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What's Next for Annuities?

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Moderator: TIMOTHY J. RUARK
Debaters: G. THOMAS MITCHELL
TIMOTHY C. PFEIFER
MICHAEL WINTERFIELD
Recorder: INGER S. HARRINGTON

Summary: Thirty years ago Walt Disney made a bold prediction about some barren land in the middle of Florida. Walt may have known rides, but did he know annuities? Ignoring the fact that he is dead, could Walt predict today the product features that will make an annuity attractive in the coming years? Probably not, but our experts can! The panelists in this interactive session not only discuss the newest annuity features, but also explore (that is guess at in a nearly random fashion) some socioeconomic trends and how an annuity could be designed to capitalize on those trends.

Mr. Timothy J. Ruark: We are going to have a modified debate. We have three experts, and we have asked each of them to give us 15 minutes of opening remarks. For consistency, what we have asked them to comment on is twofold: (1) Where will the annuity market be in the year 2000? (2) Where will the annuity market be in the year 2010? We will then move into a question and answer session. We will be furnishing the experts common questions and they will each have a minute or two to comment on the questions. Inger Harrington is going to be our recorder. She is with CIGNA Reinsurance.

I will introduce each of our speakers before they present. We are going to first hear from Tom Mitchell with Aurora Consulting. Tom Mitchell is president of Aurora Consulting in St. Louis, Missouri, and provides actuarial and other consulting services to the life insurance and financial services industries. Prior to starting his own consulting business in 1991, Tom was president of Charter National Life. He has aided several clients on equity-indexed annuity and life product projects. Tom has also spoken and written on equity-indexed products and modeling of stock market performance. He has a long background in individual life and annuity product lines, especially variable products.

Mr. G. Thomas Mitchell: I am going to first view annuities in the larger context of society in the human and financial life cycle and then focus on specifics, weaving back and forth between the year 2000 and 2010. I think we can see the year 2000 fairly well. Much of the change that is going to take place in the next three years is already in the works, 2010 is much dimmer.

I was working late last Friday night on this talk when there was a big flash of light on the computer and smoke flew out of my hard drive and my antivirus software went crazy and pointed to a new file "NYT October 29, 2010." I had that October 29, 2010, electronic *The New York Times* file printed out so that I can read it here for you.

Let's look at the Times' social economic trends first. Where are we headed? "Former President Clinton looks fit, but not so trim on his recent 64th birthday." "Thomas Mitchell, noted for his brilliant talk in 1996 on the future of annuities, was 68 last week." That is sobering.

The point is that the age pyramid is going to shift. There are not any surprises here. The baby boomers and the baby busters are going to keep getting older but with some very profound consequences. We are currently headed towards having only three adults age 21–64 for every person that is age 65 or over. The number of people over 100 in the U.S. is expected to grow from the current 50,000 to approximately 300,000.

What about mortality and longevity? "For aging, see page two. Page one, Seattle wiped out by mutant A37 virus, all of Pacific Northwest quarantined. Related story page 17. Problems with Windows 2,000, forget Microsoft." The point I want to make is we have an ongoing battle of both technology versus nature and, even more so, technology versus technology. I think the tide will ebb and flow, but there are no final winners. I would suggest that mortality can and will be surprising, and I suggest more uncertain in the future.

I do not have any answers to these questions, but I would like to pose them. If we do have significant life extension, what will be the quality of life? Will it be an expensive process of just staying alive or one with good prospects for vigor? Will it be cheap or incredibly expensive to attain? Will we be squaring off the mortality curve or indefinitely extending longevity? I suggest all these questions have profound financial planning, product design, and financial system implications.

Here's a story with the headline "Millennium Financial Crisis Finally Unravels." It reads, "Final settlements were made today to untangle the gargantuan global financial snafu in January 2000. This snafu was started by non-2000 compliant software and an electronic parking meter system in New Zealand. It seems the meters began spitting out debits to illegal parkers of about $100 million, representing 99 years of late payment and penalty interest."

I am not sure whether there is going to be a January 1, 2000 crisis. The point is with electronic interconnections and the globalization of finance and economics, I expect a much faster pace of events. Financial stability is not a certainty in the globalized electronic economy.

I would suggest that 2010 may bring both prospects of long life and retirement, but also considerable anxiety about financial, societal, and environmental instabilities. This suggests in turn a heightened interest in savings, financial planning, and flexibility in finances. Retirement behavior itself could bring some twists.

Several decades ago I was going to a dinner to which a 105-year-old-person had been invited, and we were quite concerned because he didn't make it. Everyone assumed that his health had gone downhill, but we were told that his absence was due to his 77-year-old daughter becoming ill. In 2010, we are going to have about 600,000 children of centenarians, deep into retirement with a parent to be concerned about, and about 300,000 centenarians with retired children to worry about.

When will people retire? The normal retirement age question may not be meaningful by 2010. We are going to see much less full-stop retirement. There are going to be too many older people who are going to need more income. They will have the vigor to work, and the economy will need more workers. By that time, we will be needing sliding gradual retirements, part-time jobs, and flexible payouts for annuities.

Another possibility is, as we have seen for medical care, we are going to see a blur of approaches to living arrangements and care arrangements for the retired, and this will have an impact. Current concepts of long-term care, custodial, nursing, home care, and retirement community living will all be intermingled. They will not be in the same mental slots they are in now.

That is enough of societal trends. How are we going to fund all these retirements? I am going to look at funding in two different ways. First we are going to look at the sum of individual needs. There is a huge financial pie that needs baking. In today's dollars, the amounts needed to be accumulated to provide a plausible retirement income for current U.S. adults, ages 21–65, is more or less $50 trillion without inflation, and that is quite a bit of money. Where can this all come from? Funding has been generally looked at in actuarial literature as a three-legged stool: first, government (mostly social security); second, partially prefunded private pensions; and third, personal savings.

I want to look at this in terms of a ten-slice pie. I would divide the third slice, personal savings, into explicit retirement savings (principally tax-qualified accounts), and a fourth slice, other assets and savings (mostly general savings, investments, and residences).

These four are all evidenced by actual assets or some fairly explicit promises. The other sources of retirement living are all funded on a pay-as-you-go basis.

I would suggest the following: slice five, Medicare. Slice six, working after retirement or simply not retiring. Slice seven, frugality in living. Slice eight, relatives. (You can see these slices are getting less appetizing as we go along.) Slice nine, welfare, and slice ten, charity. That leaves those no pie at all in poverty.

It remains to be seen how these ten sources will sort themselves out over the next 14 years. The big question is how much of this can be prefunded and how much of it will have to be handled in a somewhat more painful manner as pay as you go.

As persons working with the financial system, our main interest is in where the money is, that is, the funded portion. Who will hold how much of the funded pie? There are three ways to look at it. First, there are asset holders. Who are the nominal owners? Government, employers, or individuals. That is of interest and great debate in our society, but I am not sure it is an important question.

However, one basis point on $50 trillion is a lot of money; it is $5 billion a year. Of interest to those inside the financial system is how much of the pie will various financial intermediaries, including insurance companies, handle.

Of equal interest is where will the points of contact be, that is, how will financial products be distributed. I want to focus on the electronic or Internet distribution. The impact of information technology will be very strong by 2010, but much less so by 2000. In 2010, middle America will probably be essentially all connected. Familiarity with computers will not be a big issue. Many retirees are already hooked into the Internet, and many will never be hooked in. People under 40 will have grown up with computers, and we are going to see secure, commercial transfers of money on the Internet by 2000, probably even 1997. I think the mode for most commercial electronic transactions will be through consumer shopping, basically searching electronically and coming to the vendors.

All this tells me that if a financial institution is not tuned into electronic distribution, it had better be very well entrenched in some other form of distribution. I suggest there will be an enormous decline in the use of conventional agency sales forces, at least for annuities. Load funds sold by salespeople used to dominate a large mutual fund industry. Now they are a back water. For annuities, the no-load segment is currently 3%. Can it predominate by 2010? History suggests it might.

The second way of looking at funding is in terms of real goods and services. You cannot eat money. The intergenerational transfer problem is this: money is saved now and spent later. Goods and services are produced now by workers. Goods and services are consumed now by people. Goods and services produced later are consumed later. We have a very limited ability to store up goods and services. We can store value in capital investments, but even so, there is a limited ability to store capital investments. One consequence is there are certainly going to be many other influences coming into play. The aging of the world or the western world suggests depressed investment returns in the long term, simply from the competition for consumption deferral devices, that is, investments.

We turn now to the playing field for financial institutions. It is presently not level. We have regulation and structural rules for annuities which are negatives, but the big positive tax deferral is still basically intact. What are the prospects for change? First, tax incentives are going to be needed for savings in the economy. Social Security partial privatization is inevitable. A 35% or higher combined Social Security and Medicare tax rate will not fly. Privatization could be with a big bang, but I expect it to be very quiet. I think we will just let Social Security become a little bit smaller relative to the economy over the years.

What will happen to income taxes? I suggest that instead of a back tax or a consumption tax, that we will leave the income tax in its present format. It is going to be simplified, it will be flatter, and it is going to reduce some of the value of tax deferral and with broadened investment deductions.

The third thing I think will happen is a great leveling event or trend. It will at some point no longer make sense for us to have radically different rules by financial industry segments, and there will be some sort of a sweeping financial industry reform and all financial industries will be able to offer some sort of a generalized

IRA that can be used not only for retirement but also for home, education, and other purposes to encourage savings.

The other panelists are going to comment on what investment sectors we are going to find annuities and other retirement devices invested in. My prediction is, first of all, that indexing is going to be here to stay. There is too much benefit from designing products to take account of the asymmetric risk functions, protection against downside risk. Over a business cycle, I see perhaps about a 20% market share there. Fixed and market-value adjusted and variable investments are going to be here to stay, too. What is really going to happen is over a business cycle the relative attractiveness of the products vary. These percentages are going to change. We are seeing a lot of money in variable products right now. At some point the market will go down and it will shrink. It will come back again. Payout mechanisms will develop. We are going to see this blurring of lines between various medical and care facilities for retirees. It is going to require additional flexibility in payout schemes. Third, this flexibility and the blurring of lines is going to lead to an opportunity to take more risk transfer into annuities. That, in return, is going to lead to taking an individual health status into account with more sophistication.

Annuity underwriting, such as it is, is in the stage of “You cannot be turned down for life insurance.” We basically sell only super-preferred class annuities, but there now is a smoker annuity on the market. By 2000, there are going to be many more nonsuperpreferred class annuities. With this, we will have to develop the appropriate underwriting scheme, which I believe can be done.

To summarize, in year 2010, annuities will be unrecognizable in today's terms. They will be seen as a specialized class of more generalized retirement and savings accounts, will compete on a level but fairly vicious and competitive financial playing field, and will be distributed and serviced directly at low cost, to a large extent electronically.

Mr. Ruark: Next up is Mike Winterfield. Mike is currently assistant vice president and director of individual annuity product management for ITT Hartford, which is one of the leading fixed and variable annuity companies. Mike has worked with individual annuities for approximately 25 years in various capacities, both as an insurance company executive and also as a consulting actuary. Mike has designed fixed and variable annuities for distribution systems, ranging from career agents to stockbrokers.

Mr. Michael Winterfield: Each of the speakers you will be hearing has different perspectives about what is going to be happening in the future. Tom Mitchell has spoken with us about the societal and demographic drivers that are going to be very relevant in the years ahead. I am going to be focusing on what I think will be the likely annuity industry response. This might be a fairly mainstream view, but with a few twists.

Basically, my perspective is that the current health of the annuity industry is quite good. I think we are reasonably well equipped to deal with the future. I do feel that there are some significant growing pains, which I will get into. I see many of these growing pains taking place as individual companies jockey for market position. I happen to be very concerned about the replacement of the business that we are likely to see in the next few years—replacement of business from one company to another as contracts roll out of the surrender charge period. That is a problem that you cannot underemphasize.

When you go out another ten years to 2010, my view is that common sense will prevail and we will ultimately have a rather stable environment; it will be a good one, both from a marketing and a financial standpoint. As an aside on this, I guess that my view of the year 2010 might have as much to do with my view of my two daughters and the way they grew up. That probably is as much my view when I looked 15 years down the road.

First, I believe there will be a continuation of double-digit annualized sales growth. According to the numbers, of the $61 billion in the new annuity production in 1995, $36 billion was variable annuity and $25 billion was fixed. For the first half of 1996, production totaled $34.6 billion, with $26.2 billion variable annuities, and $8.4 billion fixed. That's about a three-to-one variable. That is a little over a 13% growth rate. I believe variable annuities are going to dominate the market. I do think that the equity-indexed annuities will also pick up a meaningful market share. The loser in all this is going to be fixed annuities. Fixed annuities are going to level off. There will be a wide range of variable annuity product choices. I do not think that the short-term direction is particularly clear with regard to the changes in these contracts. Whether the changes go into offering more to the policyholder, or whether we give more to the distributor is totally murky over the course of the next few years.

Variable immediate annuities and variable settlement options will take off. This is a bet that we are making at ITT Hartford. It will take a little bit of time for this to build up, but we think it is going to be a big winner. We noted that policyholder retention during the postsurrender charge period is going to be a big concern. This is the biggest single financial problem that our companies are going to be faced with. The next one is that customer service upgrades are going to mushroom. Each individual policyholder will be able to get any kind of information on his or her PC. This is going to happen well before the year 2000.

The shift continues from the variable annuities to the index annuities. The variable annuity historical performance is tremendously compelling. When you are looking at 10% to 12% type growth and capital gains and dividends with a Standard & Poor's (S&P) index over a 50-year or longer period, it is something that you cannot ignore. When our policyholders will be investing for longer and longer periods of time, as Tom Mitchell has noted, the difference between investing in an underlying vehicle that delivers 10% to 12% gross as opposed to one that delivers 6% or 7% is something you cannot ignore. I would not forecast an increase in the variable annuity share of the market in an uninterrupted manner quarter after quarter, but the general trend is very clear. There will be times, as in our case, when during the last quarter of 1994 and first quarter of 1995, we sold a large amount of fixed business when interest rates rose upwards. Stock markets were not all that great in 1994, but this overall movement is quite clear.

The remaining fixed market is going to have a very substantial modified guaranteed annuity (MGA) content. That is going to happen for a couple of reasons. The main reason is the MGA structure allows you to provide much higher credited rates than you can under a single premium deferred annuity (SPDA). You are able to invest funds for much longer durations under a MGA structure. You do not need as much of an interest margin when you are working with MGA products because there is less risk for the company. You are able to hold less risk-based capital. If a company offers a ten-year-type MGA, in today's marketplace, you can offer credited rates that are going to be at least 75 basis points higher than the comparable rate that you have under a properly priced one-year SPDA contract.

The other problem that I perceive with SPDAs in the years ahead will be the renewal rates. SPDA writers have been able to show a decent story to policyholders during the last 10 or 15 years, because there has been a benign interest rate cycle. We had interest rates in 1981 going down the Treasury side from 16% or 17% down to 6%. As a result, companies that invested long made out quite well. They were able to invest long, give policyholders renewal rates that were better than the new money rates with their one-year renewal guarantees looking good. Now the rates are low, but if the rates sail back up, even if they remain level, many of our SPDA policyholders are going to be disgruntled when they see, for the first time, that their renewal rates are not going to keep pace with new money rates.

Let's go on to equity-indexed annuities. Tim Pfeifer will be saying a great deal about this. The equity-indexed annuity is going to be a real market player. My view is that it will fall short of the variable annuity market share. Perhaps it is not happening right now, but ultimately, the prospective buyers of this product are going to realize more fully that there is not a free lunch. There is a substantial cost for the downside protection. The S&P index does not include dividends. When you take the S&P index growth, that is the capital part without dividends, you are not talking about the 10% to 12% type of historical growth I spoke about earlier. You are talking about something more like 7%, 8%, or 9% and under the normal product configurations, if you are working off of 7%, 8%, or 9%, and you are going to give the policyholder 80% to 90% of that at the end, that creates a product that is not quite as glamorous as some people think it should be.

There will be much variable annuity product diversification. Right now we are seeing choices popping up between traditional surrender charge designs (the traditional five- or seven-year surrender charge has gone well over time) and the no contingent deferred sales charge (CDSC) products that are now coming into vogue. Policyholders will have plenty of choice between having liquidity right now or having a product that delivers more value with the underlying CDSC charges. There definitely will be more combination variable annuity and MGA products. The MGA's ability to deliver a superior interest rate is a big driver. It is complex administratively to link together the variable annuities with all of the MGA products, but it is a superior vehicle for the policyholder who wants that flexibility to switch back and forth. Ultimately, I would see the MGA component replacing much of the traditional fixed pieces within the variable product.

The income market comes alive. The long-term increasing income expectation that people want is going to be a driver with the variable income annuities. The increased life expectancy is going to make a difference. If you take a husband and wife age 65 going into a joint-and-survivor annuity, you are looking at expected payments for more than 25 years in nearly 60% of situations. Having to provide income for 25 or more years is a daunting task. Full surrender rights, at least on the nonlife contingent payments, while the annuitant is alive, will be important. Many people have felt that an immediate annuity is a good value, but if you cannot get access to your funds if your life situation changes, that is quite bad. The contracts now, including the one we will be coming out with on the nonlife-contingent side, will have a commutation right for those payments. Partial surrender rights will come in the future. The tax law right now is unclear as to whether we get the right kind of taxation with any partial surrenders.

There is a tremendous amount of basic tax efficiency with the product that is going to make a difference in the level exclusion allowance. Assume you put $100,000 premium into one of these products and take a 20-year payout. You are able to claim a $5,000 per year level exclusion allowance for return of principal. With your mortgage, or when you take out any loan, most of what you are paying off in the early years is interest rather than principal. The same thing applies in the insurance company funding a variable immediate annuity. Most of what you get back in the early years is interest, but for IRS purposes, the bulk of it will be called principal. That is going to be a powerful lever.

Last, for our deferred annuities, I think we finally are going to see income options elected. Income options have been minimal for most of us. The main reason is we have not paid the sales representative anything to set them up. It is a legitimate second sale. Once we start compensating the sales representatives, then we are going to see a great deal of this happening.

The marketing and financial strategy in the next few years has many crossed currents whether we give value to the customer or to the distributor. We can give more value to the customers by lowering fees, giving them some ancillary benefits, nursing home waivers, more partial withdrawal liquidity, or we can do more with the distributors. At the session of ripe annuities, there was commentary about the need to pay the distributors rather handsomely after surrender charges wear off so that the business stays with us. If we go that route, then we need more revenue in the product to fund that kind of compensation.

Postsurrender charge lapse pressures will be big over the next few years, and 1035 exchanges are likely to mushroom as the blocks of business get bigger. When the blocks of business are in the postsurrender charge period, they reach critical mass. It gets more interesting to people to move these blocks. The customer can go on the Internet and take a look at other contracts that are out there (no CDSC forms). There are many alternatives for these people to look at. This will create a need to do a little more with the commissions or with some persistency bonus incentives for the distributors.

Looking at the changes in distribution, I believe the individual commission-based sale will still dominate, but direct business will gain market share. It will register on the Richter scale. The customer awareness of the variable annuity fees is going to come into play over the next few years. There will ultimately be a little more resistance to total asset charges in excess of 200 basis points. The large numbers show a pattern of slight increase in recent years. Total fees on variable annuity contracts went from 214 points in 1994 to 221 in 1996. Some of this is funding some of the increased commissions companies are getting into. This is going to be a tricky one down the road. There are limits to how far we can go with this.

By the year 2010, we will see some relative maturing of the market; the double-digit sales growth cannot go on forever. I would say 5% or 10% a year is probable. I do believe that the variable annuity (VA) will be dominant for the reasons I mentioned.

I see the VA playing out at about 70% of the market. I see the equity index, the fixed MGA, and the SPDA having equal shares of the rest at about 10% each. Variable immediate annuity (VIA) is going to be the fastest growth product from 2000 to 2010. We are going to be seeing many 401(k) and IRA accumulations reaching the age 70½ decision point. Customers will be aware of this. Our companies will put together the necessary education tools to make this happen.

I believe these variable annuity asset charges will go the other way in the 2000–2010 time period. I would see the numbers dropping down to something more like 175 points. Mutual fund competition cannot be ignored. If we get some tax changes, capital gains tax cuts, or any kind of a change, this will increase the need for our fund charges or overall asset charges to be reasonable.

I think the majority of the market will still be individual commissioned based, because the average person still likes someone to do a little hand holding, provide a little bit of reassurance about whether he or she is making the right decision or not. I do not think that basic dynamic is going to change regardless of how much information any of us can get on our PCs.

I said at the outset that in my optimistic view, any of the growing pains work themselves out. I do see that happening. This postsurrender charge problem that is a real struggle right now will work its way out. Companies will take the common sense measures to make it happen. We will properly educate the customer. We will realize that it is acceptable for us to deal proactively with our customers and talk with them about how things work, in the way that the sales representatives are able to go out there and talk with them. There will be cooperative efforts with the distributors. This includes the stock brokerage firms, the banks, and others. Everyone is going to benefit in the long run with transfers that are going to be limited to exchanges that are really value driven, rather than changes that more often than not might not make the real difference to the customer, but will put more commission dollars in the sales representative's pocket. The SEC will have a hand in this with some replacement type studies it will get into, and we will do a better job with our product design and the commission fine tuning to encourage persistency.

Mr. Ruark: Our next expert may be well known to some of you. He is frequently quoted in *The National Underwriter, The New York Times, Forbes*, and on CNN. He is also a frequent speaker at industry events. Tim Pfeifer is a consulting actuary with Milliman & Robertson in Chicago. He specializes in life and annuity product development, including fixed, market value, variable and equity-indexed designs. He is a former chairperson of the SOA Product Development Section.

Mr. Timothy C. Pfeifer: When looking at where the annuity market may be in the year 2000, it might be helpful to start with where it is. I divided the market into three main types: (1) products that have a rate declared by the insurance company; (2) products that have some type of declared element to them, but with some linkage to an external factor; and (3) products that do not have declared rates with direct linkage. Obviously, I am talking about fixed products in the first type, equity-indexed or interest-indexed products for the second type, and variable products for the third type.

My sense of where the market will end up in 1996 is roughly split in the following way: 40% (Type 1), 2% (Type 2), and 58% (Type 3). I think we can look at the crystal ball to predict where the market is going to be, but we have to keep in mind that product mix is really a function of where we are in the interest rate environment and the equity markets. One just needs to look at the interest rate environment to assess what has been happening to the fixed annuity business in the last couple of years, and maybe even more to the point is what the interest environment has done to the market-value adjusted annuity market in the last couple of years. We tend to think of today's interest rate environment as being abnormally low, but by the historical standards of the last 50 years, today's interest rate environment is not that low. It is low compared to the rates in the mid-to-late 1980s. Equity markets' growth has driven where we are with the current product distribution. The bull market that we continue to enjoy has been influenced greatly by company earnings and also by a lack of better return alternatives, leading us to an environment where we have nearly 60% variable production.

We also have a current environment where the public distrusts profit-seeking institutions. There is a general level of consumers distrusting their carriers, which manifests itself in a greater attraction to variable products and to products that have some type of external linkage. Coincident with this is an increasing societal attitude of independence. Customers want to believe that they are controlling their own destiny and making decisions that affect their financial lives.

We hear much about the Internet and the impact that the Internet will have on sales of insurance products. We do not see many sales today using the Internet on annuity products, and in the year 2000 I do not think we will have seen many more. I do disagree with the 25% Internet penetration. I do not see young people buying annuities in great numbers in the next five years. In general, it tends to be young-to-middle-aged people who are active on the Internet; this is not to say that middle-to-older-aged people do not have that expertise, but their general familiarity is lower, and they are not as comfortable with surfing on the Internet and buying an annuity product. I think Internet sales will grow, but will achieve nowhere near 25% penetration.

To get more specific in predicting what is going to happen to the market, one needs to look at various scenarios of the interest rate environment (specifically middle-to-long interest rates) and the equity markets. That will drive where future production goes. In the following scenarios, we superimpose some predictions of what market production mix will look like in the year 2000 (remember today the split was 40/2/58%).

Scenario A: If the interest rate environment rises, and we also experience a rising equity market, I predict the percentage of variable business will drop from 58% to 45%. I think the percentage of both declared (meaning fixed) products and fixed products with linkages will go up. The available returns will attract the more conservative customers. Indexed products are more attractive when interest rates are going up. Even equity-indexed products normally credit higher participation rates when interest rates rise. In fact, even though equity-indexed products are competing against fixed-rate products, I believe that if interest rates were about 100 basis points higher than they are, we would be in an ideal environment competitively to sell equity-indexed products.

Scenario B: This scenario characterizes an interest rate drop and a rising equity market. In this world, equity-indexed products will be less attractive. I see fixed products sliding even more with variable products dominating.

Scenario C: If interest rates go up and the equity market goes down, there will be a quick turnaround. We actually saw this in late 1994 and early 1995 when interest rates spiked a bit. It did not take very long for the shifting of business from variable to book value, fixed, and market value adjusted (MVA) products to occur. It was a dramatic shift, and if rates rise again I think we would see a similarly rapid shift, where we would have maybe over half the business represented by fixed products. Of course, all of these scenarios assume that these are substantial shifts in the economic markets, not weak shifts. This scenario is a good environment in which to sell equity-indexed products, because customers are now aware that there is a downside to the market with the drops on the variable side.

Scenario D: If interest rates and the equity markets both drop (and you might say that cannot happen, but maybe it can) there are not many product choices for the customer to choose from. This may be an unlikely scenario, but I do see in that environment that a slight majority of the business would be variable, fixed sales being about where they are, and the equity-indexed market might pick up where some of the variable sales have dropped off. I hope this illustrates the point that the future mix does depend upon what happens in those key financial elements.

I believe that there will be no meaningful state or tax regulatory changes over the next four years as they relate to annuities. By that I am saying there will be regulatory activity, but I do not think it will be so significant as to change product design. I think there will be a lot of disclosure and regulation activity for annuity contracts, but I do not see this activity changing the fundamental design of annuity products. I think it is quite possible that we will have a new annuity Standard on Nonforfeiture Law within the next four-year period. It will be a close call, but if we do that might have some impact, but not a ground-shaking one on annuity design.

With respect to the tax issue, future developments are politically inspired. I think Clinton is probably going to win, and if he does we are going to see very little change in terms of annuity taxation. I do not see that there is a groundswell within Washington right now to target annuities for the next attack on easing the deficit. It takes a long time to get significant regulatory changes into the insurance business. Actuarial Guideline XXX, Actuarial Guideline XXXIII, and the Standard on Nonforfeiture Laws have become time-consuming endeavors. Within the time frame we are discussing here, I do not predict that we are going to see substantial changes taking place.

More generally, gradual shifts to the MVA side will occur that are consistent with what Mike commented on. For many reasons, over the long haul, 40% of the fixed business will be in MVAs, although this will not occur by the year 2000. It is key to recognize that sales of MVA products are very sensitive to interest rate levels, even more so than regular book-value annuity products.

Annuities have become five-to-seven-year products in most markets. While I would like to see that change, I do not see it changing within the next five years. The fact that annuities have become five-to-seven year products is what leads us to have these renewal problems at the end of five or seven years. My hope is that equity-indexed annuities will drive people to think about longer annuity terms, because this product functions much better when you have longer terms versus shorter terms. The biggest issue right now, and one that I see for the next five years, is the in-force conservation issue.

A few comments on the world in the year 2010. Tom mentioned flatter income tax rates. Although I do not see that happening very soon, I think, over the long haul, that is something that is an inevitable trend; tax rates will not only be simpler, but will be lower and flatter. That creates some implications for annuities in that there may be some loss of tax advantages. It may require us to look for other ways to distinguish annuities from other products, such as designing nonsurrenderable designs that can credit more attractive interest rates. Commissions, particularly on fixed annuities and variables too, really need to come down. There is just too much commission being paid in some circles today. If you look at what a company is spending to put an annuity on the books for seven years and to pay another full commission after seven years, you'll see this is a very expensive proposition. Given the market that is out there and recognizing that there is stiff competition, there must be relief, especially on fixed annuities where companies are managing to a spread. In low rate environments, it may be very difficult to amortize those commissions. That may lead the industry to other distribution outlets that are cheaper. We have already seen some trail commission patterns come into play, but unfortunately those have tended to be "add-ons" rather than "in place ofs." We may see other ways of commissioning that involve noncash compensation.

A lower capital gains tax is almost inevitable within this time frame, which is a function of the global economy. We must provide incentives to people so they will invest their capital in the infrastructure. Lower capital gains taxes may have a negative impact on annuities' sales, particularly variable annuities. I have heard various arguments saying that does not make sense; you can still justify that variable annuities are a good buy even with lower capital gains taxes, which may or may not be true, but the perception of the market is going to be that annuities are a less competitive product. We will continue to see demographic shifts that will lead people to variable immediate annuities and also equity-indexed immediate annuities (the latter can be a very attractive design in which periodic benefits can go up, but not down).

In order to enhance the flexibility of payout options, there will be greater commutability. We have seen that happen already on fixed products and certain types of variable products. We will see commutability out of life-only benefit payments as well. There are a few out there now that already do this. Giving customers some comfort that they have not signed their life away and have lost access to that money will be important.

It is interesting that in this period up to the year 2010, it is probably safe to believe that we will have some sort of interest rate spike at levels higher than what we have had over the last ten years. If you think about the modern annuity market, we have really never gone through a long period of sustained high interest rates. Interest rates since the late 1980s when the market really thrived have been coming down, which is a great environment for companies with annuity business in force, but less favorable for companies that are entering the market with less critical mass. During this period, it is likely that we will have some interest rate increases, and at that point it will be interesting to see whether the business sticks, and how high fixed annuity sales can really go. I do not think we have tested that yet.

There are a few other major drivers. I do not see any let up on the idea that insurers will be distrusted by certain segments of our society. One possible implication of that is whether we should index everything. You could argue that this is the wrong thing to do, especially if our indexing approaches are too complex. The concept of indexing has great appeal to the industry, and it appeals to customers who have been subjected to bait-and-switch techniques on certain products. I see an increase in the affinity trend in which carriers look for other ways to attract people to annuities. Customers who have accumulated frequent flyer miles may be able to convert them into an annuity product instead of redeeming them for flights. Or there might be other arrangements with credit cards where the policyowner can take economic value that is not cash and translate it into an annuity product.

It is inevitable, as the shifting ethnic and social economic mix of the country changes, that companies need to do a better job of targeting, maybe through niche marketing campaigns, a broader marketing base than they have so far approached. Maybe that means designing specific products for certain types of groups, but thus far companies have been operating in the neck of the pyramid in designing products that are focused on a fairly small basis of customers.

Mr. Ruark: My role now is to put some questions to the experts. We are going to start relatively easy. What we will do is give each of the experts one or two minutes. We will start by going in the order that they spoke. The first question here is, will the list of the top-ten annuity writers look much different in 2010 than it does today?

Mr. Mitchell: I am not predicting doom for anyone that is writing annuities right now, but I think there will be several successful start-up operations. People will hit on some hot new ideas and competition will look quite a bit different.

Mr. Pfeifer: My standard answer for every one of these questions will be “it depends on what the interest rate and equity markets do.” Nonetheless, my answer differs a little bit. If we assume the future economic environment is not all that different, I do see an advantage for the fixed annuity companies who have been in the business a long time and who have large pools of fixed assets, assuming interest rates do not spike out of orbit. I think they have a big advantage in the marketplace and I do not see their competitive position weakening. I would say they would actually grow stronger. The same type of comment could be argued on the variable side, too. Barring any sort of cataclysmic economic change, I think it will look very similar.

Mr. Winterfield: I am only certain about one of the top ten. I think that ITT Hartford will still be part of it. I think there will be some reasonable rotation. Any company that wants to be a major player 15 years down the road, in 2010, including us, will have to adjust to the times. I think a few of the young upstarts that are trying to be totally flexible and go with the flow are going to be right up there. Some companies today that are not even in the top 100 will make this top ten list in the year 2010.

Mr. Ruark: We talked a little bit about mortality already. In 2010 will life expectancy be better than today or worse than today?

Mr. Winterfield: Obviously the life expectancy will be a little bit higher. The big questions for all of us, especially those who want to play more in this variable income market will be what the rate of improvement will be. I think for most of us in the business, these questions had been almost moot since we did so well on the deferred side and nobody was annuitizing, but this is going to be real stuff and we are going to have to study these trends carefully. I would personally look for continuation of mortality improvement maybe 10 years down the road. I would look for these rates of improvement to moderate slightly.

Mr. Mitchell: I think rates of improvement have nothing to do with it particularly. I am taking an opposite view. There are possibilities of some rather large discontinuities in mortality in terms of health advances, the aging process, and also some negative things that could happen and did happen during the 1980s.

Mr. Pfeifer: My view is that mortality will improve; it may be 5–10% better than it is today.

Mr. Ruark: Here is a question from the audience. Critics of equity-indexed annuities claim that current risk-based capital formulas do not properly account for the downside risk of holding S&P index scenarios. Assuming that there would be a fair number of companies that aggressively pursue sales of equity-indexed annuities, are we more likely to see: (1) more company insolvencies, or (2) better regulation?

Mr. Pfeifer: In large part, this depends on the product design. I do not necessarily buy into the proposition that you are at abnormally greater risk if rates go up and the market tanks. In the equity-indexed market, I think it depends on the specific design you have. Under certain designs, I would admit there could be an exaggerated C–3 risk on those products, and I would probably offer that most companies have not quantified exactly the size of that risk as well as they could have. In terms of the choices, more insolvencies brings better regulation. I would like to think there is a third one, which is more prudent pricing of the risk. I do not think you will see more insolvencies. I think the regulatory community will spend more time on this risk than it has so far, and you will see companies address the risk after we have more experience.

Mr. Mitchell: There is a need to refine risk-based capital rules, but the main issue is whether everyone has carefully thought through their hedging programs and executed on them. Clients I have worked with have taken that downside risk very seriously and have taken some prudent steps. Also product designs vary immensely in the amount of risk. They are not all the same in that regard.

Mr. Winterfield: I have to agree with Tom on this one. I think companies going into this equity index have an immediate awareness for proper hedging. I tend to think the asset/liability work in this area is going to be much better than it has been for products like SPDAs.

Mr. Ruark: We have several questions dealing with equity-indexed annuities. Mr. Winterfield, under what circumstances, if any, will equity-indexed annuity sales exceed SPDA sales in 2005 or 2010?

Mr. Winterfield: I think the equity-indexed annuity will do rather well compared with the SPDA. I think that in most circumstances, other than when interest rates go up into the double digits, the equity-indexed annuity will surpass the SPDA. In terms of exceeding VA sales, there is zero probability. I do not see that happening. I think people who want to go into the market are going to go in with the VA and I will leave it at that.

Mr. Mitchell: I think there is a tremendous amount of creativity in the financial engineering going into these products. The way that indexed sales would exceed the others would be basically on a technical matter. There will be so much inventiveness in that area, that it will no longer particularly matter whether the annuity is linked to an external index or a specific pool. In other words, we will be so confused about what these three categories are, we will not be able to tell who the winner is. For example, you can have an equity-indexed annuity right now that says you get the S&P plus or minus some spread, with no downside protection. Which category is that in?

Mr. Pfeifer: I think an environment like I mentioned earlier, where interest rates are a bit higher than they are now (perhaps 100 basis points higher), without any dramatic and long-term drops in the market (slight corrections in the market are possible but those do not last for a long period of time), is actually a good environment for the equity-indexed annuities to be sold in. That would be the perfect environment and that could quite easily produce a circumstance where equity-indexed annuities outsell SPDAs. I do have to agree with Mike on this last question. I do not see any likely environment where equity indexes will outsell VAs.

Mr. Ruark: Here is a question from the audience. Will there be a linking of long-term-care insurance and immediate annuities? Also, what liquidity will be built into immediate annuities?

Mr. Mitchell: The first part is a combination of long-term care and normal retirement needs. I think over this time period the answer is definitely yes, and it may be broader than just long-term care as we presently define it. We will see more flexibility too. We are already seeing that in the marketplace on immediate annuities.

Mr. Winterfield: I think the link up with long-term care is a good idea with regard to more flexibility or liquidity. The main problem that I alluded to earlier was just the lack of clarity regarding taxes. If you provide full surrender value liquidity, that is great. Obviously, you want to allow people to withdraw partially. We just need to get the IRS on board to make that happen.

Mr. Pfeifer: On both of those questions, it is really not even a future issue. The linking of the immediate annuity with long-term care is happening as we speak. With respect to commutability, we have products out there that commute all payments (including life only). There is a product launched a few weeks ago that has an equity link to an immediate annuity. With VIAs, I think the sky is the limit. Companies *are* trying to address some of the issues that have plagued immediate annuities in the past, including illiquidity, low commissions, and a low interest rate environment that make it difficult to tie up your money. All of those things are being addressed. Among the top three exciting things in annuities right now are number one, equity indexing; number two, MVAs; and number three, immediates.

Mr. Ruark: A related question is should we be encouraging annuitization?

Mr. Pfeifer: If we look at it from a selfish company perspective, obviously yes. From a customer perspective, I think in most cases, annuitization makes sense because of the tax advantages, but not in all cases. In the interest rate environment we are in right now, I think it is difficult to encourage somebody to sock money away for their life at an implied 5% interest rate. If there are other alternatives like a VIA or an equity-indexed immediate annuity and people are willing to position themselves on that risk tolerance threshold, I think there are very strong arguments for encouraging annuitization. I think the idea of annuitization is at the foundation of what an annuity is. If we do not encourage that, it strikes me as contradictory.

Mr. Mitchell: From the previous question, some of the improvements we can make in the payout structure will be very helpful here too. For a fixed immediate, one of the things that needs to happen is to avoid the long-term irrevocable lock-in of money from an investment situation. That is a problem that can be dealt with, and that will remove the number one objection, which is a very real objection, particularly currently.

Mr. Winterfield: Tax deferral is the great driver. If we continue to have folks buying deferred annuities accumulating for ten years and then packing it in, we are only getting half of the job done. If that same person stays around for 25 or so years, then you have the tax deferrals working well over a continued period of time.

Mr. Ruark: In 2010, will the Internet be a major force, a small player, or just a novelty?

Mr. Mitchell: I think it is going to be a very major force at the bare minimum in terms of having comparative quotation services available. There will be so much more familiarity and ease of use that we will find much distribution will be done that way.

Mr. Winterfield: The Internet will provide product information to the majority of customers, will capture 25% of the sales, and maybe just a little more.

Mr. Pfeifer: I still fall into the "I-will-believe-it-when-I-see-it" category. Electronic types of information will be an educational tool. People will learn which companies are out there, but in terms of actual distribution, I think there are some logistical problems, from a company's standpoint, in selling through that vehicle. I think Internet sales will grow, but I do not know what you mean by major. Is it going to be 25%? I still say no.

Mr. Ruark: Here's a question from the audience: If government is able to get deficits under control and reduce the amount of debt it floats, will this accelerate shifts away from fixed annuities or will there be riskier fixed assets used to support fixed annuities?

Mr. Pfeifer: I think there are some real practical and regulatory problems with getting too risky on the asset side. If there were no other alternatives, maybe it would be a possibility. What the question ultimately boils down to is if interest rates stay low or they get lower than they are now, what can be done on the fixed side? The answer is, not a whole lot. It is an interest rate driven sale; you look at actual history, you'll see that and it indicates that.

Mr. Mitchell: I agree.

Mr. Winterfield: It will be all variable annuities with a little bit of equity-indexed annuities.

Mr. Ruark: Last question. If the annuity market was to suffer from a market conduct controversy, which product or which feature would cause it?

Mr. Winterfield: I am going to take a different view on this. I think that any market conduct controversy will not center on a particular product, but rather it will center around replacements. I think something will have to be done about the number of situations in which people are moving from one vehicle to another. I think that, in particular, on the VA side, there are problems when we have hoards of folks moving out of contracts, going into another vehicle, and being reloaded, just to pick up a new death benefit guarantee.

Mr. Pfeifer: You have to put equity-indexed annuities at the top of the list. There are many moving parts. There are many areas where customers may believe they have been sold something other than what they are getting. If we are predicting what is going to happen, I think the number one product has got to be equity-indexed products.

Mr. Mitchell: I would agree with that. I see companies taking good care in trying to educate the field force and the customer on that topic. I hope it works.