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INNOVATION IN SAVINGS PRODUCT DESIGN

Moderator: A. GORDON JARDIN
Panelists: JOHN M. FENTON
JOHN C.R. HELE
Recorder: A. GORDON JARDIN

Panelists will review and forecast developments in "savings" product design. An assessment of purchasing trends and developments in other countries will be explored.

MR. A. GORDON JARDIN: I will be your moderator as well as one of the speakers. The main panel members are John Hele and John Fenton. John Hele is senior vice president and chief marketing officer of Merrill Lynch Insurance Group. Merrill Lynch markets life and annuity products to individuals and small businesses through its private client sales force. John joined Merrill Lynch in 1988. John Fenton is a principal of Tillinghast, a Towers Perrin company, and he manages the Atlanta life unit. John has been with Tillinghast since 1985, and his primary areas of consulting are in the area of variable insurance products, New York State issues, agents' compensation, and actuarial appraisals for mergers and acquisitions. He is also a frequent speaker at SOA meetings, professional seminars, and industry conferences. I am president of Winterthur Life Reinsurance Company in Dallas. Winterthur Life Reinsurance has been very active in partnership arrangements with companies that want to develop their annuity and interest-sensitive business.

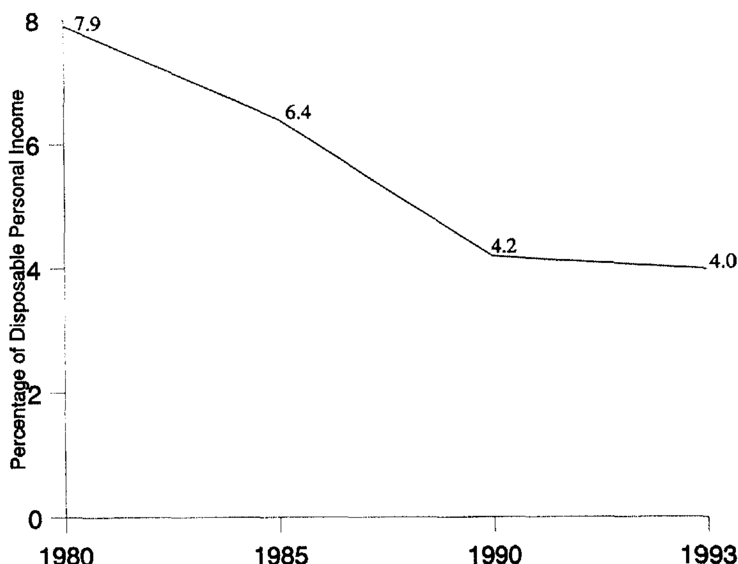
Innovation is an interesting word. To be innovative is defined by Webster's as to be creative, to develop something new. The word has a positive feeling to it. If someone is referred to as being innovative, it is taken as a compliment. Unfortunately, one cannot necessarily equate innovation with success. Remember that in any industry the vast majority of innovative ideas never turn out to be successes. There is a greater chance of success if the new product is a variation built upon an already successful product. Perhaps that is why we, in the life insurance industry, favor variations on successful themes, such as riders on policies, rather than complete innovation from scratch.

MR. JOHN C.R. HELE: I'm going to move around here a little and speak about a macro overview of the savings market, particularly savings products that consumers from all walks of life can choose from, because that's really the competition. So think of yourselves as being aboard an AWAC plane right now and you're watching the battle below for the consumer savings dollar. Some of the innovations I will speak about are primarily distributed through banks and stockbrokers. We will review the entire savings marketplace, not just the life insurance industry. I will cover the competition going on, some interesting new products, and some trends that I think will be happening in the next five or so years. What I will not be covering, contrary to what may be in the advertising for this session, is looking at the international arena. I did think about that, but many of the products sold internationally in other countries are highly dependent upon the tax laws of that country, whether it be Japan or the U.K. They have product designs because of the tax laws in those countries. So the broad spectrum of savings products within the U.S. will be the scope of my topic.

We're going to make this a little interactive, so I'm going to take a little survey here to think about savings products. I would like my esteemed panel to join this poll. How many people have some savings? A great many hands. How many people save annually? Quite a few hands. Of those savings, how many of you have a CD? Just a handful. How many of you have some stocks? Good group. How many of you have some bonds? Good group. How many of you have a mutual fund? Big group. How many of you own an annuity? Most of the audience. How many of you have some life insurance products that you're using as a savings vehicle? Significant minority of the audience. Well, at least they're buying what they're preaching.

Chart 1 shows the market of new money into the savings market, and although I am an actuary by profession, you don't have to do a lot of regression and analysis to look at this and see what's going on. This chart shows the amount that Americans are saving as a percentage of disposable personal income. There's definitely a trend line. This is very important if you think about products you're designing and pricing, because there has been a shrinking market of new money in percentage terms. What we are battling to do is move assets from one type of savings vehicle to another as well as attract some new money of savings.

CHART 1
HISTORICAL PERSONAL SAVINGS RATES



Source: *Statistical Abstract of the U.S.* Table 695

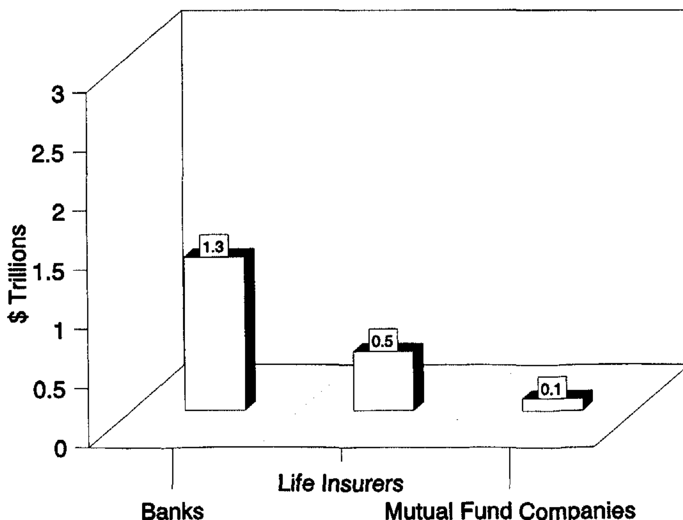
Now a lot of the savings has been coming through 401(k)s and many employer-sponsored plans, too. So as you think about your products and innovations, also think about how they're distributed. It will be very important. Everybody hopes that this downward trend will stop and start to go back up again, and we'll start to have more

new money flow into this business; that will be great. It will really explode and maybe the baby boomer generation will start saving. But, as of 1993, baby boomers haven't really started saving yet. Japan saves much more than the U.S., almost double digits, and Canada saves more than Japan. The U.S. has a very disturbing trend: as the baby boom generation grows up, the market may expand, but because of how people save, it may be for types of products that are different than what you've been selling.

Let's look at who's been winning the war for these savings dollars. Chart 2 shows the assets of major financial institutions in 1980. As you can see, banks had $1.3 trillion. Life insurance had $500 billion, and mutual fund companies had $100 billion in 1980. Fourteen years later, these are the numbers: $3 trillion in banks, $1.9 trillion in life insurance, and mutual funds had $2.2 trillion (Chart 3). In 14 years the mutual fund business has accumulated more than the life insurance business accumulated in 100 years. It is doing something right. If I can leave you with anything from my presentation here today, remember to start looking at what the mutual fund companies are doing in terms of client value, pricing, how they price their shares, how they communicate with clients, and even how they sell, because that's whom you're competing against. They've been winning.

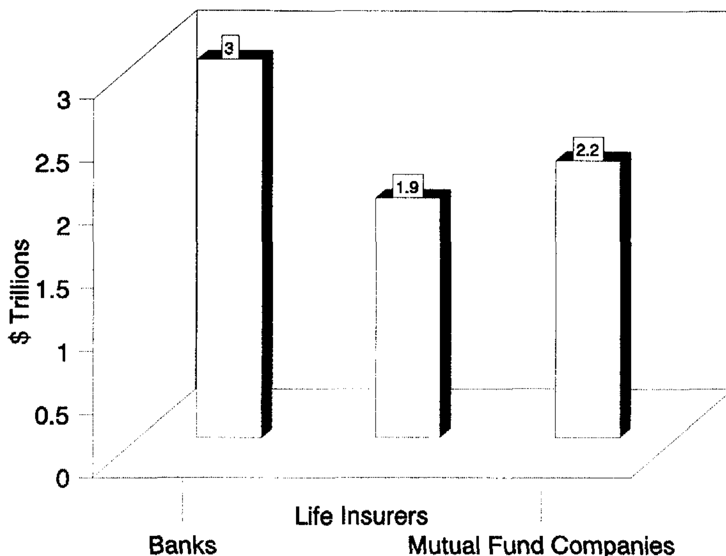
The following are the compound growth rates. Banks have grown 6.6%, so you can see why banks are really interested in getting into the annuity and life insurance business. We've done well as an industry. We've grown double digits, but the mutual fund industry has grown at 28% compound. It's all projected to slow down from here on, but it's really amazing what it has accumulated in such a short period of time.

CHART 2
ASSETS OF MAJOR FINANCIAL INSTITUTIONS IN 1980



Source: Federal Flow of Funds, third quarter, 1994

CHART 3
ASSETS OF MAJOR FINANCIAL INSTITUTIONS IN SEPTEMBER 1994



Source: Federal Flow of Funds, third quarter, 1994

With regard to banks' main sales items, they still mainly sell CDs, obviously, but annuities and mutual funds are becoming a much larger portion. Regarding bank distribution, the mutual fund side of that is even further along with some bankers, and they are putting stockbrokers right in lobbies. So there's stiff competition.

I'm going to talk about some interesting new products that reflect, in a macrosense, some interesting trends. These trends are happening not only in the insurance business, but throughout all the financial services, in many of the other competitors that you're dealing with. A new product called the Keyport Index Annuity has the rate of return tied to the S&P index at a percentage participation that it decides. Let's say it is 80%. You'll get 80% of the S&P appreciation over a five-year period, you have a minimum guarantee of always getting your money back, and there are some cash values. There are some CDs being sold like this now, and there are some securities that we've been selling in the brokerage world. They're actually called derivatives, but the market does not call them that anymore. We nicknamed them MITTS and had many other names such as that. We've sold them mainly in tax-exempt accounts because of the strange tax treatment they have. They all have many things in common: they give the client, the consumer, a minimum floor protection with a percentage upside of the equity market. The client pays a price for the minimum guarantee by not receiving 100% of the upside. Consumers have shown a willingness to give up some of the upside because they really dislike seeing their values go down. That's why many consumers are mainly in CDs today. This is a really interesting product. It's the first single-premium deferred annuity (SPDA) I've seen that is this complex, but if we look out five years from now, I think we'll be seeing more of this new product.

Another interesting trend that's developing is in the way people sell. Hartford Life has a what it calls syndication. It has had it for about two or three years, and it's really a successful way of selling business. Hartford has a product called the Hartford CRC. It's a market-value-adjusted product. You can get a three-, five-, six-, seven-, eight-, nine-, or ten-year period. Instead of just offering the rate and people walking in and buying it, the broker dealer offers a limited supply at a fixed rate. Let's take an example there. At Merrill Lynch we decide to take in $5 million above the normal rate. We buy an inventory of a five-year deal at 6.5%, which is probably 30 to 50 basis points above what is normally offered today, and we have to sell it out. If we don't sell it out in two weeks, then we're stuck with an interest rate adjustment charge. The sale exploded for Hartford last year. The big national wire houses did much business. This is so interesting because it was a twist to make the products fit the distribution system in terms of how the distribution sells. Merrill Lynch is used to taking down initial offerings and selling them out. It's really how much of our business works. So this way of selling is tailoring the product to the distribution system. You can see by the results that it's dramatic.

Another interesting new product, the CD annuity, has just had a proposed Treasury regulation released. The Treasury ruling proposal, in effect, stops the deferral period in a CD annuity. Only small banks have done this to date, but this is one that was just introduced by Metro Bank and it gives you tax deferral with FDIC insurance. The new ruling will effectively make this taxable. But what was interesting is that the new proposed regulations allow a bank to issue an annuity that will pay for life. You can defer for only one year so the payments have to begin one year from issue, and it will have to be the same dollar amount in each payment. That's otherwise known as immediate annuity. The banks will probably not be doing this type of a deferral, but they will probably become major competitors in immediate annuities and in providing guaranteed income to the baby boomers because there is FDIC insurance. What's important is the impact that this will have on the annuity market and immediate annuities with banks being able to sell this. The hearing is going to be August 8, 1995 so you can get your commentary in prior to that if you want to speak up.

In terms of trends and where we see things going, banks are going through a massive culture shift. They have not been making many small-business loans in the past five years, which is what they used to do 20 years ago. That's all they did along with home mortgages. There are all sorts of other financial intermediaries now providing financing and mortgages. Banks are going through a big culture shift as they think of themselves as distributors.

Compliance and suitability will be a major item with banks. They're very concerned with it and their reputation. We've thought that banks haven't really done much capital strengthening yet. Banks weren't in very good financial health a few years ago. Luckily, though, the feds fixed that. Rates were lowered enough, and you notice your credit card rates didn't come down very much. Banks made a lot of money in the past few years. To give you an example, just a few years ago Citibank had $3 billion in total capital. In contrast, it made $3 billion profit last year. So think about your competitors now that they're healthy and they have capital and they're looking at these savings dollars. Technology will be a major force in bank distribution. Many annuities are issued right now in the banks by using PCs and teleunderwriting (a new form of underwriting with banks). Banks will become very big distributors. You may want to

be thinking of whether you can supply products and innovative ideas through this large, growing distribution channel.

In terms of stockbrokers, we're seeing a major shift to manage money. The day of the individual stockbroker buying and selling equities is diminishing. It's still there, but there's a definite trend to much more what we call managed money: wrapped manager accounts, mutual funds, and variable annuities. The broker is not picking the stocks but picking managers for the client. We've seen consolidation that is continually in the stock brokerage world, and I bet it's going to come in the life insurance business. You must provide value to your consumer to justify your fees. Stockbrokers are becoming asset gatherers and they want to manage all the money.

At Merrill Lynch we have $595 billion of clients' money under management for both individual clients and businesses. It's about 2.7% of the net worth of America and that's our core strategy: lower velocity. (Velocity is the commissions divided by the asset base.) When you were traders, it was very high; now it's much lower. Limited offerings, the type of insurance products sold that way, will be a big trend. Again, don't underestimate the impact of PCs, technology, distribution, and products.

John's going to cover variable annuities and variable life in more detail, but with regard to stockbrokers, performance is going to become more important than features. We do a lot of market research at Merrill Lynch. The number one thing our clients care about is performance: "Did you make me money?" These products are going to have to perform.

Suitability will be a very important concern in these products, and one trend happening in the brokerage industry is the level playing field. We used to have different commissions for different products in, say, annuities. Some annuities would pay more, some annuities would pay less. As of this year, we have levelized the commission in the industry. It doesn't matter what variable annuity you buy, it's all the same commission. It's neutral to the salesperson, and performance and features to the clients make the difference. If this is happening at the SEC and it's coming top down and being regulated, think about the impact that it may start to have in a life insurance business.

I'll go out on a limb here and give you some predictions. The winners will be those that add real value to their clients. Let's have another session in five years to see how well they're doing.

I know this sounds very simple, but the best organizations spend a lot of time thinking about the following five points. Do you provide real value to your customers? Do the products provide real value? Can you express what that value is? Are you reducing costs to consumers? Value is not enough anymore. Consumers are very demanding. They want the very best and they want it cheaper. Witness the growth of these discount malls where you get name brands, Anne Klein, or Calvin Klein, at stores at discount prices. Witness what Wal-Mart did to Sears: value at less cost. The consumers are demanding this. Wal-Mart used technology to make it easier to purchase and determine if the inventory was full. So if you're using technology to make it easier to buy the product and to deal with your organization, those products are going to be winners. Do you provide education to consumers, or do you design a product that's so complex that nobody can figure it out? Only "actuary to actuary" could ever understand what's going

on here. The best products are inherently easy to understand. It's very hard and complex to make a product easy to understand. It's not trivial, but it is very important in providing education and it is really important to consumers. Consumers want to know how this product works. I think that there will be different winners in the next five years than there have been in, say, the past 15 years. It will be a different land-scape because it always comes from where you're not looking. So I encourage you to look at all the products. If you haven't analyzed, as I said, how mutual funds price A shares, B shares, C shares, and D shares, you should. If you don't know what I'm talking about, you should take a look at it. I can't go through it all for you, but I really encourage you to look at who the winners are right now so that you can design your products to be in line with that.

MR. JOHN M. FENTON: I'd like to move on, maybe expand a little upon what John talked about. The topic of my talk will be variable life and variable annuity products. I will look at some of the innovations that we've seen there in that particular marketplace.

I don't think we can talk simply about product trends without taking a little bit of time to look at the underlying market, so I have a few observations about the variable life and annuity markets. Then we'll go into some specific product trends from both the annuity and the life side. There is, obviously, a lot that we can talk about, but given the relative short time frame, we're going to hit upon just a few topics.

First, let's take a look at what's going on in the market. Overall, the variable annuity market has stalled recently. Sales were about $50 billion in 1994. This was up 11% over 1993, but the first quarter of 1994 was the best sales quarter, with sales trending downward for the rest of the year. Essentially, the variable annuity market has been a victim of rising interest rates. Interest rates have risen by approximately 150 to 300 basis points over the past 15 months, with a sharper rise at the short end of the yield curve. The rise in interest rates has led to a shift in sales to fixed annuities and market-value adjusted annuities.

Based on some observations that the Life Insurance Marketing and Research Association (LIMRA) has released, the market share of variable annuities was about 70% in the beginning of 1994, which is quite a high number. The percentage does include fixed-account business. Market share has dropped down now; I estimate it to be about 55% or so. Now that the Dow is up to 4200, this may spark sales increases, so performance figures should start to go up again. I think overall we're going to see ups and downs in the variable annuity market, and we're going to see shifts between variable annuities and fixed annuities. Overall, for the two markets combined, we will see increases in the future.

We note that companies are striving to increase or maintain their market share. A number of new entrants in the variable annuity market in the last year have led to increased competition, which has led to increased compensation levels. I understand John's point about the underlying customers having to be happy, but there is a push to sell, particularly nonqualified business, and for that you have to get on the shelf.

To get your product on the shelf you need to be able to tell a story about your funds. Perhaps you need a little bit better compensation to make it on the shelf and you need some state-of-the-art product features (we'll talk about those in a second), but those are

trends that I've seen. Most of the variable annuities have been sold in the past by stockbrokers, wire houses, regional firms, and insurance agents specializing in the qualified market. We're now seeing more sales through banks, financial planners, and direct response so we'll talk about that.

Let's turn to variable life. Somewhat contrary to variable annuities, we've noticed that the rising interest rates have not really dampened sales of variable life products. Sales were up $2.3 billion in 1994, up 31% from 1993. Right now the current market share of variable life is estimated at about 23%. That's of the total individual life market, which has moved up, and it has potential to move higher. I think one of the reasons variable life hasn't been a victim of the sales downturn is because it's less of a product-of-the-month type of sale. We have seen some of the stock brokerage firms in which variable annuities were the hot product in the first quarter. Now they're on to something else. They may come back to variable annuities. Variable life, on the other hand, is being sold primarily by insurance agents, and it's their lead product. I'd say similar to variable annuities, we continue to see new entrants to the variable life market. I would say that this has put pressure on the competition. The pressure is for competitive illustration values. We're going to talk about some of the features that are being used. It's not really a desirable trend, but I think it is a small fact of life.

We've noticed that there are some products now being designed for specialized markets. We're continuing to see the variable annuity distribution channels talking about variable life and debating the choice of products. We're still figuring that out. Also, products for fee-based planners with lower compensation levels will be something that we'll see from now on.

Let's talk about some of the specific product trends and we'll start with variable annuities. One of the products being developed is the bank wrapper product. A number of banks, as John has talked about, want to get into the variable annuity business, and they're coming at it from two points of view. There's a distribution side, and right now banks account for approximately 10% or so of all variable annuity sales. That's compared with about 30% for fixed products. They also want the ability to offer their funds. Within the past few years, they started offering their public mutual funds to their customers. They now want to leverage off that and expand and offer variable annuity products as well. So some of the banks, particularly the larger ones, and it may be the 20–30 largest banks in the country, are interested in developing a product with their funds working in joint venture with an insurance company. The banks have a wish list when they discuss a joint venture and they are bringing their distribution system to the table. They want to have their funds in the product. I think the other important point is that this is not solely banks. I think other distributors, other organizations that bring distribution to the table, are in the driving seat to some extent and they can come with some of these points as well.

In an ideal world they'd like to see a short surrender charge period, say, ideally five or six years compared with the seven or eight years that we see in the standard product. They'd like to see high compensation, of course, and payouts pushing 7%, and alternative trails, trailer commission scales. They'd also like to see a limited commission reduction at the older age, one that doesn't kick in at all or only at age 80 or so. Of course, I want a rich guaranteed minimum death benefit instead of the simple return of premium—a simple ratchet would be suitable. They want to see an annual ratchet or a

premium accumulation, and they don't want this to be cut off until a very high age. They might want an expanded free-out provision in which standard might be 100% of premium noncumulative. We add in either a cumulative feature or investment earnings, perhaps the sum or all of that sort of good stuff. They would like to see no restrictions on the fixed account. They'd like to move money out without restrictions. Of course, this forces us to keep the asset short and provide full-service features. I think that's coming to be widespread throughout all variable annuity distribution. The push for dollar cost averaging, asset allocation services up front, and portfolio rebalancing will be seen going forward. So you add all these things up and what do you think, John? What sort of return do we get if we put all these in here?

MR. HELE: Well, the distributors make a large sum of money.

MR. FENTON: The distributors make a great deal of money, that's right. The insurance companies, on the other hand, don't. There might be a potential to raise your asset charges by adding in a guaranteed minimum death benefit (GMDB) charge or adding a distribution charge. I think there is going to be some pressure on rising fees.

So let's go back now. We've talked about the wish list and looked at a few other trends. We also note that on the bank wrapper they like to offer the bank funds, perhaps in addition to your funds. Then we also have the products and it's taking a totally separate talk, two types of no-load products.

First, there's no-load sold by financial planners. This has no surrender charges; however, it has fairly high product asset charges of, say, close to 140 basis points, allowing them to pay compensation close to 100 basis points per year on a levelized basis. This product works well in situations in which the money's coming from another annuity contract. The surrender charge is gone. Put into a new contract, you'll have to pay the surrender charge, but the adviser gets a fair amount of compensation. This also allows the adviser to collect the monies directly from the contract without having clients surrender their taxable assets.

The other type of no-load product that we see is direct response. This might also be a joint venture with a mutual fund complex, often a no-load complex. Vanguard, Janus, T. Rowe, Fidelity, and Schwab are in this right now. This product has no surrender charges, but it also has much lower compensation and much lower product asset charges, say probably closer to 45 to 70 basis points. The sales for this will come primarily from the mutual fund's existing customers. This also may be offered by fee-based financial planners as well.

We've talked a little bit about the rise in interest rates and the movement in variable annuities. We'll talk now about movement on market-value-adjusted (MVA); there definitely is more interest in the MVA feature. This can operate as a stand-alone contract or as a fixed account of the variable product. Two basic types in my terms are true MVA or pseudo-MVA. True MVA invades principal and is a registered product, whereas the pseudo-MVA provides a minimum return of, say, 3%. Because it doesn't invade principal, it doesn't need to be registered. The product is desirable because it allows you to lock into an attractive long-term interest rate, a long-term period, say five to seven years in the 7–8% range. It does tend to require a disciplined investment strategy. Your market-value-adjustment formula should attempt to reflect the market

value of underlying assets, therefore, your assets should closely follow that. A big advantage of this product relative to other fixed annuities is that it has lower target surplus and valuation requirements that need a lower spread to reach your profit goals.

Another product that we can't strictly define as a savings product, but there's much interest in it, is the payout product. The primary purpose of this is to access deferred or accumulation money through annuitizations or systematic withdrawals. I think this is an important feature for qualified money. Individuals need access to that money. Individuals who purchase nonqualified deferred annuities maybe don't need that $500 check every month. Some might, but by and large, most do not. Many other variable annuities are sold to university employees and teachers who probably need that income, so I think we're going to see more use of features to draw that money out.

We've noticed in the past year more interest in variable annuitizations. It's still relatively low, but it is picking up steam. Essentially, variable annuitizations allow you to buy a number of units, rather than a steady dollar amount. The payments vary over time and I think we're seeing some designs that have allowed companies to price the initial path higher through use of a higher assumed interest rate (AIR).

On the flipside from annuitizations, we see systematic withdrawals or products designed to offer liquidity. One of the worst things about an immediate annuitization is that once you annuitize, you'll lose the money—you lose the liquidity feature and just get the ongoing payments. That's particularly a concern, I think, for some of the brokers that sell the business. So the systematic withdrawals allow the liquidity to have the ongoing payments but still provide the liquidity of the funds as well.

Finally, let's turn to the variable life product trends. As we've noticed, we tend to see more competition, more entrants into the retail traditional variable life products, and I think this has led to heightened competition. We know to push for competitive illustration values. Probably, unfortunately, we're continuing to see declining mortality and expense (M&E) charges; risk charges that maybe start off at 75 or 90 basis points, but drop down in later years, perhaps as low as 10–20 basis points. So to some extent, what we're seeing in the variable universal life (VUL) market is following what happened in the universal life market eight to ten years ago.

I'm jumping forward here in that it may not be too long before we start to see some use of retroactive bonuses or refunds. I'm not aware of any at this particular point. There might be one out there, but it's probably down the road. We also note that some companies are effectively dropping their M&E charge by either paying dividends on a participating policy or else providing bonuses. There is also a push for low cost-of-insurance charges in later years. And the final point we have is disappearing front-end loads, typically the sales loads, most on a current basis as opposed to guaranteed.

The final feature that gets a great deal of publicity, but I'm not sure there's much actual utilization, is noncommissionable term riders in which you can mix in a term rider with the lower compensation level. There is a lot of discussion, but I think at the end of the day it's only some illustrations, and I find that certain distributors are actually reluctant to use this particular feature.

Now aside from the retail channel we do see some variable life products being developed for special channels. First is a no-load for a fee-based financial planner or perhaps a direct response. There is no sales load either in a front-end or back-end basis. Two companies have come out with these products recently. I would not be surprised to see some more coming out down the road. I think this channel overall does offer something different. It's definitely getting more attention from the media. I think the pressure for fees will make more people aware of this. I think it's going to grow over time. I don't think it's going to become a major, predominant seller of life insurance, but I think that the fee base will increase over time.

The other product that we see is kind of the life complement to an annuity. The first might be single-premium life products being sold by distribution channels that are used to selling annuities (stockbrokers and independent broker-dealers). First is single-premium variable life. I believe that there definitely is a market for a single-premium variable life product comparable with an annuity product. A high proportion of the nonqualified annuities are going to be held until death. Single-premium variable, in many situations, is going to provide a better after-tax return on death than an annuity product. Some individuals may be better suited to that. We haven't seen too much; there's still a lot of discussion, but not much in actual sales. The obstacle is still the underwriting. Many agents that are selling the products are uncomfortable with the whole underwriting issue. We need to figure out a better way to get around the underwriting issue. Single-premium variable life also is more complex than an annuity product. But, essentially, the push here is to sell it as an annuity product with cost of insurance (COI) charges, say, 60–80 basis points. You also need to add some extra charges for your premium tax and your deferred acquisition cost (DAC) tax.

The other type of product is the seven-pay contract that avoids becoming a modified endowment contract (MEC). You do have life coverage. It's going to cost somewhat more than a single-premium variable life product, but the difference lessens with increasing durations. It's a good investment if you have some insurance needs, because it allows you to pull out the money near retirement, but it still is an insurance product, which is important.

Finally, there is the bank product. There was a lot of discussion earlier about banks selling life insurance. I think one of the big things we need to figure out is whether the sales are going to be protection-oriented or investment-oriented. I hesitated, John, when you asked if we have life insurance for savings. I think that's one of the big issues that the investment-oriented life insurance sellers must figure out. Life insurance is one of the important components. I think the savings aspect can play a part, but it should not be purchased, as you know, purely for investment purposes.

The other thing we see is that banks need to sort out the underwriting, as well, but the real play with the banks is that they're going to be able to leverage their existing client base to reduce their distribution costs, which will allow them to either increase the value and the return to the company or return a part of it to the policyholder. I think that's the real play in banks selling life insurance going forward. I would say that banks are doing very well in terms of making money—they're still trying to figure out their distribution and whether it makes sense to have a branch in every corner.

We'll finally note that variable products are also being used as a nonregistered product sold on an individual basis or to wealthy investors. They are trying to stay within the individual investor control areas, while also having some impact on the investment advisers and, also, on a group basis in which there is funding of deferred compensation and retirement medical benefits.

MR. JARDIN: For universal life or fixed annuity products, much of the innovation that has taken place recently has dealt with various riders, such as nursing home riders, which are there to cover risks other than savings. These riders have a "savings" element, saving the money that would be otherwise spent without the rider, but I think that we are better suited if we let discussion of, for instance, nursing home cover, take place in a panel discussion devoted to health benefits. My concentration will be on fixed deferred annuities.

Look at the advertising for annuity savings products in industry trade magazines such as the *National Underwriter*. You will notice something similar in these ads. The interest rates and the commissions are highlighted. This must be to entice the distributors with the high commissions and appease their consciences with the credited rates. Your company can sell a lot of annuity premium if you can just have the most competitive rate product and marry this with the highest commission rate; sounds like term insurance.

I want to talk about two risks that an insurance company has when it issues a typical no-load deferred annuity policy. A company either chooses to manage these risks or passes them off directly to its clients. The expense risk is the risk that the insurance company will not earn enough money to pay off the costs of acquiring the policy, either due to early lapse or inadequate spreads. The asset risk is the risk that the market value of the assets supporting the policy is less than amounts paid out from the policy. The first risk can be controlled through a surrender charge schedule. The second risk can be controlled through a variable product or by using a market-value-adjustment formula.

Variable products and modified guarantee annuities are somewhat complicated and pass more risk to some clients than they are willing to accept. The fixed annuity product, without a market value adjustment, is designed for these clients. Additional risk is accepted by the company on behalf of the client. The lack of a market-value adjustment means that the insurer has to find another, albeit less efficient, way to control this latter risk. The insurer should also charge some additional premium for this additional risk and accumulate this in a reserve until it is needed, although it is questionable whether or not the market will allow this additional risk premium.

Large surrender charges have a dual role for a fixed annuity product. It is true that they offset acquisition expenses, but they also double as a disincentive to early lapse. Thus, the insurance company can invest in assets of a longer duration than it could if the product had a negligible or zero surrender charge. The problem is that the surrender charge does decline and eventually disappear. For a product with a ten-year surrender charge, the insurance company is going to feel some pressure on its lapse assumption probably somewhere around the seventh year. This pressure, not surprisingly, will come not from policyholders as much as from the agents who can convince their policyholders that there is value in moving their funds.

The insurance company has to assess this increasing disintermediation risk as being real or not. If the risk is real, the company shortens up considerably on its duration of asset, which typically means a lower investment rate, which translates into a lower credited rate. The policyholder again sees the drop in credited rate, which increases the interest in and sometimes leads to a request for a replacement policy, a somewhat self-fulfilling prophecy. However, the insurance company should be in a relatively better matched position due to its decisions.

In a low interest rate environment, such as 1993, as the duration of the asset becomes very short, it is possible for the spread between the earned investment rate and the guaranteed rate in the policy to be insufficient to amortize the acquisition expenses. The insurance company might have capital gains from the restructuring of its portfolio to help compensate for the shortfall.

In a period of rising rates, shortening the duration of the assets has a doubly bad effect. First, there is the potential for loss on the assets sold as yield expectations increase. Second, because assets of longer duration yield a higher return than assets of shorter duration, the excess of what rate the competition can credit on new money over what rate the company can credit on old business widens. Guess where the competitions' new money comes from? On the other hand, if the company does not assess this risk of disintermediation as being significantly increased, its investment strategy will not change. It will find out in time whether it has properly assessed the situation or whether it has mismatched its assets and liabilities.

The second risk, that of the market value of the assets, can be somewhat controlled if the company can avoid the situation in which it is forced to liquidate assets quickly to pay a cash surrender value. If a company is forced to "pay off" a policyholder immediately at any time, its assets must be very liquid and must have a value that does not vary much with the interest or economic environment. The only alternative is to invest the funds very short, crediting a low, short-term rate to the client, which is very unattractive for clients who plan to keep their policies long term. If the policyholder keeps the policy in force and elects to withdraw funds on a scheduled basis, such as through a payout annuity, a longer-term investment can be utilized to support the liability. This election does not necessarily protect the company from asset risk, but it does allow for a more orderly disposition of assets.

The industry has developed the "two-tiered" annuity, which tries to address the situation described above by encouraging annuitization rather than cash surrenders. It does not necessarily encourage long-term persistency. The two-tiered annuity notionally credits a high long-term interest rate in anticipation of investing the funds in a long-term asset. This high-tier rate is not guaranteed, though. The policy must annuitize to earn this rate.

A low-tier or short-term interest rate is credited to the cash surrender value, which is available to the policyholder if the policyholder chooses to surrender the policy. The cash surrender value is all that is available to the policyholder who surrenders, even after keeping the policy in force for 20 years. Now, most two-tiered products are designed so that the credited rates to the annuitization value and the cash surrender value (CSV) are equal after ten years, but there still is a discrepancy for the first ten years. It remains to be seen whether the credited rates after the tenth year will be closer to a short-term or to a long-term rate.

Regulators have had particular difficulty in dealing with two-tiered annuities. The proposed standard nonforfeiture law for deferred annuities limits the maximum differential between the two tiers to 10% and limits the change in the ratio of the CSV to the account value from one year to the next. There is some concern on behalf of regulators that policyholders will be enticed to purchase such a product by the promise of high initial returns and then find that they are unduly penalized when they try to withdraw their funds.

This concern is justifiable but not unusual for an industry in which all products are built on trust; to try to legislate away the features of this product by artificial restrictions is not correct. The regulators do not like the "trust-me" response that companies give anxious policyholders who ask about future credited rates and the like. They worry that policyholders could be exploited by unscrupulous parties. The same could be said for any fixed annuity in which credited rates are established solely by the insurance company and for quite a number of life insurance products.

I view this situation not unlike the purchase of participating whole-life products in which the dividend scales are at the sole discretion of the insurer. The whole-life "illustration" that attracts or helps finalize the sale plays a similar role to the high-tier rate for the annuity. In fact, although the illustration is not guaranteed, the bonus rate usually is if the policyholder elects the associated options. I find it interesting that some insurance companies that have survived and flourished with participating whole-life policies have such a low opinion of two-tiered annuity products. What is of the utmost importance is that there is proper disclosure about the terms of any life insurance or annuity product.

The proposed nonforfeiture law will eliminate much of the flexibility in policyholder values introduced by the two-tier approach, with the probable outcome of forcing companies to offer modified guaranteed annuities with market-value adjustments. I suggest that each of you review the latest versions of laws and regulations affecting not only annuities but also life insurance. There is a growing concern that the NAIC wants to exercise as much control as possible over the nonguaranteed elements in our policies and contracts.

The two-tiered annuity can help but does not fully insulate an insurance company from asset risk. As a reinsurer who is involved in assisting companies in this business, I find this risk most difficult to deal with. A catastrophic event may occur if interest rates spike sufficiently. This is perhaps equivalent to the risk of a widespread plague for a life insurance company, the risk of perhaps a depression for a disability income writer, or the risk of a hurricane or earthquake for a property insurer. Property insurers calculate probable maximum losses based upon scenario testing of their blocks of business situated in high-risk areas. It is possible that the methods used by property insurers could be transferred to our business. On the other hand, one advantage that we have over a property insurer is that we can manage the in-force portfolio in response to market conditions. Our options may be limited, but we do have some. This is better than being a property insurer in an area just hit by a hurricane. Options in that case are extremely limited.

Modified guaranteed annuities with market-value adjustments can deal with the disintermediation risk in most cases. These annuities adjust their cash values to reflect the change in interest rates from the date purchased until the date of surrender, unless the

surrender takes place on the term of the annuity. In no case, though, can the account value be less than the original principal. With the proper investment strategy, the insurance company can better quantify and control its risks under this type of annuity and guarantee a long-term return to the client as long as the policy stays in force. The timing of when a client surrenders the policy should have little bearing on profit and loss. This should mean that the insurer should be able to pass on a better deal to policyholders who behave as expected, such as those who keep their policies for the term of the rate guarantee. We must wait to see if this proves to be the case.