is that it depends. It depends on the distribution system, it depends on the types of products that we're talking about. There are certainly some trends towards lower front-end commissions in annuities, while more of the annuity commission is being spread in the form of either spread commissions (literally) or spread in the form of asset trails. We've also seen a few distribution systems where the trend involves increases in annuity compensation.

We all know that the solvency issues that we faced in the last few years, coupled with the new risk-based capital (RBC) requirements have changed some of our methodology in designing products and will continue to do so. Tim's going to touch on that a little bit more.

We have many insurers coming to us looking for alternative distribution. They say that they distribute through these avenues today, but ask if they should be in other distribution avenues and if so, how should they get there and what type of products should they have. One underlying theme in the other session in which I participated was to know your distribution system before you know your product. In other words, don't try to take a product that you haven't fitted to a distribution system; instead choose your distribution system, and then design the products on that basis, and you'll be much more successful.

My last issue is taxes. This is a very timely SOA meeting from a tax standpoint. Tim and I have both been very active in the taxation issue of the internal buildup of an annuity. We have both served in a consulting capacity to the general accounting office (GAO), and were called before the GAO to discuss this issue in late 1993. The GAO is the arm of Congress that performs many functions, one of which is to conduct studies in the area of tax treatment. They are in the middle of a study on taxation of annuities. However, there's more than one point of influence in our government: the Treasury Department is another one. Treasury brought forth the taxation of annuity proposal that we saw almost two-and-a-half years ago during the Bush administration. Recently, we have had to deal with another one. This one came from the Office of Management and Budget (OMB) and many in the annuity industry expected this one. We had been told, through our sources in Washington, to expect to see annuity taxation as a methodology of raising revenue to offset some of the shortfalls under the GATT legislation. The industry scrambled, but came together very well. It was falsely reported a few days later that the taxation of the inside buildup of annuities was taken out. It actually wasn't taken out, although some other taxes were stricken. The good news is that the administration very recently took the inside buildup proposal out of the welfare reform proposal. Do we all breathe a sigh of relief? Yes, but don't let that feeling of relief go on very long, because there still is a great possibility it could end up in the GATT legislation. The faster GATT legislation is introduced, the less likely it is that it will be included. The administration feels a little bruised over the reaction they got to putting it in welfare reform, so I don't think they will put it in GATT, if GATT emerges quickly. However, if it isn't included in GATT, I think there's a reasonable probability that we'll see an annuity tax proposal in health care reform. We can't let our guard down, we have to be vigilant on this issue. We have some very good policy arguments, very good investment arguments, and we also have some good political arguments.

What is the chance that we will see some changes in the form of taxation to annuities, either through limitations on deposits or limitations on income or some type of minimum distribution regulation on annuities? If you have questions on any of those, I'll be happy to address them and the current GAO's position on those issues. I'll give you some estimated percentages. Before the beginning of this week, I was putting the probability of new annuity taxation as high as about 30%. Following this week's events, I would say it has dropped substantially, probably to a 5-10% risk for the remainder of the year.

MR. PFEIFER: One of the things I do want to touch on briefly is the activity at the regulatory level to change the nonforfeiture law for deferred annuities. Let me start by saying that there are some provisions of this proposal which I view as extremely positive and that will open up product design in many different ways. There are other provisions that are going to curtail the types of products we've been developing. A major fact about the proposal is that it would clarify and broaden the scope of the current nonforfeiture law. It would explicitly include variable annuities and it would explicitly include group cases that were not "true group cases." It will authorize and legitimatize market-value-adjusted or modified guaranteed annuities, and will allow those products to be sold in a general account. The proposal will clarify the treatment as to how they should be handled under a nonforfeiture law. It will also open the doors to restricted surrender-provision annuities, annuities that are nonsurrenderable for a period of time, that have windows that the customer can use to surrender. Those contracts generally cannot be sold, simply because the law requires that if a contract is ever surrenderable, it has to be forever surrenderable. It would also define no-cash-value annuities which are permitted today, but this proposal would expand on how those are to be treated and the ways in which they can be structured. Right now companies are constrained by a 3% minimum-credited rate on a cumulative basis. The new proposal would establish, as a minimum, the lessor of 2.5%, and the five-year treasury rate less 150 basis points, to be applied on an annual basis. The new law would also allow companies to change the guaranteed minimum-credited rate on subsequent deposits within the same contract, to reflect changes in the interest rate environment, provided that companies provided ample notice to the customer.

The draft also talks about maximum surrender charges. It couches the limitation in terms of maximum front-end charges to be 20% on the first $5,000 of premium, and 10% on any excess over 5,000. This would curtail products that pay higher commissions and charge higher surrender charges in the early years. It would also create difficulties for two-tier products. This particular aspect of the proposal was a major point of discussion at the last National Association of Insurance Commissioners' (NAIC) meeting. There have been a couple of changes made, or at least proposed, which could possibly work their way into the next draft. Also, the draft would prohibit the surrender charges from increasing by more than 2% within a 12-month period. That would also create some theoretical difficulties for two-tier products. As far as fee limitations are concerned, the new draft would require that policy fees have to be justified on a stand-alone basis. Right now, as long as you meet the minimum accumulated cash value with the requirement of the policy fee included, you've complied. Now the draft requires stripping out the policy fee, and mandates that it has to be no greater than $30 adjusted with inflation. This might hurt some variable annuity contracts.

The death-benefit provisions of the draft are not very onerous for fixed annuities. Most products should be able to satisfy those with no problem. What it would do, however, is potentially create a problem for variable annuities that have death-benefit minimums that are calculated at an assumed compound rate of interest. If that rate of compounding is greater than the valuation interest rate for the policy's year of issue, it wouldn't be allowed under the current proposal.

Those are just a few provisions, and there's obviously much more that we can get into if you're interested. One of the items that Tom mentioned on the product side that I wanted to mention specifically was the market's interest in index-type products. You might be saying, "I don't see any of those out there." Well, it's true that there aren't many out there as a stand-alone contract, especially on the equity-index side. However, we see probably more interest right now in index-type products than we do in any other type of product, including variables. There's much development and thinking going on right now about how to structure index products. They can be structured in several ways, one of which is to create an interest-index product. There are probably at least five companies right now that are selling some version of an interest index, and it can be structured along the lines of specifying a minimum credited rate that is always guaranteed to be no lower than the ten-year Treasury less 200 basis points or a Solomon Bond Index less 200 basis points. That guarantee would apply for a certain defined period of time, usually the surrender charge period. This product is aimed to get rid of the "trust me" element that some customers fear in fixed annuity products. To adequately fund such a liability, companies have looked at interest rate caps and have attempted to pass on at least some of the cost of the caps to the customer in the form of a lower credited rate. Presumably, a customer would be willing to sacrifice some rate for this downside guarantee.

Equity indexes typically tie a rate of return to the Standard & Poor's (S&P) 500, and would be structured along the lines of the following. First, you purchase the contract, and five years later, the company guarantees that you'll get the appreciation in the S&P 500 without dividends; the insurer also will give you a guarantee that your return will never drop below either 3% or the original principal in order to avoid the need to register it as a security with the SEC. There are many interesting ways to structure this. You can do it on a point-to-point basis (also known as the European option approach), or fund it through an Asian option (where the monthly arithmetic average over that period of time is calculated). There are many unique product issues regarding nonsurrenderability, compliance with the 3% minimum, funding approaches, etc. Companies have looked at call options as an underlying investment approach.

Other companies are looking at other ways to index products, using any index that can be hedged using existing derivative instruments. That could consist of LIBOR or a package of sector funds or whatever. What we're seeing now is that product design is probably racing ahead of the available instruments to fund the liabilities.

Last, a few issues of miscellaneous interest. Many of you are probably aware that there are some new valuation method discussions taking place that would effectively change the way that companies are holding statutory reserves. These discussions are in the preliminary stages, and are nearly as far along as the nonforfeiture revisions. Basically, the valuation changes would involve refreshing valuation interest rates, basing the valuation interest rates on treasuries as opposed to Moody's rates, changing the method to eliminate the greatest present value of all possible streams, eliminating the change in fund method, and getting rid of valuation types A, B and C as we know it. There would still be a great deal of responsibility placed on the valuation actuary to assure that reserves are adequate, and that's really the direction that this new valuation law is aimed to enhance.

Another issue is the Blackfeet National Bank, which is a bank that's American Indian-owned and has received Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC) approval for selling what amounts to a retirement certificate of deposit (CD) that has annuity-like characteristics. Customers could put in a series of payments and be able to withdraw up to two-thirds of the principal and interest at retirement. The other one-third would have to be annuitized over the person's lifetime. The OCC has issued a letter stating that they view this instrument as a legitimate annuity subject to the need for a series of disclosure requirements. The FDIC has said that they would provide insurance of up to $100,000 of account balance. The key issue right now (which everyone's very carefully watching) is the Internal Revenue Service (IRS) treatment of the accumulation of those funds. Is it truly an annuity which permits the inside buildup tax deferral, or will something else be taxed? This matter potentially has implications in a number of areas; it's not only bank involvement in selling annuities, but also the overall tax treatment of annuities.

I'm just going to cover the other three issues quickly, because I want to leave time for questions. Profitability is obviously a key issue of concern right now. Most companies now price with RBC, and if they're pricing with RBC that is NAIC-required or rating agency-required, spreads get narrow. I would hazard to say that most variable annuities out there find it very difficult to achieve profit targets unless there's some fund income that's coming back from the fund managers or through some internal mechanism.

We're seeing much interest in alliances, especially on the variable annuity side, where marketing agreements are being signed and joint ventures and third-party administrator (TPA) arrangements are being signed between companies to try to leverage off strengths that exist. Companies are trying to get into the market quickly and don't want to take the time or don't have the time to seek the variable authority that's necessary.

So let me just stop there. Anybody who has any questions relating to individual annuity products, please go to one of the microphones:

MR. PAUL H. LEFEVRE: I know Tom wrote an article in *National Underwriter* that came out very much in favor of systematic withdrawals as the optimal method of liquidity or distribution of annuity assets. Most of us did not price for the expenses and the implications of systematic withdrawal. I use the word systematic destruction of the tax benefits of annuities to describe systematic withdrawals. It has always been a surprise to me that we get involved in something that totally negates the tax benefits of the annuities by withdrawing all the interest and having absolutely no tax benefits. It seems to get into the area of what is an annuity, etc. From a policy-design standpoint, when you reach the so-called normal annuitization age or the age in which people are supposed to annuitize, will you annuitize if they've already been taking systematic withdrawals? Variable annuities and systematic withdrawals of income have been a problem because when the funds go down, people suddenly are not getting payments and there's all kinds of problems. So I'm just curious, I'd like a little discussion of systematic withdrawals. Also is annuitization dead?

MR. STREIFF: You probably asked about 30 questions in that, so let me, as best I can take them one at a time. I'll take your last question first. Is annuitization dead? No. I think that annuitization will be somewhat dormant for the period of time that we're in a perceived low interest rate environment. From a tax standpoint, the IRS has specifically approved, in certain cases, systematic withdrawal for the exclusion ratio. So I am not and I didn't in the article say that you lose exclusion ratio tax benefits. If you had properly filed your systematic withdrawal as a settlement option, you can and companies have gotten IRS approval for the opportunity to use the exclusion ratio. If a producer comes to me today, and says, should my client annuitize or should I take the income via systematic withdrawals, my answer to them is, if you can tell me the direction of interest rates over your client's lifetime and you can tell me when your client's going to die, I can answer that question for you. Otherwise, I have problems answering that question. Most people think interest rates are relatively low, especially when they're looking over a period of time like the rest of their life.

We certainly see a growing interest in variable annuitization. Sometimes variable annuitization is more advantageous than systematic withdrawals and sometimes the opposite is true. The part that's left out of the equation when people say that variable annuitization always beats systematic withdrawal is the imposition of life expectancy. When you superimpose the life expectancy issues (whether you use a single life expectancy or joint life expectancy with some type of survivor benefit), it doesn't matter. No matter which of those you use, if you superimpose life expectancy into that calculation, it changes the results. Now I'm not saying it's always going to change results to make systematic withdrawal the more viable alternative; oftentimes it will, but sometimes it won't, so these are all the things that have to come into play. We've certainly seen (I think it's been primarily interest rate-driven) a significant growth in the use of withdrawals for taking annuity income.

I'll address one last part of your question, and that is the issue of, does this put the entire tax deferral aspects of annuities at risk to be promoting systematic withdrawals as many companies do? Again, my answer to that is no, and it's based on both Tim's and my own experience in working with Congress and the GAO on these issues. The one wild card that makes me waver a little bit on that is the IRS. The IRS has traditionally pushed annuitization as a requirement for annuities. We haven't got that push from Treasury, with the exception of the one instance when it was in the Treasury proposal two-and-a-half years ago. The people that drafted that proposal are gone; none of them are with Treasury any more. There were three people that wrote that proposal, one is with a consulting firm, and two others now work on the side of the American Council of Life Insurance (ACLI) where they're proponents of annuities being used as they are today, so things have changed. But we do have a constituency at the IRS that likes to see annuitization, and likes to see definable maturity ages in annuity contracts. So it's something that we do need to be aware of, but I don't think that a proper utilization under the right circumstances of systematic withdrawal puts that at risk. I'd like to see more variable annuitization used, because I think it is used relatively infrequently. We see some growth and we see a great deal of interest in it. I think a good balance of withdrawals, fixed annuitization and variable annuitization is where we should be today because we don't know how long we're going to live and we don't know what interest rates are going to be.

MR. PFEIFER: I agree. It remains to be seen what direction the GAO will eventually take with their report, but I guess both Tom and I had the impression from our discussions with GAO that it appears that the direction they're apt to go is to forego taxing the inside buildup; rather, we should place a maximum maturity age along the lines of 85 on nonqualified annuity business. Hopefully, we won't have to face that.

MR. MICHAEL E. DUBOIS: Just an addition to that comment. I think with the systematic withdrawals, we're simply making it easier for policyholders to exercise rights they currently have under these annuities, so it's a benefit for the policyholders. Also, I have one other comment and two questions. First, you mentioned, with regard to the fee limitations, that the variable annuities would now be limited to $30. I think, in the Model Act, variable annuities had been limited to $30, indexed from 1979 forward to this point and the new draft has it indexed from 1993. I know several people have commented on that, and if anybody has fees greater than $30 in their annuities, it's probably worth letting the working group know.

Tom, you had mentioned that you should know your distribution system and build your product to fit it. As an example, what is different about an annuity for a career agency system versus one for the wirehouses?

MR. STREIFF: One thing I would do for sure is build compensation systems differently. In the wirehouses, I would build a variable-cost distribution system. In other words, if they produce nothing, they get paid nothing. Your career agency system is obviously very different. You have the fixed expenses and the overhead built in, that even if they don't sell any of your new product, you have those costs attached.

The other response to your question is that I would certainly take into consideration which wirehouses I was pursuing. If I was going after national wirehouses, I would look at the universe of products in national wirehouses today, and I would look specifically at the features of those products. National wirehouse are not the most popular distribution today, but there are plenty of companies that are trying to get a piece of that market share. You have to be different. There are choices as to how you wish to differentiate. You could differentiate on the basis of features. You can differentiate on the basis of price (whether that be commission or interest rate), and you can differentiate on the basis of service. My strongest recommendation is to differentiate (no matter what your distribution is) on the basis of features and service so that you don't get in the position of selling a product that isn't profitable or is far lower than your target profit levels. As an example, I would look at maybe some indexing, whether I'm in a fixed or a variable product. In the variable product, I might look at funds that were indexed, or maybe I'd look at a general account that had some indexing. Indexing in your career agency force may be too complicated. You may have some problems in indexing in certain distribution systems, because some index products are just too complicated for the agents and for those agents' clients. So you do have to be careful with the level of complexity that you put in products and certain distribution systems.

Also, I wanted to go all the way back to your first comment on the systematic withdrawal, because one question that I forgot to answer in that was an excellent point. Most products are not priced for systematic withdrawal. They're priced for those assets to be held for a substantial period of time. If you start to do some calculations involving customers using these products in the very early years for income, it quickly changes the pricing dynamics. I can assure you that there are many products out there today that are being used for withdrawals that are inaccurately priced, and that is going to be a problem. A couple of things you have to look at is not just how you designed the product, because that may not be how it's being sold. You have to look at how your agents are selling that product. If they're selling it for distributions, the pricing dynamics are different, and it could change your profitability in a hurry.

MR. DUBOIS: The one other question that I had is that I've heard some things going around with respect to statutory reserves and variable annuities where the NAIC is taking a look at whether, for variable annuities, one can set up a transfer from the separate account to the general account to essentially pass the expense relief on to the general account which is paying the expenses. Have you heard anything about that? Can you elaborate if you have?

MR. PFEIFER: I know that companies have been doing that for quite a long time. They've been taking the Commissioner's Annuity Reserve Valuation Method (CARVM) expense allowance into the general account as a negative expense or negative reserve item to reduce general account reserves. A few years back, California had some problems with that, and at one time was proposing that companies hold full fund value as the reserve on variable annuities. The industry had some problems with that because it implied that you had to hold more reserves for variable annuities than for fixed annuities which didn't seem to make much sense. That issue is being taken up by the industry task force that's working on changes to the valuation law. They haven't, to my knowledge, come up with any firm conclusions as to reserving for variable annuities, but that's in the purview of what they're looking at.

MR. DONALD J. SCRIBNER: My question relates to the NAIC RBC formula as it applies to variable annuities, specifically, the C-4 component which is expressed as a percentage of premium. Should this be included for variable annuities either with or without a general account fixed-fund component?

MR. PFEIFER: My answer is yes, that it should be, although in the pricing that I generally see for most companies, there are few who would express the capital requirement as a percentage of premium (the way it's truly applied in the formula). Most companies that price variable annuities express the target capital requirement more as a percentage of assets or as a percentage of fund, ranging anywhere from 50-100 basis points. And when you ask the companies, what it is for, most of them say, it's for the C-4 component and also for any guaranteed minimum death benefit risk component that they're making an allowance for. So my answer is yes, I think it should be, but oftentimes it's not expressed as a percentage of premium.

MR. MATTHEW J. SHERWOOD: A question for both of you. You spoke about profitability goals. If you just did a survey of the business today, what do you think companies would actually be realizing as a return on capital? Also, what should these products be returning?

MR. PFEIFER: It's harder to answer the second one than the first one. We still see companies pricing generally for 12-15% after-tax, after-target capital. On the variable side, in many cases, if you're getting some fund fees back, it's quite easy to have a return of investment (ROI) well in excess of 13-15%. In reality, most companies in the competitive markets are settling for something less than 13-15%. Oftentimes we see companies satisfied with 11-12%. In answer to your second question, what should the target be?, I think the target has to be a function of the risk-free rate. If you can go out and buy 12% treasuries, I don't think you should be pricing an insurance product for a 12% return. There should be a margin over the risk-free rate that depends on the riskiness of the business. So where most companies are today, probably 13-15% is their target on the fixed side as well as the variable.

MR. SHERWOOD: Are they achieving the target?

MR. PFEIFER: It's interesting you should ask that because we just did a study on that question. I would say if I had to do a rough split, and I'll round to two places like Tom did, I would say probably about 40% of the companies are achieving their targets and 60% are not.

MR. SHERWOOD: I hate to ask too many follow-up questions, but of the companies that aren't achieving them, what are they getting?

MR. PFEIFER: They're probably achieving more like 10%. Many of the problems with not achieving their goals stems from two main reasons. One is an expense issue. Companies are just not managing to the expenses that are priced in the business. Second, it's simply just the competitiveness of the market in terms of interest rates and the need to keep rates at a level that requires a narrower spread than what was priced for.

MR. STREIFF: One of the things we've seen is that obviously companies will target where they think they ought to be. Oftentimes, because of the pressures that are brought on by the market, they find that they start to move their initial credited rate higher, or put a commission kicker in there to get introduced into the market. That's fairly easy to justify, but it takes a great deal of discipline to take that out later and get back up to your profit objective. There are many companies, quite candidly, that do not have that level of discipline.

MR. SHERWOOD: What kind of return on assets (ROA) are we seeing as compared with those returns on capital?

MR. PFEIFER: Return on assets was going to be one of my slide topics, but I'm glad you asked the question. More and more companies are pricing on a return on assets basis as one of their pricing components. I think part of that is because with the rise in the variable annuity market, where the focus really is on building assets and the key is on achieving critical mass, it makes sense to look at how much the company earns as a percentage of assets. In the variable annuity market, I would say most companies are pricing for somewhere between 25-35 basis points after tax, again after target capital (so it's really sort of a distributable profit number). On the fixed side, we see something a little bit higher; 35-45 basis points would be a typical after-tax gain. GAAP basis ROAs obviously would be a little bit higher than that.

One of the things we didn't talk about is that there is a great deal of interest in internal exchanges. These are situations where a company has a block of fixed annuities that is either coming up to the end of a surrender charge period, or for some other reason the company believes that the business might be apt to be leaving en masse sometime soon. Companies who have designed internal 1035 programs would move that business to either another fixed product with a more attractive rate, or to a variable program. In so doing, that business is retained at least for another five to eight years. The way programs we've seen are set up would usually involve charging half of a surrender charge and paying half of a new business commission so that the producer is rewarded for doing very little work but he's happy, and the customer's happy because they got out with minimal surrender charges. The new contract that you're moving to would be like a brand new contract with a new surrender penalty, and the goal hopefully is to retain some business that you otherwise would have lost to another carrier. Many companies are looking at those right now for various reasons, and there are some GAAP implications in doing these. But this is something that I think you're going to hear more about as some of the more mature fixed annuity blocks are starting to run off the books.

MR. MARK P. ABRAHAM: You mentioned that there would be some impact based on the standard nonforfeiture law changes on product design. Could you elaborate on that a little more?

MR. PFEIFER: Yes. I'm excited about the nonforfeiture law in most respects. I think it will open the door to products like the equity index products. The reason is that, at least in one form of the equity index product, the contract has to be nonsurrenderable for a five-year period or a seven-year period, and then you would allow the customer to have access to the accumulated lump sum. You can't do that today; under the new law you could do that because it would allow for what is termed restricted surrender provision annuities. It will greatly help modified guaranteed annuities because, right now, we operate within a patchwork of state regulation. In some states, you have to file market-value-adjusted (MVA) products on a group basis, while in other states, an individual basis is required. You're never quite sure what you're going to encounter at the states when you file. If this draft gets adopted, the market-value-adjusted products are really going to be a mainstream type of product.

The ability to alter minimum credited rates by duration of the payment is going to allow companies to better manage their products and may allow companies to pay higher credited rates on funds down the road, knowing that they can drop future funds to a different lower guaranteed minimum. Those are a couple of examples. But there are others too where I think, it is going to hurt the two-tier companies if it passes as is, and there's still a big 'if' there.

MR. ABRAHAM: What type of time frame are we looking at?

MR. PFEIFER: There was some hope that we would see the exposure draft adopted as a model at the June meeting. That looks very unlikely now because at the last meeting in April, there was substantial commentary on whether this 10% limit on the surrender charge was fair, so there are some ensuing discussions going on there. It appears now like we're probably looking at December. I would caution you too that we're in the fourth year of this project which was supposed to be a one-year project. We hope to see something adopted in December.

MR. LEFEVRE: We have been involved in about a $2 billion exchange program at our company over the last year-and-a-half, and we believe it has been quite successful, but I just want to make a few general comments about it. The driver for the program that we did was basically asset/liability management. This exchange program was based on the expiration of the penalty period of some rather large blocks, mostly sold through wirehouses. The premise was that we had to go out and say to the customer and/or the agent, do you want to pay for the liquidity that you've just acquired by having a lower rate, or would you like to have a higher rate and give up some of the liquidity? The end result of the program was that we were able to segment the liabilities into ones that had short duration liabilities and ones that were longer. In a sense, it really curtailed the duration drift of our entire portfolio and turned it around. We started getting a higher duration of liabilities. In very general terms, the result was that we lost about half the business, about 10% of it ended up choosing to stay short duration and 40% went to long duration. Right now, the challenge at some companies such as ours, is that with the current kick up in interest rates, which is about 150-200 basis points in the five-year part of the curve, there's a lot of old blocks of business laying around that are out of the penalty period that have been quite happy getting renewal rates that have been coming down. All of a sudden, new money rates are a lot higher than that, and those blocks are going to be needed to be dealt with via similar programs.

MR. PFEIFER: If your company has done one of these or is considering doing one of these, you probably should be aware that there's a tremendous amount of inertia, notwithstanding what Paul just said, in the in-force blocks of many companies. Keyport's 40%, from what I've heard, is extraordinarily high compared to what some other companies who have actively promoted the internal exchanges have been able to realize. You can design one of these programs and you can really promote it, but you shouldn't expect 80% of the people to buy it. You're not going to get anything like that.

MR. JAMES G. CARLIN: I had a question on the profit objective. You're saying companies are shooting for 13-15%. Is that on a stochastic or a deterministic basis?

MR. PFEIFER: That would be on a static basis. I hate to say this, but there are companies that still have a long way to go as far as mastering pricing annuities on a stochastic basis. We've seen companies that are running 500 or 1,000 scenarios who look for 80% attainment of the profit goal as a threshold that they're seeking. In other words, they're pricing it on a stochastic basis and saying that if 80% of the results achieve that 13-15% goal, then pricing is acceptable. Looking at the results that don't achieve company goals and trying to understand what went wrong, evaluating those scenarios and questioning whether this really is plausible is important. But, there are many companies that maintain the process of only pricing on a static basis and that's difficult to justify.

MR. ROD L. BUBKE: Do we have to consider the systematic withdrawals in the valuation? Is there anything in the new valuation discussions considering systematic withdrawals, and is there anything in Guideline GGG that would apply to these withdrawals?

MR. PFEIFER: I don't know of anything in Guideline GGG. Donna, do you want to handle that one?

MS. DONNA R. CLAIRE: I was the Academy representative at Guideline GGG meetings, and at this point, the systematic withdrawal issue was not specifically addressed. What was addressed was basically annuitization versus cash values. However, I think in terms of the actual valuation, you'd have to consider the systematic withdrawal in terms of whether you think you have adequate reserves. Relative to the new proposed annuity valuation law, that would be one of the types of utilizations that you have to consider. We're not saying you have to set up reserves for 100% of the people doing it, but it is something you have to look at.

MR. STREIFF: As we wait for somebody to ask another question, I'll make one other point. There are areas where you can find ways of entering the market today that may not have been available even a few years ago. If you're looking at ways of expanding your annuity distribution, there are certainly many opportunities on the proprietary annuity side, such as proprietary product or private label product among mutual fund houses, discount stock brokerage firms and financial institutions. I'm speaking both from the fixed and variable side. Tim talked about strategic alliances, and this is an excellent opportunity for you to make a strategic alliance with a distribution system—a distribution system that might be new to annuities that is looking for good, strong partners. Although I think it's probably a little too early to call them wildly successful, they seem to be working extremely well whenever the right partnerships are formed. I think it is a way in which you can very closely control and monitor your business and know exactly what type of business is coming on.

MR. RAVI CHANMUGAM: I hope I have an easy question for Tom to finish up with. I'm looking for some good, pure public-policy arguments for why our industry should continue to receive favorable tax treatment on annuities.

MR. STREIFF: Actually that's probably a good question for both of us. It may not be as easy as you think it is because different people look at these types of arguments differently. The best public policy argument today and the one that's most widely accepted by both the Clinton Administration and Congress, is one that says we need to encourage savings. Annuities are powerful savings vehicles. They're one of the few savings vehicles we have that's growing, and it's increasingly becoming a part of people's savings portfolios. It's specifically designed for retirement; it's not a short-term savings vehicle. It has a penalty attached to it if you take it out before age 59½, so we can argue very effectively that it's designed for what this country needs most—people to save on their own behalf for retirement so they're less dependent on government programs now and at retirement.

MR. CHANMUGAM: Are there any economists or studies that you can quote that would show that the savings rate of the country would go down if we eliminated this treatment?

MR. STREIFF: I've see no studies that show that. That's so hypothetical, it would be very difficult to study. Annuities are not so much a part of our society so I don't think that would happen. Annuities are bought by only 14-15% of the households in this country. It's growing, and I think ultimately it could be significantly higher, especially with the type of positive exposure that annuities have gotten over the last couple of years. So no, there's nothing that would show that kind of catastrophic consequence.

MR. PFEIFER: One thing I would add, though, is that probably some of you are aware of the Gallup Study. There have been two Gallup studies that were sanctioned by the Committee of Annuity Insurers, and the most recent one confirms the findings of the first one. That is, annuities are generally purchased by middle-income people. I think the number was something like 80% of sampled annuities were purchased by people with incomes of less than $75,000.

MR. STREIFF: That's household incomes—also an important point.

MR. PFEIFER: And that's a nonqualified sample also. The first study looked at qualified annuity business as a large part of the sample, which you would expect would portray a more middle-income market, but the second study is truly non-qualified business. I would make use of that study, if you have access to it. That's certainly a convincing argument.