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Session 19PD
Ripe Annuities

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Summary: Ripe (adj.) (1) ready to gather and use; (2) matured and ready to be consumed; (3) mature, fully developed, advanced; (4) ready, in a fit state.

Are your annuities ripe? Is your business ready to be harvested by the competition? This session examines strategies that companies utilize to profitably retain business on blocks of annuity business where the surrender charge has expired or is about to expire.

Mr. John M. Fenton: Tom May is the senior vice president for sales and marketing for the Equitable of Iowa Companies and he's been with the company for 15 years. Bill Tomilin is the director of individual market development for Providian Capital Management. He has been with Providian for two years and before that he was with Aetna for 18 years.

I know that the title of our session, "Ripe Annuities" has created some discussion amongst attendees. The traditional definition of ripe as shown in Webster's Dictionary says "ready to be harvested for food as in grain or fruit." We all know that the insurance industry definition is "business out of the surrender charge period which is ready to be moved to another contract."

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With respect to how we have our terms defined, we are going to examine a few prototype annuity designs. We will focus on a typical single premium deferred annuity (SPDA), a flexible premium deferred annuity, and a variable annuity.

Then we will ask, “If we want to sell profitable business, why is persistency such a big issue?” We will then list some of the factors which impact persistency. We will also talk about sources of persistency experience which are out there. Finally, in an effort to get a better appreciation for how big an issue this is for the insurance industry, I will present some statistics to give you a sense of how much business is out of the surrender charge period. After my presentation, Tom and Bill will follow up with some programs which they have worked on in their companies and their customer service survey results.

What does a prototype SPDA product look like? It is designed to accept a lump sum of money, either nonqualified monies or a qualified rollover from a defined-contribution plan which the consumer is leaving. This product would typically pay initial total commission of 5–7% to the distributor. Of course, some companies are higher and some are lower than this, but this is the general range. There are also additional marketing costs in the 1–2% of premium range for third party marketers or internal marketing support. Typically the distribution costs are recovered through an interest spread in the 150–225 basis point range. This is also used to provide profit in addition to the recovery of distribution costs.

I think it is generally accepted that you need to have surrender charge protection to keep the business in force and to aid in the recovery of these distribution costs. The surrender charge on an SPDA is typically expressed as a percentage of account value. A typical length is 5–7 years and the initial percentage is in the 6–8% range. There are obviously exceptions to these figures, but again I would say these are common ranges. The product often has a guaranteed interest period. It seems that one year is the most common these days. If you want to go longer than that in the current marketplace, you typically would do so with a market value adjustment (MVA) feature. I believe that a number of years ago there were products with longer interest guarantee periods such as certificate of deposit (CD) annuities, but they are less common now. This profiles the typical products in the SPDA marketplace.

Let’s focus on the flexible premium deferred annuity. I would say that it is similar in many aspects to the SPDA product. I realize that some of the flexible pay products really masquerade as single premium products, when they are designed to accept large sums of money. What I am focusing on here is designed to accept ongoing recurring premiums. These are typically used in the 403(b), 457, or the 401(k) markets—the qualified plans where the insurance companies play. Typically these products may have a higher first-year commission rate than an SPDA, offset by lower renewal rates. Due to the ongoing premium payments on these contracts, the surrender charge must be different. It either runs longer from issue, say 10–12 years, or a new surrender charge similar in nature to an SPDA surrender charge is applied to each premium payment.

One of the frequently asked questions is, "Why are we selling annuities in a tax-free market?" I think that the predominant reason is that these products are sold, not bought, so tax deferral is not an issue.

Let's turn to the variable annuity. I would say it is similar in many aspects to an SPDA. I am focusing on a lump sum type of premium. Predominantly, a sale in the nonqualified market is presented as a tax-deferred mutual fund. Of course, there are also variable flexible premium deferred annuities sold in the qualified market. Surrender charges are usually expressed as a percent of premium rather than account value because of the Securities and Exchange Commission (SEC) or National Association of Securities Dealers (NASD) regulations, with a maximum of 8.5% of premium. Typically, the length of the surrender charge is similar to an SPDA.

With variable annuities, distribution expenses are recovered through asset charges rather than an interest spread. However, you probably are not able to get 225 basis points on a variable annuity like you would with a fixed account product. Then again, perhaps you do not need as much because you might have lower compensation, lower target surplus requirements, and no interest rate risk other than your guaranteed minimum death benefit provision. Current market conditions probably will bear an asset charge in the 175 basis point range.

Of course, the product has multiple fund options available. This allows the policyholder to transfer money without incurring current taxation. This is just one feature of the variable design which lends itself to improved persistency.

Let's turn to the impact of persistency and profitability. I think, and many people are aware, getting business to persist beyond the surrender charge is generally critical to the profitability of the insurance companies offering a deferred annuity product. Table 1 shows the profitability results for a simplified SPDA pricing case where we show a variety of lapse scenarios and the resulting return on investment (ROI) figure. Let me just go over a few of the categories presented here.

First, we have the spike rate, which in my definition is the year immediately after the surrender charge expires. The ultimate rate would be the rate in effect in years after that. The return on investment is the statutory return on investment after provision for taxes and target surplus. Under the base case scenario where we could see a spike lapse rate of 25% and an ultimate rate of 12%, the ROI is 11%, which for a fixed annuity is within the range of industry profitability which we typically see with appropriate reflection of interest rate risk.

TABLE 1
GETTING BUSINESS TO PERSIST BEYOND
SURRENDER CHARGE PERIOD IS CRITICAL TO PROFITABILITY

Lapse Scenario	Spike Rate	Ultimate Rate	ROI
Base	25%	12%	11.1%
“6-year contract”	100	NA	6.3
“Stress Test”	50	15	9.8
“Favorable”	10	8	12.1

There is a tendency for some distributors to view this as a six-year contract. We have a six-year surrender charge and when they view it as a six-year contract, the entire block could disappear at the end of that period. In this scenario, profitability plummets from 11% return down to 6% return. Admittedly this is a simplified example, but it highlights how undesirable this situation is. We have also shown two other scenarios to give you an idea of the range of profitability. They are labeled stress test and favorable, and show how profitability is impacted by these interim scenarios. Considering the base case figure is 25%, movements are not particularly dramatic, but if we have a 50% lapse rate, then our return drops below 10%. If we are able to manage the ongoing lapse experience so that it stays at or below a 10% lapse rate, then we can get more desirable returns. I would point out that this example probably does not fully capture the potential losses on underlying assets due to disintermediation risk. If you are investing longer and have to cash out your assets at the end of the surrender charge period, your results could be much worse than these presented here.

I think many of you already know that the conclusion is you cannot make money and fully recover your distribution costs over a six-year period. In the current environment, if we are going to continue to assess the interest spreads which we charge and pay the distribution expenses which we are paying, we need a portion of this business to persist beyond the six-year period. Perhaps it is a significant portion, or else it is not really the business we can stay in if we want to make money.

Let’s examine some of the factors which impact persistency. There are product design, distribution channels, and other favorable factors. Bill and Tom are going to expound upon these issues in more depth, but I just want to lay the groundwork.

Obviously, one of the key features of product design is the length of the surrender charge period. Experience studies which we have seen show that there are relatively low lapse rates during the surrender charge period; typically in the 1–4% range. Perhaps they are sometimes a little bit higher, but generally they are quite favorable. We see a spike upward into the 25–50% range after the surrender charge expires. After that the lapse rate settles into a moderate range which is higher, than the initial, but much lower than the spike. The business is up for grabs immediately after the surrender charge period, but after that, movement tends to be less of an issue.

This example proves that if you can lengthen the surrender charge, the business will stick around longer, and have a better chance of achieving your profitability goals. This would be a difficult change for some distribution channels to accept. Some channels will accept it more readily than others. Market appeal is a very important aspect to consider when contemplating design changes intended to improve persistency.

Another product design factor which has been important in the past is the interest guarantee period on fixed contracts; particularly contracts with longer interest guarantee periods which were tied to the surrender charge period. This particular design was expected to lapse at the end of the surrender charge period even more so than the typical SPDA design.

Another design feature affecting profitability and persistency is the free-out provision. Some contracts provide liquidity—perhaps significant liquidity—through the free-out provision. Companies which sell these types of annuities may see the money move out via this feature more so than through full surrender. Overall the utilization of the free partial withdrawal feature also impacts persistency.

Paying trail commission is another interesting development in recent years. Some people feel that the presence of a trail commission will improve persistency. I am not aware of any experience studies which currently exist that could support this supposition. It will be a few years before enough credible experience is amassed to perform such a study. I believe if you do pay a trail commission, it can improve persistency; however, I think the payments need to be significant. I think a ten basis point trail commission probably will have negligible impact. To achieve substantial persistency gains, a trail commission needs to be higher than that.

Of course, another one of the key drivers of persistency is the distribution method used and how you are related to the distributors. Relevant experience suggests that a controlled field force has better persistency than an independent field force. My definition of independent includes stockbrokers, both the national wire houses and some of the regional firms, as well as the independent broker/dealer firms, and the independent insurance agents, and banks.

We also have to realize, however, that distributors other than traditional life insurance agents account for well over 50% of deferred annuity sales. If we want to sell annuities, utilizing a distribution method other than a career agency field force is probably a necessity.

There is some discussion that stockbrokers in some of the independent firms are more likely to view this as a six-year contract. I have had some personal experiences with family members concerning these views. Their account executive told them that the contract had expired. We know that there are distributors out there who feel that they are entitled to a new commission every six years.

With respect to banks, I would say that their experience is varied. Some companies who are selling through banks report that the persistency experience they have had has been very favorable. It is not uncommon for the shock lapse figure to barely reach into double digits while others are closer to the stress test case scenario rate of 50%. I think you see a broad cross section of experience there.

The final distribution channel we are going to address is direct response. The experience I have seen to date generally has been favorable for this method; however, it is a very limited amount of experience and it also tends to consist of selling to existing customers so there is added incentive for them to retain the product.

Let me explain some other factors which can contribute to favorable persistency. One often overlooked point is that continued use of the original distribution channel has a positive impact on persistency. If you are no longer selling through the channel where you wrote the business originally, the original distributor has no loyalty nor any incentive to leave the business where it is. Also, offering the distributor financial incentive has the ability to improve persistency. This can be done through significant trailer commissions, perhaps 50–100 basis points after the surrender charge is up, or persistency payments, perhaps based on achieving your baseline persistency. This can be viewed as sharing a portion of profits by bringing them in as joint venture partners on the manufacturing side. The key point there is to align their interest with yours.

I think the industry is going to see more compensation arrangements of this nature, particularly the latter scenario. Experience continues to be unfavorable. I do not think we can continue to have experience which shows poor profitability results.

Persistency may be helped if the distributor lacks access to good policyholder records. Conversely, if the distributor is provided with reports that list the dates on which each policyholder's contract exits the surrender charge periods, that distributor is more likely to move more business. I have heard of a situation where one bank merged into another and the distributor no longer had access to the records. The lapse results for this block were generally very good.

Obviously, this is a sensitive subject for most distributors, but to some extent, a company can improve persistency if it can maintain the records and maintain a relationship with the policyholder. However, I think we need to be realistic and realize that the distributor will have the closest relationship with the policyholder.

Another factor is whether you have a good story to tell. On the variable annuity side this translates into whether you have had good fund performance. Persistency would be expected to be better if your funds performed well relative to other types of funds and relative to comparable indices or were just good performers overall. When your returns are up 20% over last year, it is probably tough to move it out of that fund. That is definitely a factor, albeit one over which the product design actuary has little control.

Tom is going to give us some thoughts on crediting strategies which can be taken, but obviously to the extent that you can offer a fair rate and stay close to the competitors, I think it will help you in your overall story. I think we are going to see that changing economic conditions in capital markets can impact performance. I am concerned that today's variable annuity sales were fixed annuity sales six years ago. Of course, if interest rates rise, today's variable annuity sales could be fixed annuity sales down the road. There is some cyclical nature in that depending on where we are in the economic cycle.

The final factor is whether the company is maintaining a strong financial condition. I would say this is critical in the fixed annuity market. It is more important in some channels (like banks and independent agents) than others, but obviously, whatever you can do to maintain your favorable ratings will impact your persistency favorably.

When it comes to pricing for acceptable profitability we all know that the persistency assumption is important, but what sources of information are available on which to base assumptions? The bottom line is that it is relatively limited. There is a Life Insurance Marketing and Research Association (LIMRA)/Society of Actuaries (SOA) studies on fixed annuities. Also, Tillinghast/Towers Perrin is in the process of undertaking a survey on experience for variable annuity products. Obviously the third and perhaps most important source is relevant company data, especially if you have company experience beyond the surrender charge period; although I think that you need to be careful in evaluating company-specific data. The experience in the past can be impacted significantly by product design, capital market conditions, and different characteristics of the business. For instance, I do not think we can say that since variable annuities have had favorable experience in the past, it is automatically going to continue in the future.

Let’s take a quick look at the LIMRA/SOA Study. This study was dated April 1992, and I believe it was based on experience through 1989–90. It is rather outdated at this point. It also included very limited experience beyond the surrender charge period. It studied a number of features: surrender charge, age, size, distribution channel, interest guarantee period, qualified versus nonqualified, and credited rate. If you are pricing a deferred annuity, it is a meaningful study and I would urge you to read it. However, if I were to summarize a few key points I would say that the spike lapse rate ranged considerably, from 6–70%. Also, it appears that the biggest driver of a high lapse rate was nature of product design. A CD-type contract where the interest guarantee period was tied to the surrender charge period was essentially viewed as a five- or seven-year contract.

We saw that career agents had the best persistency relative to independent stockbrokers and banks. This data was limited to contracts with shorter interest guarantee periods. I also believe that the Society is considering updating this survey, which would be a big help.

The survey which Tillinghast/Towers Perrin has undertaken recently is for companies selling in the variable annuity market with the focus on experience beyond the surrender charge period. As I said, we are still in the process of pulling together, but the preliminary results seem very favorable. Basically, we are seeing lapse rates which start off low, in the 2–4% range in early durations and rise to barely double digit in later durations. I think this is a function of two primary factors. First, the participating companies use primarily career agent distribution, which ties back to the point we made earlier. Also, many of the contracts have ongoing premium payments, perhaps with new surrender charges imposed, so the surrender charge may not be quite zero. Hopefully, we will have this study pulled together shortly, and we may see some experience from other channels as well, which might be helpful.

Let me conclude by presenting my estimate of how much business is currently out of the surrender charge period. Table 2 projects an increasing share of business leaving the surrender charge period over the next several years. This analysis was constructed using sales as proxy for in-force account value and makes the simplifying assumption that all products have a six-year surrender charge. Under these assumptions, this table shows that the percentage of business out of surrender charge, and thus exposed to movement, has risen from 4% at the end of 1993 to 11% at the end of 1995, and is projected to increase to over 20% in the next several years. I would say that even if you quibble with my assumptions, the overall trend is quite clear and dramatic. Over the next 3 years, the dollar amount of business which was sold more than 6 years prior will more than triple from approximately $26.1 to $91.1 billion. As the variable annuity market continues to mature, it is going to become a bigger issue.

TABLE 2
VA MARKET WILL HAVE INCREASING SHARE OF BUSINESS
OUT OF SURRENDER CHARGE PERIOD

Year	Cumulative Sales Through Year-End	Cumulative Sales More Than Six Years From Issue	Ratio
1993	$138.1	$5.6	4.0%
1994	188.4	14.6	7.7
1995	236.9	26.1	11.0
1996	306.9	42.1	13.7
1997	376.9	62.1	16.5
1998	446.9	91.1	20.3

For the fixed annuity market (Table 3), it is a somewhat similar story, except it has a larger exposure. We see here that for the end of 1995, 31% of the business is out of the surrender charge period, but by 1998 the figure rises to 50%.

TABLE 3
FIXED ANNUITY MARKET HAS LARGER EXPOSURE

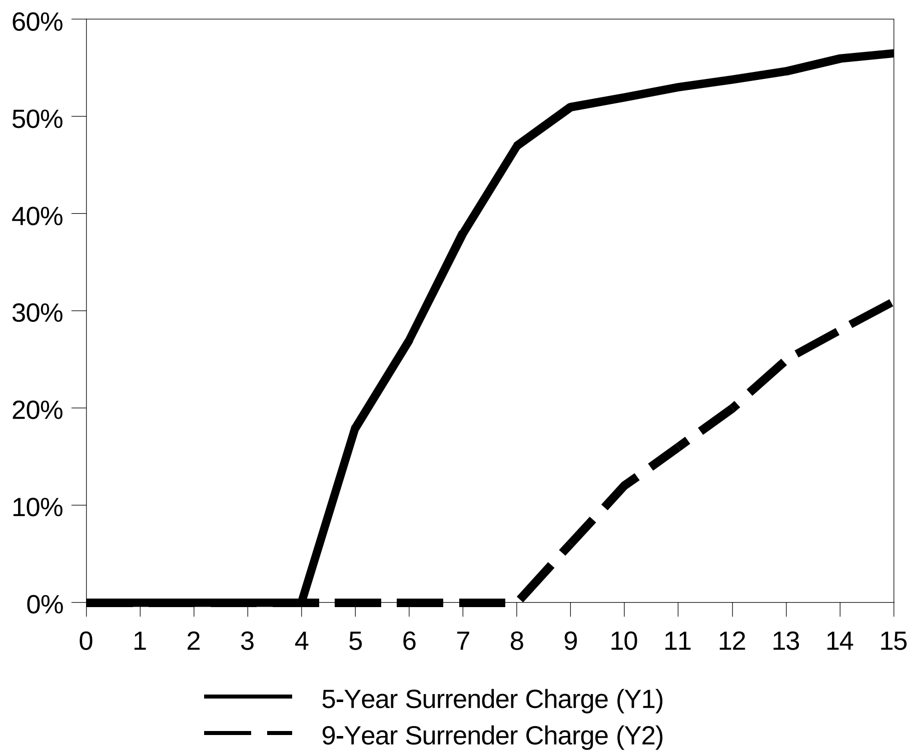
Year	Cumulative Sales Through Year-End	Cumulative Sales More Than Six Years From Issue	Ratio
1993	$288.5	$47.1	16.3%
1994	322.0	75.6	23.4
1995	354.8	111.8	31.5
1996	384.8	151.2	39.2
1997	414.8	190.6	45.9
1998	444.8	224.9	50.6

Now that I have set the stage in terms of what are the issues with persistency and profitability, we are now going to turn to Tom May.

Mr. Thomas L. May: Is an annuity ripe? John talked about that a little bit and I think that we need to continually define this because there really is not a universal agreement on how to objectively describe it. One of my personal favorite definitions of ripe annuity is any annuity issued by another company. Another one that I know a number of distributors use is that any annuity with a first-year bonus ripens in year two. For purposes of discussion, we are going to define a ripe annuity as being any annuity that is outside the surrender charge period. Obviously, we are leaving out a lot of interesting topics like lapse rates on two tiered annuities. Also, I am going to be speaking only on fixed annuities, because I have dealt with fixed annuities most of my career and at this stage, none of my companies have any variable annuities which are outside of the surrender charge period.

The exposure to ripeness varies and that is the next thing I would like to talk about. For Chart 1, I took two hypothetical SPDAs, one with a five-year surrender charge and one with a nine-year surrender charge. I took what I think are fairly typical looking current termination assumptions that are 2% in the first year grading to 10% over the surrender charge period with a 25% shock in the year following the expiration of the surrender charge.

CHART 1
RIPE ANNUITY EXPOSURE



The reason I did this was to illustrate that our troubles are only just beginning. I have taken a level new business assumption, projected it out and shown the percentage of the account values that are without surrender charge, by year after the block starts. Keep in mind that most of the fixed deferred annuity which the industry has on the books has been sold in the past ten years. If you take a look at this, the five-year surrender charge product does not have any ripeness during the first five years and then it starts to build. I believe it is 19% after year five and fairly quickly builds to 60% of the block. Keep in mind, this is not a closed block. This is a block which has new business being written each year. Sixty percent of the block would be without any surrender charge at the end of 15 years.

The nine-year annuity, obviously starts out slower. It does not have any exposure for the first nine years and then it starts to climb. Now the nine-year annuity will climb slower and although I do not show a steady state here, because that is out about 40 years, it will reach a much lower steady state than the five-year annuity.

This is one of those aspects of corporate risk management which probably is not adequately taken into consideration when we determine the kinds of products we are going to sell. That tends to be based on marketing and pricing considerations, but there clearly is an advantage in terms of exposure to ripeness and exposure to replacement by having longer surrender charge periods.

Let’s just talk about a few of the issues which are facing companies with ripe annuities. The first, as John mentioned, is the interest crediting strategy. A ripe annuity basically has all the characteristics of a demand deposit. There is certainly a school of thought which says that you probably could credit some type of relatively short-term demand deposit interest rate to it. I think there are probably companies which are doing this. I think those companies get there in one of two ways. There are some companies which are doing it by not changing their investment strategy, but still offering the lower money-market type rate and in essence are increasing their price for spread or their required spread at the end of the surrender charge period.

There are other companies which are trying to shorten their investments making their corporate actuaries happier and trying to stay relatively well matched with what they are crediting. There is a certain limit to this because a lot of those older blocks have 4% or 4.5% guarantees and you add a couple of hundred basis points of spread to that and it is difficult to shorten your investments’ duration too much. Nevertheless, there are companies doing that. Practically speaking, there is probably no significance between the results of those two companies. I do think, however, that there is, ethically and from a market conduct point of view, a fairly strong difference between the approaches those two companies are taking.
The other approach, of course, is to try to maintain an investment strategy which is similar to what was maintained during the surrender charge period and try to continue to offer fair rates along those lines. It certainly presents a challenge in your cash-flow testing and it also obviously tests your resolve with your lapse assumption.

Another issue facing companies is the perception of agents. A lot of distributors of these products believe that the company has made all of the profit by the time the surrender charge wears off. I am not talking about this in a cynical sense. Many very well meaning, very intelligent distributors really believe that once a surrender charge is worn off, the company has basically made its profit and that policyholder considerations and agent considerations can legitimately be looked at without harming the company. I think, to some extent, we have helped give rise to this over the years because we have answered the question so many times of why are the surrender charges so big and why do they last so long. We have explained ad infinitum our need to amortize our acquisition costs over time and they cannot be paid off in one year. We probably have created a model which is coming back to haunt us.

I could address some of the same issues which John talked about, but I think the big issue that faces companies which have substantial blocks of ripe annuities are the various risks associated with replacement. Obviously, the biggest is disintermediation. Now I am not going to say a lot about disintermediation because it has been discussed so much. Six or seven years ago, or even longer, if you came to a Society meeting it was hard to avoid a session where disintermediation was discussed. You really do not hear that much about it now, and we have not heard much about it for the last couple of years. It is one of those ironies. Even though interest rates are low and we probably will face in the future a relatively greater chance of having some disintermediation losses, people are not talking about it because we are not suffering those losses presently. One issue I do want to spend some more time talking about is unamortized acquisition cost, because it really is not strictly an accounting issue—it is a pricing issue. Every pricing methodology, regardless of your surplus or profit target, conceptually needs to pay back costs which are paid in the first year, which cannot be recouped in the first year.

A third issue related to risk of replacement is the loss of a future profit stream. This is an issue which probably has been discussed more in the past 18 months than what it was previously. If you set your surrender charge so that your policies are relatively lapse neutral, and if you can always sell at the limits of your capital and can replace any dollar that goes out the door with an additional sale, there probably is not a lot of risk to the future profit stream of the company. In essence, the company is replacing $1 which it is managing at a given spread for another dollar which it is managing at the same spread and in a certain conceptual sense, the parting policyholder pays for the commission of the incoming policyholder and all is right with the world. That is probably the model which a number of our companies worked with in the early 1990s when we could basically sell until our corporate finance people told us to stop. However, over the last 18 months, I doubt whether any company which is serious in the single premium deferred annuity market, particularly the fixed annuity market, has been satisfied with their sales. This has become a real potential loss of future profit and future capital for those companies which are publicly held stock companies. If you assume that you are pricing with, say, a 15% return and you have an equity requirement in the 6–7% range, in essence your pricing requirement is about a 1% after-tax return on assets. Now the value of the loss of those assets could be between 5–8% of the amount lost and that becomes a real loss to the future projected earnings of the company.

One of the possible courses of actions for companies that have a substantial exposure to ripe annuities is basically to do nothing or as I say "let it rot on the vine." Probably five or six years ago this is what most companies were doing that had any exposure to this. They really were not taking it particularly seriously.

Another approach is to use traditional conservation methods which I call "pick it up off the ground before it rots." The reason I say this is because with the traditional conservation methods you really do not do anything until you have already received word that the policy is in jeopardy and is about to go out the door. Then you scurry around and try to do some things which normally have more to do with the new policy which your cash value is going into than with the existing policy. In other words, you try to convince the policyholder that the policy it is going into is not as good as the policy it is coming from, or the agent which is selling it is not as good as the agent that sold you the last one or the company which is taking our money is not as good as we are. Those kinds of approaches have some merit, but certainly are not particularly proactive.

Bill is going to discuss some new methods of conservation which I think have a lot of promise and have an ability to give us some better returns. What I really want to talk about are exchange programs. One approach would be to have some kind of no-commission exchange program in an attempt to protect the profitability of your line. For reasons that I hope will become clear, this also could be called "pick the low hanging fruit." With the no-commission exchange program, basically one of two things happens. Either your agent is not involved or your agent is involved. If your agent is not involved, you are basically providing the no-commission approach, no incentive for that agent to ever become involved in the process. If the replacement involves another agent who is not licensed with you, you are missing a very valuable ally there. Also, I think with the no-commission exchange program, when you do approach the policyholder with this better deal, you quite often are asked the question, "Why couldn't you do this for me before, if you could do it for me now?" If your agent is the replacing agent, you run the risk of creating an adversarial relationship and we all have to keep in mind that none of us will provide a lot of service unless we get paid for it. Generally, these approaches will only result in saving a few select cases, which leads us to the commissionable exchange program. We are seeing, particularly in the brokerage market for nonqualified single premium deferred annuities, more of these things which are coming out now.

The danger with the commissionable exchange program is that you do it because of the concern over rising lapse rates and yet it has the potential to drive the lapse rate up even further. For this reason, I call it “the potential for stripping the tree.”

Let’s talk a little bit about commissionable exchange program issues. First is unamortized acquisition cost. As a proxy for pricing, I am going to use deferred policy acquisition cost (DPAC). Actually, I like John’s approach to this by showing the decrease in ROI when you assume that 100% of the business lapses off at the end of the surrender charge period. The problem is that not all of us are pricing on an ROI basis. But, conceptually, regardless of the method that we are using to price, there are still some remaining costs which have not been amortized over our original pricing assumption. Since my experience is with a publicly held stock company, I have gone in and taken a look at what DPAC would remain in the eighth year of a hypothetical seven-year surrender charge product. In the brokerage market that is a mid-range product, I have also used a 5% level withdrawal rate.

I was expecting the number to be big. I was not expecting it to be this big. You still have 63% of your deferred policy acquisition cost asset on the books at the time when the replacement program replaced everything. Remember, DPAC is an interest-bearing asset, but if you think about it, conceptually what you are trying to do is amortize costs off what you had in the first year and there is an interest loss which you are experiencing because you did not invest that money. Most of the blocks out of the surrender charge which are now ripe probably were priced with some sort of simple level lapse assumption. It was only much later, after we saw what happened in the early years, that we developed the graded surrender patterns that John talked about. But even if you take one of those graded surrender charge patterns, if you have 2% grading to 10% over the seven-year period, you still have over half of your acquisition costs unamortized at the end of the period. This is consistent with John's six-year example. If you recall, his ROI was basically cut in half. Even throwing in a shock lapse, you still are going to have 40% of your DPAC remaining in the eighth year. You have a substantial portion of your profit that is really exposed to loss.

The second issue is the increase in lapse rate, which I mentioned earlier. You have to be careful with any commissionable exchange program so that you do not wind up increasing your lapse rate. The ideal commissionable exchange program is the one where you identify just those policyholders who would have lapsed otherwise and you replace their product. The ideal commissionable exchange program, in essence, is the one that does not drive the lapse rate up at all above what it would have been, but I do not know how to do that. I think in pricing it is particularly important to perform stress tests. You have to assume that you are going to have an increase in lapse rate and it becomes an optimal value problem.

The third issue is market conduct concerns. If this were five years ago, we probably would have said you have to keep the lawyers happy, but I think at this point we all are sharing these concerns and these are all things that are going to have to be addressed. I think that companies which are doing some type of commissionable exchange program need to be very careful. Five or ten years from now this could very well replace vanishing premium as the industry’s main litigation problem. I have some very serious concerns with some of the programs I have seen out there. Let's talk about those concerns a little bit. Obviously agent motivation is one of those. There is a very fine line between compensating an agent and motivating an agent and a commissionable exchange program has to walk that line.

The second is suitability. Now we have had suitability testing on our variable products for years because of the National Association of Securities Dealers (NASD) rules, but most of us really do not have any suitability testing other than maybe a maximum issue age requirement which we would probably waive anyway.

Then there is the annuity side and there are a lot of questions in this one. Is a new policy with a higher interest rate always going to be in the best interests of the policyholder? I think there is even an issue to address concerning whether another deferred annuity is always suitable for the policyholder. Now, people will say, “But they already have a deferred annuity.” That is not really the issue. They may have a seven- or eight-year-old deferred annuity which was suitable for them at the time it was issued, but that may no longer be suitable for them. The law clearly places a heavier emphasis on suitability at issue than it does for our ongoing obligations to our clients in terms of suitability. Every time that we have a replacement of a product, we basically recreate, in some small way, a requirement for suitability that we did not have before.

The third issue is the new surrender charge. It is difficult to pay a commission while protecting yourself. If you are going to protect yourself, you have to have some sort of either front-end load or back-end load. Both of those are going to create potential issues because you are going to be moving a policyholder from a position of more liquidity to a position of less liquidity. It is particularly important with these kinds of programs because this is unlike churning. Churning, which we are all familiar with, is, in most cases, something which is agent-driven and can be categorized as isolated incidents. The company has some defenses for this and at least the liability is somewhat limited. The replacements in these kinds of programs are not isolated incidences. They are done with the full knowledge and encouragement of the home office.

Finally, we have to take a look at the role of the agent as one of the issues which we need to consider. First, are we going to involve the agent or not? There is some logic for saying that we will have a fully commissionable program, but we are not going to involve the agent, at least in terms of the first approach. We will make some sort of automatic approach, perhaps a year before the surrender charge wears off with the policyholder and we will still pay the agent if something happens. I think that it is an interesting argument, but I think it is also very difficult. If you are going to commission the agent but try to avoid the agent's involvement, you are probably going to create a great deal of stress and irritation. As a practical matter, this probably cannot be done. What can be done, however, is to limit the eligibility to take part in this program. To not make it available necessarily to all distributors. I am using agents now in the very broad sense. It is possible, for reasons which John talked about, that you might want to limit it simply to your career agents. You might want to limit it to your career agents and brokers, but exclude your institutional clients—the ones who do better record keeping like the banks and the stockbrokers and who perhaps statistically have a worse history when it comes to replacing life annuities.

You may want to limit it to only those distributors who have done a certain amount of production with you, either historically or currently. You may want to limit it only to distributors who have a certain record of good persistency with you. You may want to limit it as a practical matter only to distributors who have been with you for a certain period of time. My own companies have recently announced a commissionable exchange program for fixed annuities and we are placing limits on eligibility, at least in the beginning and I would like to take just a few minutes to discuss what we have done.

Recently we announced the program, and in early October 1996, we issued the first few annuities under the program. We are going to have a commissionable internal exchange program where a fixed annuity can be exchanged under certain circumstances for a variable annuity in the company. Why did we choose the variable annuity? We chose the variable annuity because our studies have shown that most of the replacements which we have are really performance generated and earnings generated, and it is very tough to have a fixed annuity replacement program in our current economic environment. Believe me, it was a tough decision to decide to go with the variable annuity. Our return on assets on a variable annuity is only a fraction of what it is on a fixed annuity. This program is really talking about exchanging a dollar for dollar current assets and so we are, in fact, decreasing the return on our asset portfolio marginally when we do this. Also, this is going to limit the program only to those agents which are currently securities licensed, which on the career side is a fairly substantial percentage, but on a brokerage side is still fairly small.

We have decided to avoid the liquidity and market conduct concerns by waiving the surrender charge on the variable annuity and the exchange program will be to a variable which has no surrender charge on it. I will discuss the commission implications of that momentarily, but we will not decrease the client's liquidity by doing this.

This is going to require us to pay what is called a trail commission. It is not quite accurate, because it is going to be a small up-front commission with a trail commission starting in the first year which is equal to the up-front commission. It is basically about 1% a year, which will be paid out in total value. This clearly is not going to be enough compensation to motivate an agent who is looking for a new first-year commission, but frankly, that agent has probably already rolled the business if they could. This will have a real economic value to the agent who is looking for superior economic value and is willing to wait a period of years in order to get it. I did some present value calculations on 1% with mortality lapse and various after-tax agent investment rates and the numbers are fairly interesting. If the agent's after-tax investment rate is 8%, this represents an economic value of about 7% to the agent. In fact, if the agent is probably investing like I do, at a 4% after-tax figure, then we are talking about something more like 9% of account value. I think that the agent who has a large block will be the one interested in a superior economic value, because he or she typically has been in the business a long time.

Pricing of these is interesting. If we could assume that we would be able to identify only those clients who would leave us, the pricing for this thing would be a piece of cake and the profits would look very nice. On the other hand, if you assume that some people are going to take this who would not have otherwise lapsed as early, then it becomes a little dicier. This is something which could clearly get out of hand and I think in pricing a similar program, you want to take a very close look at it. Basically, each 5% increase in our shock lapse rate, after the surrender charge wears off, decreases the profitability by about 10%. You cannot play that two-for-one game too long before you have given away all the profit in the block. There is, by the way, some spread sensitivity to this because we do offer a wide variety of annuity products and the smaller spread products tend to be less volatile than the larger spread products. In other words, we are hurt more by a marginal increase in lapse rates on the larger spread products than by the smaller spread products.

The final aspect of our program is we are bringing it out on a trial basis with our career agents only. This is not going to be terribly limiting for us. We have been in a career business for 130 years and have been in the brokerage business for only 8 and currently 39% of the annuity cash values in our career block are ripe, whereas only 7% of the cash values on our brokerage side are ripe. This is not going to be a serious disadvantage to most of our brokerage field force, but it obviously has a real potential value and usefulness with our career people. Initially the reaction to it has been very positive. The people who would not be positive about it have probably already rolled the block that would be eligible for it anyway.

I do want to stress that this program is only one of several efforts that we are taking to address the issue of ripe annuities and we also are taking a look at other things which we can do on the conservation front.

Mr. William C. Tomilin: In today's increasingly competitive marketplace, only those companies which strategically address both raising new accounts and retaining existing accounts, will thrive and continue to grow. Most every company has a plan for raising new assets. Unfortunately, while this is the easiest strategy to plan and implement, it is also the most costly. For each new account, there are dollars spent in advertising, collateral fulfillment, written correspondence, new account processing, answering new client questions, and a variety of other fixed and variable expenses. For most products, profitability only occurs after accounts have been on the books for several years, as you heard earlier. The highest levels are achieved on those policies retained long after surrender charges have expired, yet while most every company has dedicated time, effort, and money to attracting dollars in the first place, few have really developed the strategic plan for retaining those accounts long enough to maximize profits.

One of the major reasons that we have identified with this lack of follow-through is the belief that somehow service and sales are mutually exclusive. That is, the proactive sales efforts extended only until the account is opened, at which point the passive service paradigm takes over.

Those companies which have successfully moved toward greater account retention recognize that, in fact, the sales process never ends. In order to be effective, service and sales must be intertwined throughout every client encounter. Even after understanding these truths, most companies have difficulty creating and implementing strategies for closing the barn door. After all, at what point is the client in need of additional sales oriented information?

An effective first step can be in conducting exit interviews; contacting clients who are closing or have closed accounts to find out exactly why. While the reasons will vary, patterns will emerge which can be used to mold the company's culture toward asset retention, developing proactive training programs, and preemptive sales strategies, contacting similar clients prior to an account closing decision. At Providian, we have started contacting closed accounts and finding out why.

We decided to survey, by mail, over 3,000 individuals. It was conducted by our database marketing group. Participants consisted of individuals who surrendered a Providian life annuity product from mid-March to mid-May 1995. We had a 30% response rate.

We categorized reasons for surrender. The fact that 59% responded "better return" is not going to surprise anybody. Also, 20% cited more options, but the customer could have gotten other investment opportunities internally. Therefore, we really believe we have not done as a good job of cross-selling as we could have.

The next statistic was very interesting. It dealt with who contacted who first, and we found that 46% of the customers initiated contact. Only 13% of agents contacted their customers first, which we feel was a terrific opportunity to initiate customer contact before the business runs off.

Why did the agent or broker recommend surrender? An overwhelming majority (88%) recommended the current surrender solely on basis of interest rate. If you have been in this business long enough you know that is a code word for another commission or a higher commission.

Make sure your customers understand what you have to offer (in our case what we had to offer). Are they interested only in rate or is it a better rate of return, i.e., of variable annuity.

We also asked participants if the same agent was involved. New agents are involved, but 44% of the money is being moved by existing agents. Company management needs to answer the question, "Who is your customer?" This is a tough one. Is it the agent or the end policyholder writing a check?

How important was the agent's advice? The end customer makes the decision about 45% of the time. This survey was our opportunity to get to understand exactly what the customers were thinking. Not necessarily at the point in time when they surrendered, but much further ahead of that time; so you can get into their minds in the sense of what they really want. Is it really a better rate or is it other investment options? It is overwhelming that there is a large amount of them out there who are not making their own decisions.

The fact that 77% of respondents did not cite lack of service as a reason for lapse did not surprise us. There is not a heck of a lot of service which we have to do on the fixed annuities, but we did ask the question anyway and it was overwhelmingly that service was not the reason they were leaving.

We also asked about the importance of interest rate return on investment. Again, 58% of the respondents indicated that it was extremely important, but we kept on asking ourselves, “Was it really the fixed rate or was it the performance of variable rates?” We were in a situation during that time period when the Dow went over 6,000 and all the while it has been doing that, a lot of our customers have been saying to us, it is not the rate, it is other investment choices. We do have variable annuities, and we have had fairly good returns on our variable annuities, but we really were not giving the customer a chance to know and understand that. It is extremely important from our perspective that they remember it. These are fixed into the contract folders, but it was a time for them now to get into some variable type product.

Did you buy another financial product? Overwhelmingly, 73% said yes. This was not a surprise to us, but it was important hearing it from the customers and hearing why they did it. Again, a lot of it was rate, but a lot of it was investment choices, too.

Then we got into what type of purchase did you make? Thirty-eight percent were variable annuities, but 23% bought mutual funds. This means over half bought a different investment type vehicle, not a fixed rate. This survey was our opportunity to get at the practices of our distributors, banks, brokers, dealers, and advisors. If they are not selling anything other than fixed annuities, we had better educate them about our variable annuities, so the customers who are looking for other avenues of investment can take advantage of our variable annuities.

Then we asked the question: “What other types of products do you own?” No mystery here again, but the number who responded “variable annuity” was only 30% so we felt our work was set out for us. If you look at the other investment type vehicle such as mutual funds, stocks, things of this nature, a very high percentage of those individuals who had fixed annuities were willing either to buy other investment-type products or at least listen to you talk to them about it.

It seems the partial withdrawal feature is most talked about but least used. The National Association of Variable Annuities has run many surveys regarding a number of different things. One of them is the percentage of individuals who takes the systematic withdrawal of 10% a year. In this survey, it was overwhelming that 73% knew that they could have taken a withdrawal and 70% said they would not do it. They would rather just move the whole contract. You start asking yourself, is it time for us to really look at the withdrawal features? I know when you talk to distributors, if you do not have it, you have something missing, but when you go a step further and talk to them about the use of it, it is really not understood. This survey and others like it show that most customers really do not use the systematic withdrawal or the withdrawal features as much as we like to believe that they do.

We also asked if they would purchase another annuity from Providian. This is a tough question to ask. Thirty-nine percent said yes, so that was favorable. However, 36% said no, and that was discouraging. At least we can work on the 25% who had no response.

What can we do to go forward? Obviously communication with our customers is extremely important, preferably before they move out of a surrender charge period. If you can get to them at that time, that is the optimum time to do it but that is not always as easy as it sounds. We talked about distributors who have large books of business with us currently, but for a number of different reasons are not selling any of our other annuity products. We have come up with what we call renewal programs. They are tough programs to get into because you are reminding the customer that you do have an option. The program could entail a new renewal rate, or it could involve moving the monies to other annuities we have, not only fixed, but variable annuities as well. You really have to come in control with your own self and think about what the customer wants to do. Sometimes they will move out of the renewal programs, but at least you are talking to the customer on a regular basis and have an opportunity to keep some of this business.

Make sure that they understand what they have. It is amazing to me that you could talk to a customer who is maybe only four or five years into the product and it is an entirely different product that they thought they bought. Then you add to that those who have had the product for ten years or so and it is nothing even close to resembling what they currently have. You must really talk to the customers and make sure that they understand what they have. Probably more important is what they want. We make the assumption that if they have a fixed product they are going to want another fixed product, but that is not always the case. Understanding what they want is very important, but so is making them understand what their options are.

The withdrawal feature is something which we found was not even in the cards for most of the customers, but there are other options as we mentioned earlier, such as exchanges, or just simply explaining to them that there are other products available in your company that they have the opportunity to take advantage of. Explaining to them what they are exchanging and what they are exchanging to is nothing more than communication and information. We found through all of our studies that if you talk to the customers on a regular basis they will be more secure, understanding, and feel better about the product. I think it is important to get to them and if they are exchanging make sure that they understand what they are exchanging to.

We came up with an acronym for protecting ripe annuities. From our perspective it is renew and reinvigorate the customer relationship (R). Invest your time and initiate customer contact (I). Pursue your customers and personalize your approach to their needs (P). Educate and enlighten your customer on the different options (E).

I said it was a mail survey, so for our last question we asked for remarks. A lot of them had to do with rate. Some even talked about the fact that we changed the name from National Home to Providian and we did not tell them. Now if any of you have been involved in that type of a name change, you know you spend an enormous amount of money on communication, and it can be incredibly frustrating to see comments like these. If you think about it, there are a lot of good reasons to surrender a contract. Obviously a payout is one good reason, but we felt the following response was one of the most touchy-feely reasons for surrender. It was from Mr. Dan Seater, and it says, "I received your letter, thanks so much. Yes, I was pleased and happy doing business with you. I am a widower, 85 years old. All my life I wanted to take a trip, so that is what I did."

Ms. Barbara Theodoros King: Regarding the Equitable of Iowa exchange program. I was wondering what considerations, if any, you have to give to having the fixed assets liquid enough to do this type of exchange.

Mr. May: That is a good question. At this point, I wish I had a better answer for you. We are anticipating that the election of this will be modest enough so that it will be immaterial. We have cash flow which is in excess of $2 billion a year and we anticipate that the exchange is going to be relatively insignificant. Frankly we did not have a specific provision for that in the program.

Mr. Fenton: Tom, I have a question for you on the exchange program. Is initial contact going to be to the agent or directly to the customer?

Mr. May: It will be to the agent. Again, that is one of the reasons why we have limited this to the career people. We have thought the program out, and we have explained it to them in terms of how it can be used. We obviously intend to monitor it closely, but at this point we are not anticipating making any direct contact with any of our ripe annuities policyholders.

From the Floor: I actually have two questions which are somewhat related. Bill, you had indicated through that survey that a fairly large portion, almost half, of the exchanges or lapses seem to be generated from client interest, which seems to be a little bit different from what I had thought was going on. I thought most of it was generated by the agents trying to move the business.

Mr. Tomilin: This was a surprise to us too.

From the Floor: I just wanted to know, do you think this is limited to the fixed annuity business? Second, if we are also seeing a substantial portion that is agent related, this is probably more a variable annuity issue. Do any of the panelists think that the best practices which are being implemented by the SEC and the NASD which would remove the ability to favor internal products when other products are available through company's broker/dealer will have an impact going forward on the experience which we will see from the variable side? I am speaking more in regard to the career agent distributed products.

Mr. Tomilin: Again, we were somewhat surprised ourselves to see the high percentage of individuals making that choice, but yes, it was a fixed annuity. If you look at it from that perspective, it should not surprise you that much. In working with different distribution, we found that increasingly, we were struggling with the question of whose customer is it. Is it our customer? Is it their customer? You certainly have a lot of tug-of-war with that. That is why I suggested we experiment with some renewal programs. We used fixed renewal rates with certain distribution systems, primarily in the broker/dealer arena. It was a tough pill to swallow because you give the customer the opportunity to move the business. You must feel that there are other opportunities internally so that they would want to stay with the company (i.e., a competitive renewal rate or other internal products such as the variable annuities). That brings a problem to bear that some of the distributors did not sell variable annuities and so it was an education to the distributor on what types of variable annuities we have. We did not have a licensing or registration problem because these were broker/dealers, but we had a shelf-based problem. A lot of them had access to a number of different variable annuities and it is similar to real estate, location is all that matters. In variable annuities it is the funds and their returns, so we happen to have a number of good variable annuities with good funds and good returns. We had the advantage from that perspective. Of course, the distributors wanted to get involved with this. Again, if you want to give more information to the customer, in most cases you have to go through the distributors and have that little power struggle on who the customer belongs to. Once you get over that hurdle, our results have been fairly good.

Mr. May: We have found that where the expressed interest is to move the money into another annuity product, the impetus for movement has been predominantly agent driven. We have also found that where the surrender is to move money into a CD or a mutual fund, the impetus seems to be client driven. We have seen a substantial increase in this activity in 1996. I think it is a matter of the relatively low interest rates and a fairly flat yield curve. When your product has a 5.25% or 5.5% renewal and you can get that in a five-year CD which is Federal Deposit Insurance Corporation insured, it is a tough conservation effort. We are seeing a dramatic increase over the past year or so, but it has been in that segment which is going some place other than to annuity. We are finding very few policyholders who are making the decision to move the money into another annuity.

Mr. Michael Winterfield: I think this entire ripe annuity issue is one that is going to really represent the classic situation of being between a rock and a hard place. We spent a lot of time brainstorming on this one and it seems to me that all of us are going to have to do a lot to keep persistency up to the level which we would like it to be. One of the consequences of the actions that have been discussed, in particular, commissionable exchanges, is that we will ultimately drive up the costs to the customer in doing this in order to pay for commissionable exchanges. That might be necessary. This will lead to the case for SPDAs to have higher interest margins than the 150 or 225 which John mentioned or in the case of variable annuities, we will have to do something with expense charges if we go this route.

Mr. Douglas K. Dunning: I had a question about the Equitable program. Prior to that program, what is the commission structure on an internal exchange moving from a fixed annuity to another fixed annuity or a variable annuity with a surrender charge?

Mr. May: Zero.

Mr. Fenton: I had another question on something you raised. What leeway does the insurance company like Providian have to communicate directly with a client? I guess it is my perception in some channels it is the distributor's client and everything you say goes through them.

Mr. Tomilin: The difference with Providian is we do not have any career agents. We are dealing with third party marketing firms. Some of them have come and gone as we all know and we are left at times with what I consider large blocks of orphan cases. When you are dealing with a broker/dealer, you still struggle with the question of whose customer is it. Again, getting back to our renewal programs, we had to address this gut-wrenching question. If the customer pays a surrender charge, and takes their money, obviously it is the broker/dealer's customer at that time, we try to prevent some of that through our renewal programs.