

RECORD OF SOCIETY OF ACTUARIES 1995 VOL. 21 NO. 4B

WHERE'S THE MONEY GOING?

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Recorder: JOHN M. FENTON

This session presents an interview with financial industry experts on the ways in which consumers allocate investment and insurance dollars. The interviewees will examine factors that contributed to the 1994 industry results. Are there any continuing trends? What are the key factors that influence consumer decisions? How do these factors influence product development?

MR. JOHN M. FENTON: We have assembled several industry experts to look at issues related to where consumers are spending their investment dollars in the life insurance industry. We know the annuity market continues to be a big part of the life insurance industry. Total premiums in 1994 were approximately \$95 billion, which includes fixed and variable individual business. This is up from roughly \$50 billion in 1990; therefore, we have seen considerable growth in the market over that period of time.

On the other hand, life insurance sales over the past few years have been generally sluggish, and the life insurance product has faced increasing pressure from mutual funds, annuities, and CDS for consumer savings dollars. I would say that variable life has been the one bright spot, with the market share increasing from about 7% in 1990 to over 20% in 1995.

Our panel is going to help us examine the issues of where customers are putting their money, which factors have led them to choose these particular products, where they will likely choose to put their money in the future, and how all these factors influence the products that we as actuaries help to design.

Our first speaker is Rick Carey, editor of *The VARDS Report*. *The VARDS Report* is a comprehensive monthly analysis of the variable annuity industry covering fund performance, contract feature information, company and product sales, with market share and articles on the market. VARDS stands for "variable annuity research and data service." Prior to starting VARDS, Rick was a practicing registered investment advisor specializing in individual and pension mutual fund management. Rick is the founding board member of the National Association for Variable Annuities (NAVA) and co-editor of the bimonthly publication *Variable Annuities Outlook*.

Our second panelist is Michael Lipper. Michael is an acknowledged expert in the mutual funds field and chief executive of Lipper Analytical Services, the leading provider of data and analysis on the investment brokerage business. He is the former president of the New York Society of Securities Analysts and he currently serves as the director of the

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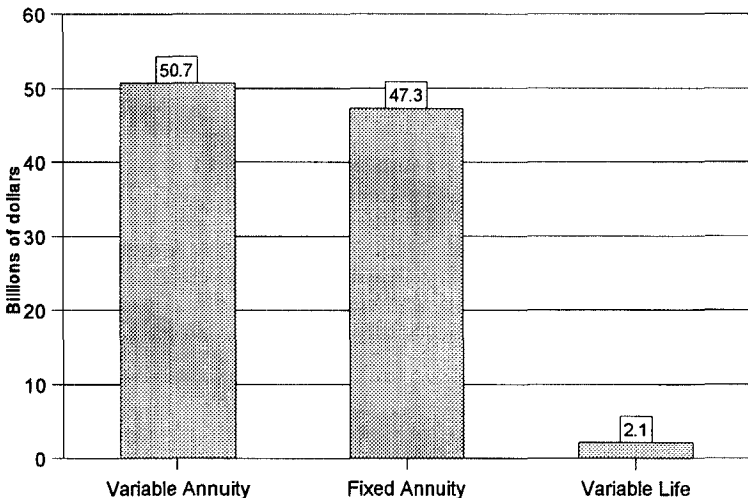
International Society of Securities Analysts. His firms are members of the New York Stock Exchange, the Investment Company Institute, the Association of Unit Trust and Investment Funds, and others. With data going back to 1959, Lipper Analytical currently tracks performance of over 15,000 worldwide funds with assets in excess of almost \$3 trillion.

Our third panelist is Craig Raymond. Craig is vice president and chief actuary for ITT Hartford Life Insurance Company. At Hartford, he is responsible for all corporate actuarial functions, including the oversight of actuarial policy, product design, and pricing, and the valuation of reserves for Hartford's direct life insurance operations. He is a member of the AAA's Life Committee and the Vice Chairperson of the SOA Financial Reporting Section Council.

Rick, there has been a great deal of talk about variable annuities and fixed annuities and the market moving up. What has been the overall trend in sales would you say in 1994 for those products, as well as for maybe variable life?

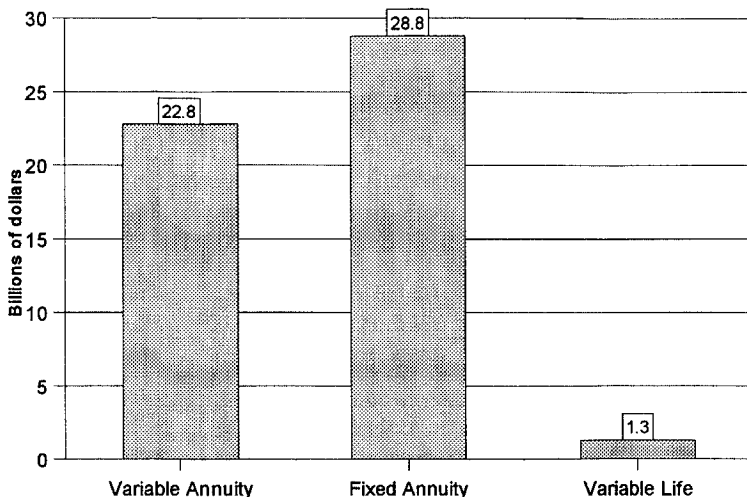
MR. RICK CAREY: Chart 1 shows 1994 sales by product. Basically, over the last 16 months (with the exception of the last quarter), variable annuity sales have been down, and fixed annuity and variable life sales, as you might expect, have been up. In 1994, variable annuity sales were up only 9% over their 1993 volume and that was the smallest gain that we have had since 1988. In 1994, fixed annuities were up 22% from \$38 billion, and variable life was up 4% to \$2.1 billion. By midyear 1995 (Chart 2), variable annuity sales were at only 45% of their 1994 volume. Keep in mind, 1994 was the smallest gain that they had seen since 1988 and by midyear 1995, at only 45% of their 1994 totals, they were still lagging behind as of midyear with fixed annuities and variable life products. As I mentioned, the second quarter of 1995 was the first quarter of the last five that variable annuity sales actually rose.

CHART 1
1994 SALES VOLUME BY PRODUCT



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CHART 2
MID-YEAR 1995 SALES VOLUME BY PRODUCT



I have obtained the fixed annuity numbers from the Life Insurance Marketing and Research Association (LIMRA) and they came in at 61% of 1994's total. Variable life, which we track, came in at \$1.3 billion and that is at 62% of 1994. Again, as of midyear, we still have the fixed and variable life moving ahead percentage-wise on the variable annuities.

MR. FENTON: What factors would you say have influenced the trend of results over the past year or so?

MR. CAREY: I think it is quite obvious that interest rates started to rise early on in 1994. There has been a tremendous move over to the fixed accounts. There has been a tremendous interest in market-value-adjusted accounts. You had a tremendous interest in much of the hybrid variable annuity products such as your indexed variable annuity product lines. I think this provides a good example of how important having a fixed bucket was in a variable annuity. The MVP award for variable annuities in 1994 and in the first half of 1995 went to those products that had market-value-adjusted fixed accounts. There are two products in particular that were in the top 15 variable annuity contracts, and neither one has a fixed account in them that is indicative of how variable annuities sales have declined. The Merrill Lynch Retirement Plus product's midyear sales this year were only 14% of their 1994 totals. They came in at \$225 million in sales versus \$1.6 billion in 1994. The Allianz Franklin Value Mark midyear sales were only 22% of the previous year's sales; they came in at \$531 million versus \$2.4 billion. Those are two products that, combined together, have lost almost \$2 billion in sales as a result of not having a fixed bucket or a market-value-adjusted account in them at all.

MR. FENTON: Looking forward, interest rates right now are relatively low, which help drive good fund performance in the equity markets. If we looked ahead a year and looked at a scenario where interest rates were to rise 100 or 150 basis points, how might that impact the market?

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MR. CAREY: If they were going to rise, I think the pattern that we have seen would continue, but both for fixed annuities and variable life. Variable life has picked up quite a bit. We are quite surprised at the increase in variable life.

MR. FENTON: There has also been a great deal of talk in articles written in *The Wall Street Journal* and consumer magazines about downward pressure on fees. Do you expect to see that happen? Rick, what are your thoughts in this area?

MR. CAREY: If we take a look at some of the charts that I have on distribution channels, you will see that the direct sales right now are only running about 3% of the total variable annuity sales amount. Right now, the top 25 variable annuity products control almost 80% of all the sales volume in the country. There are 225 variable annuities out there looking for cash dollars, but the top 25 are taking down 80% of the total sales volume every year. You have many products that are not doing very well, to be quite frank. What we found when we did an analysis of the top 25 variable annuity products is that you had some of the most expensive products along with some of the least expensive products in there. The one commonality that fit into all of those top 25 variable annuity products was the reputation of the investment manager and the performance results. That is what drove many of those products. There was not a great deal of price sensitivity at least for those 25 that controlled 80% of the market. Price sensitivity is much more important in the direct sales. It is much more important in your fee-only planner sales and that is where you see price sensitivity. But at this point in time, the price sensitivity as it is related to the overall product line is a very small portion of the total variable annuity sales.

MR. FENTON: There has been much talk about distribution channels that are used to sell variable annuities. What distribution channels are being used and what have the trends been over time?

MR. CAREY: If you look at Chart 3, you'll see the 1994 distribution of the variable annuity product line from midyear 1995 and then I have put in our projection towards the year 2000. There are a number of variables that I know Craig is going to discuss which probably will get into what that distribution is going to look like in the year 2000. But in 1994, 46% of variable annuity sales came from captive agencies at what I call controlled distribution (Chart 4). That would be sales from companies like Massachusetts Mutual and Northwestern Mutual. Close to 7% came from banks, 3% came from direct sales, such as the Fidelity product, 12% was from regional investment firms, 16% was from New York wirehouses, and 16% was from the National Association of Securities Dealers' (NASD) independent firms.

If we go to midyear 1995 (Chart 5), we can see the shift that had taken place. Those two products that I just mentioned, the Franklin Value Mark and the Merrill Lynch Retirement Plus product, have lost almost \$2 billion in sales over the last year and have contributed to the decline of the market share highs for the New York wirehouse groups. They are down 5% from the end of 1994. Your captive agencies and controlled distributions are up 5%. Banks went up 1%. Direct stayed the same at 3%. Regional firms gained 2% and independent NASD firms lost 3%. For products like the Franklin Value Mark and other ones similar to that, their life blood is in either the New York wirehouses or those independent NASD firms.

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CHART 3
THE VARDS REPORT
PROJECTED VARIABLE ANNUITY SALES THROUGH THE YEAR 2000

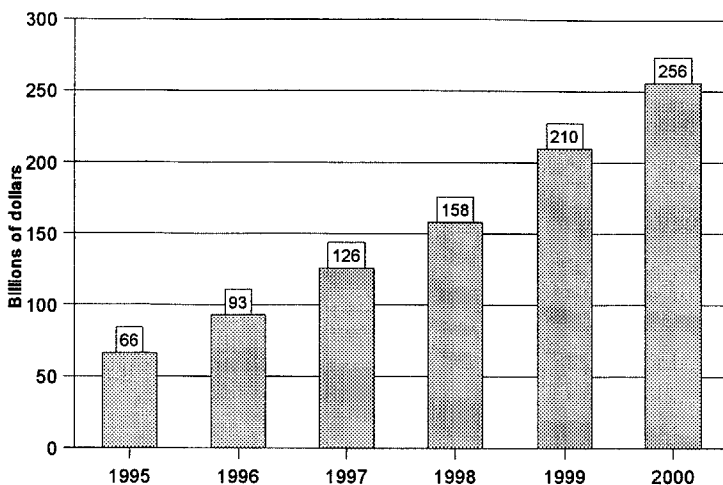


CHART 4
THE VARDS REPORT SALES BY DISTRIBUTION CHANNEL 1994

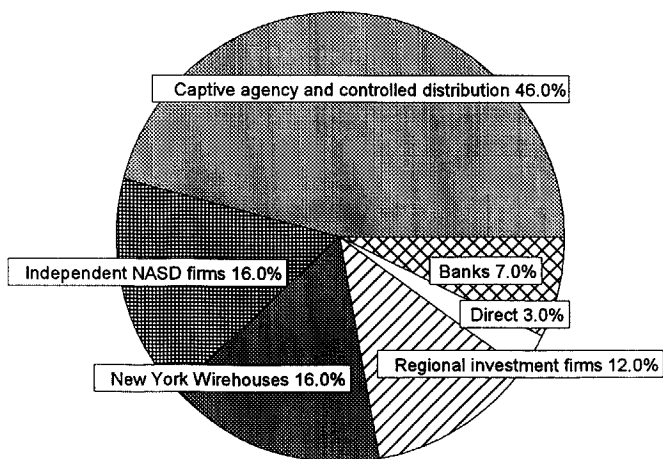
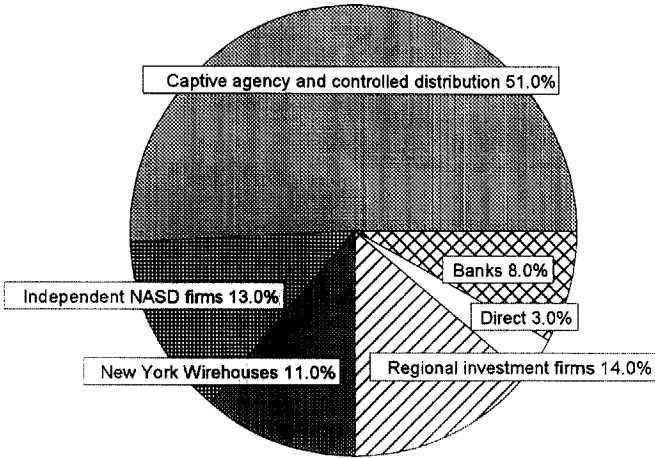
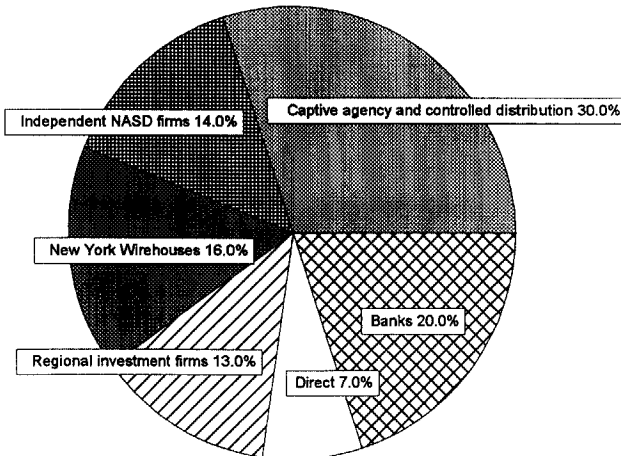


CHART 5
THE VARDS REPORT—SALES BY DISTRIBUTION CHANNEL
MID-YEAR 1995



Let us take a look at the year 2000 (Chart 6). Again, much of this gets back to what is going to be happening in the flat tax and the interest rate environment, but we see a large increase in the banks going from their current 8–9% to about 20% by the year 2000. We think that the captive agencies will go down somewhat. New York wirehouses should return to where they have been in the past and direct will probably rise slightly, but not a great deal. We never expected direct sales to increase dramatically, although things like prospectus simplification, or other things going on in that area could definitely benefit the financial planner markets and the direct areas.

CHART 6
THE VARDS REPORT—SALES BY DISTRIBUTION CHANNEL
PROJECTIONS FOR THE YEAR 2000



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MR. FENTON: Why do you think banks will become a much bigger part of the variable annuity market by the year 2000?

MR. CAREY: The Variable Annuity Life Insurance Company (VALIC) case is one good example. You have 225 variable annuity products out there looking for an increase in market share, but you still have the top 25 controlling the significant amount. Several companies, National Home Life for example, came out with a whole new trio of variable annuity products last year, and many companies are looking to find some niche markets. Companies have tried to make it in the New York wirehouse marketplace and have not been successful. There is tremendous success in the banking distribution such as Keyport. A big focus is in that area, both from proprietary and also from companies that are going in and doing more customized work with banks.

MR. FENTON: Rick, let us talk about the factors that influence consumer purchasing.

MR. CAREY: Again, I noted that consumers are looking for price sensitivity. Although I think that they are price sensitive and their awareness of variable annuity products has grown dramatically over the last three to four years, I still do not think that they shop the market unless they are in the direct purchase area or the fee-only planner market area. I do not think that the consumers are as price sensitive as one might expect, as evidenced by the continued success of products that are in the top 25 and have total loads that are greater than the national average. Again, it gets back to investment management reputation and performance.

MR. FENTON: If you had a crystal ball and were to look forward five or ten years in the future, where do you foresee the variable annuity market?

MR. CAREY: I think there is going to be a tremendous amount of consolidation in the variable annuity marketplace. For those 225 products that are out there searching for market share, whatever their critical mass might be at their individual companies for maintaining the back room operations, for maintaining the product line, I think there is going to be a tremendous consolidation that will probably take place in the variable annuity marketplace over the next two or three years. I think the issues that we are going to discuss today on flat tax certainly have a tremendous potential certainly for damage in those areas. If people proceed to flat tax with something coming in to play that is going to be seriously considered, that could, in effect, dampen sales of tax deferred products as we go through this process. Again, I think you are going to see more and more bank products, particularly proprietary bank products, that are designed for those individuals that shop at those banks.

MR. FENTON: Are there any other design changes that you foresee in the product side?

MR. CAREY: Right now all of the variable annuity products we have can fit neatly into one of six cubbyholes (Table 1). Included in the table are the asset-based charges for each group. Those are the mortality and expense risk charge, the administrative fees, exclusive of any separate account fees which include the management fees and other expenses of the separate accounts. We have general retail contracts. You have fee-only planning contracts. I think there is going to be more work in this area in the fee-only contracts you have.

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Companies such as Skandia have designed products that are very similar to direct sales products. They do not have a front-end or back-end load as far as a sales charge is concerned. They have a lower mortality and expense (M&E) charge. They have a lower load on the total asset-based charges and they allow for the registered investment advisor to take a 1% fee for investment management out of the assets of their management. There are a great many controversial issues that could come up regarding whether or not the company wants to be paying 1% investment management fees to registered investment advisors involved in that. I would think most companies would presume that they would not want to be involved with that, but there are many more product designs that are trying to go after the fee-only. That is where you see the price pressure on swap products and things like that. As far as pricing, bank-targeted contracts run the gamut from very reasonably priced to relatively expensive, and it does not have anything to do with whether it is a proprietary product or a retail product that is brought into that banking channel.

TABLE 1
THE VARDS REPORT
VARIABLE ANNUITY PRODUCT TYPES
AND AVERAGE ASSET BASED CHARGES

| | |
|--|------------|
| General retail contracts | 1.00—1.40% |
| Fee-only planning contracts | 0.65—0.90 |
| Bank targeted contracts (retail and proprietary) | 0.55—1.40 |
| Immediate variable annuity contracts (IVAs) | 1.00—1.40 |
| Asset allocation contracts | 0.80—1.40 |
| 403(b)/401(k) group contracts | 0.45—1.00 |

One area we hoped would grow into an area of work for the insurance industry, especially in light of the potential for a flat tax, is immediate variable annuity contracts. There are not many immediate variable annuities out there. When Fidelity came out with its immediate variable annuity contract that you could not use in a deferred mode, it was a major step by a major company. But, the amount of variable annuitization that takes place is relatively low.

Companies are experiencing an increase when they focus on annuitization. Aetna's variable annuitization rate has risen quite dramatically, but for most companies, it is still relatively low. That has a potential for tremendous growth as the baby boom generation matures. I do not think that we are going to see a tremendous growth in individual deferred annuities, but immediate variable annuities is a great growth area.

Asset allocation contracts are basically those kinds of contracts that have predefined, premixed plans involved in them, perhaps from Michael's organization. A large amount of work is being done in those areas. There are also many fee-based, fee-only planner products that also take a flavor of asset allocation, allowing the registered investment advisor of a fee-only planner to be involved in that asset allocation process. The 403(b) and the 401(k) marketplace continues to be very strong. Half of your annual variable annuity sales are coming from the nonqualified area and roughly half are from the

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qualified area. I think the 401(k) and the 403(b) area has been an area of tremendous growth. Much of the successful variable annuity contracts that did well through this high interest rate market environment were in the 403(b) or the 401(k) area. They came in with bonus interest rates on their fixed account, pulled money in, and retained money from that perspective.

MR. FENTON: There has been a great deal of talk, Rick, about guaranteed minimum death benefits on variable annuities, a very popular feature. How important is that to consumers relative to the agency selling?

MR. CAREY: Truthfully, that is a question I am not sure I want to answer. I think it is important, but when we get down to it, it is still the tax deferral, the investment management, and the opportunity to be able to transfer and take profits within the various mutual funds that are internal to the variable annuity and not have to pay current capital gains or pay current tax on the profits that may be taken. The minimum death benefit is much more important in some cases where it is used for estate planning and that is an area that we certainly are not involved in, but I would say that it is probably much more important for the agent from a sales standpoint.

MR. FENTON: I know we have some companies here who have significant guaranteed minimum death benefits. Would you care to make any comments or reflections?

MR. CAREY: I will give you my opinion on that. I do not think the guaranteed minimum death benefit, as far as the product that the consumers are buying, is all that important. I think more than anything else the continuing battle within this market is to differentiate yourself, and the guaranteed minimum death benefit was a new bit of glitz to add on to the products. It does offer some additional benefits to the policyholders, but the real issue has been just a way of differentiating and showing something else to sell. I think the biggest advantage of the benefit is to try to help lock in the persistency on these products. That is where they started in the first place, and there is more of a persistency motivator than anything else. I think that is still part of the motivation, but I think it is a combination of the companies looking for ways to increase persistency and just a way to differentiate yourself. The customer buying the variable annuity probably does not really understand the benefit of it, other than it is something extra he or she gets.

What's probably more important (and this gets back to possibly the potential for immediate variable annuities over the next 10–20 years), and I think what is more appealing for probably all age groups is the ability to not outlive your income stream. However, we are not at the point where we are going to see any tremendous increase in immediate variable annuities, at least not for another 7–10 years.

MR. FENTON: Let us switch gears and put Michael Lipper into the picture. Michael, you have done work in the mutual fund industry over time and also have taken a look at the variable annuity industry. How would you say that the typical purchaser of a variable annuity compares to the typical purchaser of a mutual fund?

MR. A. MICHAEL LIPPER: I think there are a number of differences and that is important because I think many of the selling organizations do not have to make a choice of funds or variables. I think the proper strategy is both. The variable buyer, as distinct

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from the mutual fund buyer, for the most part is retirement plan oriented. Often the mutual fund buyer is just capital-gains oriented without a specific plan. Second, I believe that the variable buyer accepts that they need help, but the fund buyer in a no-load mechanism believes that they have the requisite knowledge. I am guessing that the variable buyer is younger and is certainly more risk adverse. Those are the principal characteristics that I perceive.

MR. FENTON: It is interesting you say that. I know it is based on your perception and there are no hard facts, but with the variable annuity buyer being younger, what types of funds is the typical mutual fund buyer purchasing?

MR. LIPPER: The typical mutual fund buyer—and this is weighted in terms of dollars, and we are excluding the involuntary buyers through the 401(k) plans—is 50–55 years old and probably buys a mix of products. If we compare that with the variable annuity buyer, and I am excluding in my analysis of variables, at least for the moment, the fixed account—not a fixed-income variable, but a fixed account—he or she puts 61% of his or her money in variables in general equity funds. These are largely domestic funds that are not particularly concentrated in any one sector. For the mutual fund, it is 31%. Another major difference is in the flexible, where you let the manager decide the allocation. The flexible in variable is 15%, whereas in mutual funds it is 5%. I think there is a real distinction in how they are investing.

Both of these types lack appropriate further analysis in this sense. We never see all the money of any account. These percentages are internal percentages to the piece that we see. I am willing to bet, particularly as people's wealth grows, that they do not have as much as 50% with any one intermediary. I think we have to be a careful about how we draw conclusions.

MR. FENTON: You are saying the mutual fund figure was approximately 30% into the equity accounts?

MR. LIPPER: Thirty-one percent into the general equity.

MR. FENTON: Do you have any idea where the remaining 69% is going?

MR. LIPPER: Sure. One of the major differences here is that on the fixed side for mutual funds, you have roughly 13% in taxable fixed, 15% in tax-exempt, 25% in money market funds, and 9% in specialty or sector funds. Again, it is my view that variables are used almost exclusively for retirement plans or perhaps spilling into an estate plan vehicle. Certainly the 25% that is in money market funds will never go into equities or even long bonds. This is escrow money, either officially or unofficially. It is money that is being parked or waiting a purchase that is not securities related.

MR. FENTON: A number of the variable annuity funds that are offered are similar clones to the mutual funds that are out there. Yet, I understand that for the similar type of fund, there can actually be differences in the performance. Is that true and can you comment on that?

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MR. LIPPER: Yes, we think it is true. As a matter of fact, at the recent NAVA meeting, I commented that we had a large number of clones and we saw that the variables performed better than the funds on a very high percentage of them. This was based on the pre-expense level, where we adjusted the returns for all expenses. I guess the logical question is, why? We believe the reason is primarily, but not exclusively, cash flow. In just about every case where the variable has performed better, it has had a higher percentage of net flows in as a percentage of beginning assets than the mutual funds. Or if it had redemptions, it had a smaller outflow. In and of itself, this gives the variable a tremendous advantage.

MR. FENTON: We are probably more familiar here as a group with the persistency flows on annuities; can you comment on a mutual fund? What is the typical sales and redemption pattern over time and what are the factors that might influence it?

MR. LIPPER: We do not use the term “mutual fund industry” because, as an analyst, when I was starting back with Adam, the whole idea of an industry was that companies did things the same way. They kept their books the same way, and the motivations were the same, but this is not true in the mutual fund business. There are no two groups that are identical in terms of product line. As a matter of fact, there is no decent functional cost accounting in the management company business. It is very difficult to make comparisons.

When you look at holding periods in terms of dollars—and remember the only way we can do it is by measuring dollars, but that does not give you necessarily the right answer in terms of accounts—you go from a fund sold by a proprietary group, such as what we used to call IDS, which is now American Express, or an old dealer group such as Lord Abbott or the American Fund. There you will find holding periods in the 15–18 year range. At the other extreme, you will find a holding period of three years for a number of no-load funds. The mathematical dollar-weighted average comes in between five and six years, but we see it vary all over the map.

MR. FENTON: On the no-load funds, where is that money going after three years?

MR. LIPPER: Much of it rotates maybe within the same family or into another family. We suspect that a good sum of it actually gets consumed. We think many of the no loaders then go out and buy cars or homes. We think that, in addition, they may feel so bright that they can enter the securities market directly themselves.

MR. FENTON: Rick has talked about the qualified money and the fact that on the variable annuity side, approximately 50% is coming from qualified sources that include 403(b), IRA rollovers, and some 401(k)s. How important is qualified money and the different types of qualified money in the mutual fund sales?

MR. LIPPER: In Boston, it's very important; in other towns, it's less important. The 401(k) market—and I am including in that description 403(b) and 457, but not IRAs—is dominated by roughly a half a dozen fund groups, and as with most things in this business, it is led by Fidelity. It is very important to those half dozen groups. It is far less important to the others. One of the key elements on the 401(k) business is we question whether on that piece of business any of the groups are profitable, as they are constructed today. We think they are in that business hoping for a persistency and hoping for the rollover.

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MR. FENTON: Is the movement of 401(k) funds driven by the employers or employees? What are the factors?

MR. LIPPER: You first have the drive to get out of the liability of a defined-benefit plan and move to a defined contribution; that is very heavy. We think it may get overdone. Once you are into the defined contribution, the employee benefit people seem to think that daily valuation is absolutely critical. Having said that, you have almost locked yourself into a mutual fund or you could be in the fund that is a variable; nevertheless, you need a fund-type vehicle with a daily price. I think that is a major drive. The next drive is whether you are in the newspapers and whether you are a recognizable name. One of the problems I would suggest for the variable business is that you must figure on ways to shorten your names. For those of us who have to deal with those who buy ink by the barrel (the newspapers), we have, depending on which paper, 15–25 characters to represent your entire name. One of our issues is by the time we abbreviate the name, unless you know the name, you really cannot translate it. I think that is an issue.

MR. FENTON: Let me talk about mutual fund product design. I think most people are familiar with what a typical variable annuity fix looks like. It tends to have no front-end loads. It tends to be back-end loaded or have a contingent deferred surrender charge, which might last for five to eight years. It would also have asset charges, both investment advisory, as well as the M&E charge. Can you talk about what was a typical mutual fund product five years ago, what it is today, and where might it go in the future?

MR. LIPPER: Again we do not have much that is “typical,” but let me go to extremes. Certainly 10 years ago there was a large group of funds that were selling on the basis of the maximum allowed sales charge, which was 8.5% of the money that was put into the fund. I have always been delighted that no one ever actually figured out that 8.5% was really 9.3% when you compared it to the money that actually went in. You certainly had some no-load funds; there was not much in the middle. What has happened is the pricing structure has truncated and most of the products are between 3.0% and 5.75%. There are still some pure no-load funds, and there are some about 5.75%, but not much there. The offset clearly has been the growth of 12b-1 funds, which have asset charges. In our last analysis (which was through the second quarter), the 12b-1 funds actually produced more sales than the funds that were not 12b-1. This is the first time in history that has happened and we think that it is going to continue.

MR. FENTON: A typical variable annuity has a wide range of funds. I guess the current average is probably 15 funds generally in either several different mutual fund families or one family. There are some products up there that are as high as 35 funds.

MR. CAREY: There are 42 funds.

MR. FENTON: Where do we likely see the new fund type emerging on the mutual fund and/or the variable annuity business going forward?

MR. LIPPER: I think what we will see on one hand are new funds coming out as a result of developing more flexible pricing approaches. In effect, any large player, be it a consumer or a dealer, will be able to strike their own deal. On the other side, you will see a great deal of creativity in terms of portfolios. Some are designed to produce lower

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volatility, some are designed to key off of certain dates, and some are designed to capture a specific effect, such as a small company, January, neglected security, and other similar effects. How much of these new products are going to be products that are really different, rather than just having distinctions for marketing purposes? We will have to see.

MR. FENTON: Rick, do you have any thoughts on the variable annuity side, your perspectives on the funds and what might emerge over time?

MR. CAREY: I certainly would agree with Michael, and I think we are going to see a tremendous increase in the asset allocation area and the fee-only planner market area, where the investment advisor can collect his fee from management charges. There seems to be a tremendous amount of development in that area. The Schwab product itself is a good example of that. They have had steadily increasing sales, although they are not dramatically increasing. I think that is a big area and I think a much of that will carry over from pricing fund options into the bank marketplace for the bank consumer. The products that are into those distribution channels are ones that need to be designed from the ease-of-purchase standpoint, where the banking customer goes in and the variable annuity has to be sold; it is that complicated. What do you do to make that process easier, more of a seamless transaction, with a flow of funds between banking customers funds in the bank? Michael, you may have some comments on this, too. The issue of the variable annuity marketplace moving itself into a national clearinghouse format may have an impact as well.

MR. LIPPER: We were contacted by a potential group that wanted to do that. We think that the issue will be the broker-oriented products, and because of their experience with NSCC they are likely to play, but we think the insurance groups are very unlikely to play. We think it is going to be very uneven.

Rick, you have mentioned the bank channel. We believe that the variables and not the mutual funds should be the principal product that banks should sell. However, we think the majority of present delivery systems in banks will fail because they do not train their sales people effectively. We think that as far as we can tell, the product that is selling in the banks under the variable label is a fixed account again, not a true variable. That has to do with interest rate shock, and in the long run, it is not going to produce enough earnings to meet the retirement needs. We may be seeing the banks, contrary to my earlier comment about variables being sold to the younger people, selling to older people. The banks that are selling most effectively are old savings bank locations where people are used to coming in and waiting in line for their money, and they are used to that location. They are used to somebody at the bank explaining things to them. We do not think the younger ATM-oriented commercial bank user is a probable buyer of a variable product through a bank. Therefore, it is probable that the variable sales through banks are going to be made in more areas of the country that do not have a federal reserve branch bank.

MR. CAREY: I might make one comment on the committee of annuity insurers. Many of you are aware that the Gallop Poll conducts surveys for them, and they found that the average annuity buyer was age 63 and was using the variable annuity for such things as nursing care coverage.

Getting back to the banks, I think if we look at distribution channels, some of the companies that tend to get out into these areas that you were talking about (groups such as

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E.D. Jones), have had tremendously viable, rapidly increasing, and growing groups that have offices in the rural areas and in smaller communities, as opposed to the regional firms such as A.G. Edwards. Many of the banks have made good efforts to hire training staffs and go into the New York wirehouses such as Merrill Lynch and others. There has been quite a movement of employees from the New York wirehouses into some of these banks, but I do not think it has been broad-based enough. It is a good observation though on banks not being able to sell the variable annuity product in their currently trained staffs.

MR. FENTON: Let us turn now to our third industry expert. There has been a great deal of discussion recently about flat tax, and there has been a variety of tax ideas that have been put forth in Congress earlier this year. A key element of the flat tax is no tax on any type of investment income, meaning that the tax deferral aspects of annuities and life insurance would have no value. More recently there has been other tax proposals talking about the lower capital gains tax rate. What would the impact be on the life insurance industry? Is this going to happen? What are your thoughts on this?

MR. CRAIG R. RAYMOND: I have a difficult time believing that the type of broad sweeping change that is usually associated with a flat tax can ever be accomplished in this country. I would not be surprised if we see something that gets billed as a broad sweeping change, but it's similar to the last time, when we overhauled the tax law. Something that is usually billed as tax simplification always ends up getting everything else to creep back into it. We have so much social policy and business preferences tied up within our tax laws, it is difficult to believe that we will have a major change that ends up simplifying them. I think if we do get something that goes as far as eliminating the differences in the tax advantages between life insurance and other insurance products, it could have a drastic impact on our industry. The question is, Is that a good or a bad thing?

Much of our industry has moved towards selling much more investment-oriented products and that is a difficult area for many of us to compete in. The one thing that would clearly happen is we are going to move back to the basics of what insurance companies do well and that is selling protection. Much of us sell death protection, but we also find that the money is a lot easier to get your hands on if you are selling other things. If this happened, we will no longer see billions of dollars of annuity sales, but there are other things that we will do. We will talk about payout annuities, and I think those will pick up drastically. The difficulty is finding ways to sell that. That is the type of thing we need to find ways to sell.

If we get some kind of a change to more of a flat tax, but we still have tax preferences in what we do, I would be surprised if there is a serious impact. I have heard the comment a number of times that a flat lower tax rate would have a big impact on us. Most people I have talked to are fairly skeptical on whether a flat tax would really be lower than we have now, and I actually have heard comments that it could be good because it would be higher. Overall, I think one of the things that we need to continue to focus on as an industry is what we do well. Most of us spend a great deal of time and money coming into the insurance industry and being driven by investments. I think when you look at what insurance companies do well, we have to start competing against mutual funds and other organizations, we do not necessarily handle investments all that well and we definitely do not handle customer service for investment-oriented products anywhere near as well as our competitors do. That is something we have to get better at if we want to be competitive in

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a more level playing field. Our standards are nowhere near as high as they need to be for customer service.

MR. FENTON: Michael, did you have a comment on this?

MR. LIPPER: The job of an analyst is to think the unthinkable thoughts and carry something to an extreme. Let us say we have the flat tax and do away with any investment preference. I still think that many of the organizations represented at this meeting have a very real function. Let us go back to basics. Having insurance means essentially somebody else is saving for you. If you had sufficient savings, you would not need insurance, but because most of us do not, we need insurance. I would maintain that the insurance business is a savings business.

Let us take a look at a couple products that are very old, but to this day continue to be sold and are very profitable. The first is the Christmas club. There is no analytical reason why they exist, but they do because there is a human need to enforce savings. The second one is the old-face certificate program of IDS and Waddell & Reed; to this day they are selling those products. Yes, there are some bonus provisions in them that bring the rates to being somewhat competitive, but they are not selling on rates, they are selling to everyday people who need to save money and this is a way to do so. I think if this day does come, that is, pulling out all investment preferences, there is still a place for the insurance business that has effective selling power.

On the other side, I think we are going to do just the opposite. We are going to sponsor investing. If you look around the world, there are two elements in why we tolerate governments. The first is a military police power that we feel we need and those are typically enshrined in the constitution. The second is never in the constitution but is the thing that causes political upheaval—jobs. You do not win elections with unemployment going up. We live in a society that already has a reasonably high level of structural unemployment. If you look at our educational process, you'll see unemployment is guaranteed to go up. You look around the world, you see the same issues. When we have moved away from state control, be it on the Right or the Left because it did not work, people have found that the government sector cannot create jobs as the employer, but what they can do is sponsor the private sector to create jobs. Creating a job for somebody who flips hamburgers means the capital cost is something like \$25,000 per job. Our society needs to create that capital and make it available so that jobs are created. While we may have radical changes in taxes, I would suggest to you that we will be actually sponsoring investment long term. It may come in some different form. I am not as concerned long term about the potential of this flat tax and removing investment preference; however, if it does come, I think the Warren Buffets of the world will have some wonderful opportunities to buy some great sales forces and good balance sheets at deep discounts.

MR. CAREY: The key question is, What products are they going to sell?

MR. LIPPER: I just said I think you can sell a savings product. I think you can go back to the origins of many insurance companies, which is in burial insurance. I think there are a number of things that you can do and the market will decide whether they are variable or fixed.

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MR. RAYMOND: That is an interesting comment and it follows up on some of the comments I made. Basically, I think you are saying that we sell promises and certainty. It is interesting, though, that when we listened to the earlier conversations, some of the comments that Rick made, one of the primary issues in the annuity market today is, who is your investment fund manager? That does not seem to have much to do with what we sell and where we need to be positioning ourselves long term.

MR. CAREY: I would like to get the opinion of the panel as far as immediate variable annuities into the future. It is too early to speculate as far as where that will be, but I think baby boomers, especially if you take a look at where they may stand with regards to social security, are going to need to have additional income. The concept of not outliving your cash flow should play very well and that kind of product could play very well into the future of the country, again some years out. Do you see, Craig, from Hartford's perspective or Michael from Lipper's perspective, a tremendous value there? I am sure there is a value there, but can that be translated into a profitable product line?

MR. RAYMOND: I love the product. I think it is a great idea and I think it goes back to looking at needs and looking at what we can do differently. We can provide the guarantees. We can provide certainty and when you bring the variable concept in, you can bring a way to try to add some value and try to add some additional growth to the policyholder. I think you are right. I think it is off in the distance because it is a little early. Still there is too much money to get your hands on; that is you're looking at accumulation, not payout.

However, as we move forward, more and more of the market is looking at payout. I think a large number of us became very heavily involved in the deferred annuity market, although we were all certain that we would be able to keep our hands on this money even until the payout periods. We are starting to become surprised at how many of these people actually do start taking annuitizations. From a service point of view, we all have to get a lot better on how we cut checks. Over the years, most of us have developed a very good facility at taking money in, but paying it out is not something the insurance industry is good at. To get into that market, we have to get better at paying money out. That is a difficult thing. We have to provide good service on that end.

Also, we need to find ways to make these products understandable, particularly when you bring the variable components in. It sounds exciting, but how do you make that easy to sell? All of us have been successful in the annuity market by making the products easy to sell, easy to understand for the brokers and easy for the consumers to understand. When you start getting into the payout annuities, it is not as easy a sale. It is not just looking at a single transaction necessarily. You must have people who are looking at long-term planning for clients. Helping them do that and helping them find ways to make products easy to sell is what is going to be the key.

MR. LIPPER: I would suggest that even if the product is good, it is probably wise to assign it a self name in the sense that if it gets too visible, I think it brings in the desire of Congress to find ways to increase tax revenues. I would be somewhat careful about promoting it too visibly.

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MR. RAYMOND: I think there is a line to walk there because I agree. I think it is dangerous to start talking about the investment nature of these payout annuities when you get into variables and that is part of what makes them exciting. On the other hand, as an industry focusing more on the payout and on the fact that what we are doing is providing income, not just deferral, investments is an important side. I think you are right, it is a difficult line to walk. What seems to get the marketing glitz on it and the excitement going is the fact that not only is it a payout, but also it is an investment and that does kind of come down on the wrong side. The one place that we should be focusing on as evidence of the fact that we are doing what we should be doing as insurance companies and then try to put an investment spin on that is the wrong way to go.

FROM THE FLOOR: Does the life insurance industry do a good enough job examining what the end customer really needs rather than selling to the agent, and if no, should we?

MR. RAYMOND: I have always felt that the insurance industry has been driven by focusing on the sales representatives. Whether it is life insurance or annuities, our client is the person selling the product. I was interested in some of the comments that both Rick and Michael were making, as far as the changes that they perceived happening in the future, such as moving more to fee-base or banks, may indicate a change. I guess I am not convinced of that, but it may indicate a change in that. Much of the industry is hurting because it focuses too much on the sales end of it; it is important. The way to sell the product is by focusing on that, but still most of what we sell is sold and not bought. Unfortunately, when you start to focus on that, you lose the focus of how you keep the customer happy and how you keep the customer with you—I think that is important.

I made some comments earlier about customer service and about product designs that encourage persistency; things like that are extremely important. You cannot lose sight of the fact that these products are still sold, they are not bought, and I would love to see a change in the market to the point where people are actually wanting to buy them. Maybe as the baby boom comes through and there are many more people concerned about their money and taking more ownership of what they do with their money, rather than being told what to do with it, there will be more competition. However, in order to maintain long-term profitability in our books, the industry needs to balance who our customer is, because even if it is sold once you get it, he or she is your customer and keeping that customer happy is the most important piece of keeping the business on the books.

MR. CAREY: I agree with that. I think the insurance industry is trying to get itself into the investment marketplace as evidenced by the 225 variable annuity products that are out there today. There is the rush to get products out the door, the rush to have the better enhanced death benefit, the rush to have 42 separate accounts versus 7 or 10, and the rush to beat the other guy. As we have seen in the past, attempted tax legislation in this area is going to hamper the product; I think we may be moving back towards more normalcy, hopefully, in some of these other areas like the fee price planning or price sensitivity. It certainly has not been there in the past; it has gone slightly overboard.

MR. LIPPER: One of the things that we do when we do some consulting to fund groups or insurance companies is ask a series of questions such as, When was the last time you did a focus group? How big is your marketing research budget? What do you know about the profitability of your agents or dealers? We usually wind up with no answers. It is

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fascinating. If you were in the auto, appliance, or book business, you would know those things because you would have a true marketing research effort. The financial business does not; therefore, I do not think we know our clients, be it the clients who are the intermediaries or the ultimate clients. We have done some focus groups recently and some other tests and you come back with answers that are quite different than what you go in with. While Ma and Pa Kettle may not understand investment speak, they have a great deal of common sense and have most of the key concepts correct. There is a frustration at their level and there is clearly a level of frustration at the intermediary level. We are not even opening our ears or even asking what other things are needed.

MR. LARRY J. BRUNING: I just wanted to add a couple more things that Rick mentioned. He has mentioned the Gallop Poll on annuities that the insurance industry has conducted. I cannot remember the percentages exactly, but I just wanted to reiterate some things that stood out. First and foremost, their reason for buying an annuity was not for retirement savings, which surprised me; it was for a catastrophic event. People were worried about huge hospital bills; maybe they did not have medical coverage for nursing home care. That was one comment. The second reason was retirement.

The other thing I found interesting was that the sources where they got their money to buy the annuity were generally from transfer payments. You can think of transfer payments as they might have received a death benefit as a beneficiary or their prior generation that did not use their annuity or consume their annuity and the annuitant died and passed it on. I found that interesting. The third item was not a large percentage. I think 76% of annuitants were very aware of the tax advantage status of annuities and would definitely lobby Congress to continue that advantage. They felt it was an important feature in an annuity.

The last comment I would make pertains to immediate annuities. We always keep referring to this group of baby boomers and I think the jury is still out. When we retire, will we be the consumers we are today or will we become those same frugal people that our parents are? Will we hang on to our retirement money rather than spend it, or consume it and then maybe pass it on? I do not know the answer; I guess I will find out some day. Depending on what the economy is like, if we have built up a retirement fund with our employers and have some good medical coverage, I am not so sure that those annuity savings that we have stuck away will necessarily be used.

MR. CAREY: I think they will certainly use a portion. Several groups have done studies in this area, including the SOA and Stanford University. I think baby boomers may be forced to average up their overall rate of return and consider using a portion of variable annuity funding or annuitization funding to meet those needs. I have copies of the last two Gallop Polls that Joe McKeever, the managing partner at Davis & Harmon, wrote for us.

MR. FENTON: I think it is reasonable to assume that at least half the people in this country will be not be able to afford to retire in the same state as they were accustomed.

MR. EDWARD B. MARTIN: I would be interested in any of the panelists' comments about the potential for variable life or variable universal life in the future from a distribution perspective. Will there be a role for distribution other than the traditional agent in life insurance products?

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MR. CAREY: Variable life is still only 4% of variable annuity sales in terms of premiums; from that standpoint, it is small.

MR. RAYMOND: I have several comments. One of the comments that was made earlier is that many of the variable annuity statistics are somewhat misleading because a significant proportion of what gets recorded as variable annuity sales is really money going in the fixed accounts. The companies that have been very successful in selling variable life have also had significant amounts of money going into their fixed accounts on those products also. It has been a challenge for the industry that we have all been struggling with to find a way to sell this product. It makes sense, but it is a very complicated product to sell. I think the sophistication in the markets is getting to the point where variable life is becoming slightly easier to sell as a true life insurance product, as a replacement for individual life or a combination of a replacement for individual life and investments. I think that is going to grow slowly. We have seen some success in it, and I know a few other companies have, as agents, become more interested in it. It is difficult to sell interest rates today, so people are looking for something different to sell and I think that will help it. If interest rates shoot back up, I would be surprised if the variable life sales continued to grow, because it is just too hard to sell. It is easier to sell universal if the companies are offering good credited rates.

One place that is of interest is the single-premium market where the product can be made much more simple. We saw a huge boom in the mid-1980s in single-premium variable life sales primarily through the stockbrokers. At that point there were some very clear tax advantages, and it was being sold as an alternative to annuities. With the tax changes in 1987, that market died out. What I see happening now is interesting—it's almost ten years later, but there is some interest coming back in that product. We are going back to basics again, and going back and looking at the true needs. Comments were made earlier that much of the variable annuity money is being invested not for annuitization, but for estate preservation in many ways. There is a large sum of money in variable annuities that moves on. That is a good niche to sell a variable life product instead because it makes much more sense, if you are going to die with the money, to put it in a life insurance product than in an annuity product. But again, that is moving back to a needs-based sale, which is very important if you are going to sell life insurance. The trick is finding a needs-based sale that you can make easy to sell and easy to understand. The people you have to work with to sell variable products typically are looking for something simple; life insurance is hard to sell.

MR. CAREY: The variable life filings are up as opposed to variable annuity filings. There are quite a number of companies out there that have variable life products on the drawing boards right now, so we may see over the next 12–36 months more variable life policies coming out and the variable annuity policies tapering off.

MR. LIPPER: We do a great deal of work overseas, and we see in places like the U.K. that unit-linked life has just about driven out all other forms of life insurance. We think that when the playing fields are level, it is a superior product. I would also suggest another reason for a significant number of issuers to push variable life. We think that the capital ratios for insurance companies will raise serious questions about how many companies will be around in 20–30 years. If you shift that risk on to the holder of the variable life, just as we have shifted the risk from defined-benefit plans to defined-contribution plans, I think

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you open up a significant market. If you are planning out a two- or three-generation plan, give me a list of 50 insurance companies that you can guarantee will meet their promises into the second and third generation; I don't think any will actually come through.

FROM THE FLOOR: There are a couple of issues and one is the variable annuity guaranteed death benefit. The perception I have had with that, and I am not in that marketplace myself, is that it may become a more valuable feature if a flat tax or some other tax advantage is lost. It is also something that I think becomes again a retention option. I know people that have a product with a seven-year-refreshing-type death benefit that periodically resets to the current account value, and, at that point, recognizes the value of that benefit. They may not have recognized it up until then. Part of that could be because of our lack to educate and market it. I wonder if there are any comments on that.

MR. LIPPER: I suspect if we took a hard look at a couple of investment objectives, such as junk bonds, small capital, and international, particularly emerging markets, those plans that have an increasing death benefit probably sell very well.

MR. CAREY: Michael talked about daily valuation being a key feature in the plans that are being sold today. I think he mentioned that mutual funds were the only option. Insurance company separate accounts are also an option for daily valuation and that has been one of the things that I think has fueled some of the growth on the insurance industry side. I do not know how widespread it is. It has been a link.

MR. LIPPER: I think that is absolutely correct. The way the insurance is sold is by marketing it like a mutual fund but claiming it is better. It is sold in that manner because when you go into the employee benefits people, they are the ones that control the 401(k), not the treasurer side. They do not understand much that is not in their local daily newspaper.

MR. CAREY: In terms of who is controlling it, that depends mainly on the size of the company. Maybe we are talking about two different marketplaces. The smaller marketplaces are determined by the president, treasurer, or someone else.