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Session 55PD
Keeping Current on Fixed Annuities

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Panelists: THOMAS C. FOLEY
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Summary: The panel discusses topics of timely importance to any actuary working in the annuity product line including:

- *strategies for managing annuities beyond their surrender charge,*
- *the status of the Annuity Illustration Model Regulation and how it will impact today's annuities,*
- *the impact of equity-indexed products on fixed and variable annuities.*

Ms. Linda S. Streck: I will be talking about equity-indexed annuities and how they relate to traditional fixed annuities. We aren't going to be talking about variable annuities. Our topic is traditional fixed annuities—book value annuities and market value adjustment annuities.

This session doesn't necessarily cover the hottest topics of the day, but if your company writes annuity products, we think the topics that we will be discussing will be very valuable to you. When we were preparing for this particular session, one of the publications that crossed my desk was the *National Underwriter* (Life & Health/Financial Services Edition, April 7, 1997), in which there was an article by David Shapiro entitled "Time to Revive Interest in Fixed Annuities." There are a couple of comments in there that I thought were very interesting. I quote from his article: "There is absolutely a place for the fixed annuity in the client's portfolio.

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Fixed annuities, as long as they are reasonably priced for the company, the consumer, and the agent, represent one of the products that should be the foundation of the financial pyramid for the client." He goes on to say, "The fixed annuity is a low-cost, low-risk product that offers significant advantages over other products typically marketed to consumers who have a low tolerance for risk."

So what's wrong with the fixed annuity? Let me answer simply—nothing. We want to "Revive the Interest in Fixed Annuities."

We have three very separate topics that we're going to be discussing and three extremely qualified individuals to speak on these topics. Eric Sondergeld is our first speaker. He is going to be discussing some recent sales results for the fixed annuities. Eric is a research actuary in the Industry Research Business Unit of Life Insurance Marketing and Research Association (LIMRA) International. He directs annuity research, persistency, and product design studies for all individual products. He also serves as a staff representative to the Quality Business Committee. Prior to joining LIMRA in 1994, Eric spent ten years at the Travelers, working in individual products, investments, real estate, and most recently, in the individual annuity area. He is an ASA, a member of the AAA, a Chartered Financial Analyst (CFA), and a member of the Association for Investment Management and Research (AIMR). Eric has had a pretty busy tour of duty up here in Montreal; this is the second of three sessions that he's doing.

Mr. Eric T. Sondergeld: I'd like to provide an overview of the fixed annuity market, give a very simple answer to the question "What's been driving fixed annuity sales?" I'll briefly discuss the situation regarding lower sales and asset retention, and then get you thinking about how we can buck the trend and revive the fixed annuity business. My presentation may seem a little depressing at first, especially if your company is a fixed only annuity company, but the message I want to get across to you is it doesn't have to be that way.

Annuities have enjoyed healthy growth over the last couple of decades with annualized growth rates of 20% per year since 1973, and 14% over the last ten years. If $100 billion was the threshold in 1994–95, that was quickly forgotten in 1996 when sales reached $111.4 billion. Much of the growth in annuity sales has been fueled by the increasing popularity of the variable annuity, which grew at a 23% rate since 1986. The fixed annuity, on the other hand, has not been so fortunate. If I were to split the last ten years in two, you'd see that, for the first half, fixed and variable annuities shared equally in the growth, both growing at about 18% per year. Since then, variable annuities grew at a rate of 28% and fixed annuities actually grew at a negative 3% for the past five years.

Not only did the fixed annuity sales in total not look so good, but on a market share basis, it's worse. Let's discuss the percentage of total annuity sales that went into stand-alone fixed products (not including the fixed subaccount within variable products or combination products). The portion of the annuity market captured by fixed annuities has seen a relatively steady decline since 1985. The sharp increase in early 1988 was most likely due to follow-up from the October 1987 stock market crash, if that's what they're still calling it. Although the stock market only increased about 9% in 1993, it rose steadily throughout the year. I call 1993 the year of the variable annuity, because that's the first time that variable annuity sales surpassed fixed annuity sales. The third quarter of 1993 was the second time that variable annuities outfaced fixed annuities, but the first time that the fixed market share fell below 50%. It has stayed below 50% for many quarters in a row. And 1995 turned out to be a banner year for the stock market, which paid off very well in 1996 for variable annuities.

What if we look at the fixed annuity market share results but overlay it with the T-bond rate? Annuity sales in total are mainly driven by real personal income. While the impact of the stock market on total annuity sales has been growing, the level of interest rates is second in importance to personal income. This is especially true with the share of sales that go to fixed annuities versus variable. Given the level of interest rates and stock market prices, it's very easy to estimate fixed or variable market share. There should be no doubt in your mind that interest rates drive fixed annuity sales.

To combat lackluster fixed annuity sales, companies have tried designing competitive and innovative products. You would think, or at least hope, creativity and product design would help sales. And while it has not discouraged creativity, I don't believe it so far has been the savior of the fixed annuity business. Rather, I believe product innovation in the fixed annuity business has helped individual company market share rather than promoting industry growth.

Competition in the fixed annuity market is very high. The fact that over 600 insurance companies write fixed annuities probably has something to do with it. And unlike the variable annuity market, the sales of fixed annuities are not controlled by a few companies.

When reviewing product innovation, three types of fixed annuities come to mind. The first is a market value adjusted (MVA) annuity. MVAs were first introduced in the mid-1980s when interest rates were high and the yield curve was relatively steep, two factors crucial for successful MVA sales. Unfortunately, that rate environment didn't stay around very long.

A second, more recent phenomenon is the bonus rate annuity. According to A.M. Best's, in their 1996 Flexible Premium Retirement Annuity Survey (FPRAS), the number of fixed or flexible fixed annuities with a bonus rate interest is ten times what it was five years prior. According to LIMRA's Interest Crediting Practices Survey, we found that 36% of stand-alone fixed annuities credited some type of bonus interest.

And of course, what would a fixed annuity overview be without mentioning equity-indexed annuities (EIAs)? EIAs were probably the only growth area in fixed annuities in 1996. While only one in 25 fixed annuity sales dollars in 1996 were invested in EIAs, I don't believe they'll become a huge part of the fixed annuity business in the future.

Although I believe things are changing, one area that companies have not yet focused on to a great extent is the payout side of the business. Based on pure demographics, sales of single premium immediate annuities (SPIAs) should be increasing rather than decreasing. Let's take a quick look at the impact that EIAs have had on the market and on the companies that write them. Unlike their traditional fixed annuity counterparts, future sales of EIAs will more likely be tied to stock market growth rather than interest rate growth, which is how the traditional fixed annuities tend to behave.

For companies with EIAs, their EIA sales represented 17% of their total fixed annuity sales in 1996, including the EIAs. While it's still too early to tell, EIAs haven't been the boon to sales many have hoped they would be. The total fixed sales, including EIAs, decreased 23% last year, which is worse than the 21% decrease experienced by all fixed annuities. The non-EIA fixed annuity sales fell by 37%. Together these two points argue that the EIAs serve to displace their non-EIA sales. These results didn't change even after excluding the two market leaders, Keyport Life and Lincoln Benefit Life, who together controlled two-thirds of the EIA market in 1996.

Not only have recent fixed annuity sales been less than exciting, but the growth in fixed annuity reserves has been as well. It is probably safe to assume that a large portion of fixed annuity surrenders are not going to other fixed annuities. LIMRA recently conducted a 1035 exchange survey. Unfortunately, many companies participating in the survey still are not able to track whether sales coming in or surrenders leaving mean that funds are simply being passed from one company to another.

Of those that could report the information, 41% of variable and 25% of fixed annuities sold in the first half of 1996 were some sort of annuity-to-annuity transfer, based on the number of contracts sold. In 35% of fixed and 55% of variable contracts surrendered, the funds were sent to another carrier. All these numbers are consistent from 1994 through the first half of 1996, based on those, albeit few, companies that could give us those numbers.

So not only are fixed annuity holders taking their premiums to variable annuities, they're bringing their assets with them. This is a disturbing trend. After all, why do people who have, in the past, invested in fixed annuities, now buy variable annuities? Did their time horizons get longer as they aged? Unlikely. Did their risk tolerance change? Perhaps. Although people tend to get more conservative with their investments as they age, this could have happened. Would a variable annuity have been a more appropriate investment in the first place? Perhaps the company did not offer variable products or the sales representative was not variable product licensed. My opinion is that these are all excuses. I discussed how sales are driven by interest rates. I think that, plus the fact that the stock market has been doing so well lately, is what’s driving it.

It seems to me that, as an industry, we have two choices. We can sit back and let the financial markets determine how much of the annuity business will be captured by fixed annuities. In that case, let's all hope the federal reserve raises rates later this year. Or, we can buck the trend. How?

We certainly cannot control the level of interest rates, or cause a stock market correction. What we need is a fixed annuity industry correction. Annuities are sold not bought. The impetus for sales is from the distribution of them, not people banging on their doors trying to buy them. There's a tendency to sell what's easy to sell. That's why annuity sales tend to follow interest rate and stock market performance. People tend to chase performance. But what are we trying to sell after all? Annuities. Annuities have long time horizons, so we shouldn't let recent financial market activity blur our vision in choosing the right product. And whether your time horizon is one month or 30 years, I'm not sure what last month's stock market performance is going to do for a potential investor anyway. We need to get that point across to our distribution systems, to our customers, and probably more importantly, to ourselves as an industry. It's very easy to push these products because of what has been doing so well lately, not necessarily what's the right product to sell in a specific situation.

The fixed annuity industry tends to focus, almost to exclusion, on rate. If that's the case, it's no wonder fixed annuities are often compared to certificates of deposit (CDs). In my mind, this is very dangerous because now you're comparing a short-term, non-tax-deferred vehicle with a long-term, tax-deferred one. Each product has its merits, but in different situations, so we need to make sure the annuity is the right product for the right situation. One thing we must never forget is that an annuity is an annuity. Annuities exist to help people save for retirement and provide an income in retirement, an income that cannot be outlived. The only time I ever see the “A” word in advertisements is when they say "annuitization not required to receive interest bonus." What kind of message are we trying to get across when we say things like that?

If we ask people if they want a product that can help them accumulate assets, tax-deferred, and then create an income in retirement that they cannot outlive, maybe we can buck the trend in fixed annuity sales. And if we do a good job at it, maybe they'll hang on to those annuities and even annuitize.

Ms. Streck: Eric took care of discussing what has been happening at the front end in annuity sales. Tim Pfeifer, our next speaker, is going to take the flip side and look at what's happening with mature in-force blocks, and the different sorts of conservation issues and programs that are in place.

Tim Pfeifer is a principal and consulting actuary in the Chicago office of Milliman & Robertson, Inc. He specializes in the areas of life and annuity product and market development. Tim has been active in the life insurance industry as an author of many articles and a frequent speaker at industry meetings. He is the past editor of the *Product Development News*, published by the SOA, and is past chairperson of the Society's Product Development Section. He is currently editor of a publication entitled *Product Development Bulletin*, published by Milliman & Robertson, Inc. Tim is an FSA and a member of the AAA.

Mr. Timothy C. Pfeifer: My topic is one of great interest to many of you—what to do with mature annuity business. Hopefully the answer is we can conserve it, but what can a company do to maximize the probability that we can conserve the business? This is a major issue for many companies right now, including your company, if you sold book value fixed annuities in the past. There's really inadequate time to cover all aspects of this issue. It goes very deeply into company culture, distribution strategies, and a number of other issues, but what I hope to do is skim the surface and give you some ideas of what companies are doing out there and how large the problem is.

To begin, let's look at five major tenets regarding the challenge of conserving and dealing with mature annuity business.

Tenet #1 is that annuities’ profitability generally depends on persistency, which is something that may sound very simple. This is typically the situation unless you have a product design in which the surrender charges are dramatically greater than the commission that you're paying, in which case you probably want to encourage lapses because there could be profits on each surrender. In general, surrender charges and compensation are tied together a little more closely and persistency is something that you want to encourage.

If we look at a typical seven-year book value single premium deferred annuity (SPDA), and use some very standard assumptions as to mortality, persistency, and the like, we would find that the percentage of the statutory profits that are realized by such a product after the fifth year, assuming a 20-year pricing horizon, would be about 60% of the overall profits. For most typical annuity contracts, profits are significantly back-ended.

After ten years, 35% of the profits are realized. You can probably quibble with my assumptions, but the point is that significant profits are being assumed to be earned in years after the surrender charge period is over.

There's further reinforcement for that point if you're looking at items on a generally accepted accounting principles (GAAP) basis. The remaining deferred acquisition cost (DAC) at the end of the surrender charge period, assuming you're using a 15-year amortization, would be 45% of the original DAC. So if you get a flood of surrenders, you’ll find yourself writing off a lot of DAC at one time. If you're looking at a ten-year amortization, the remaining DAC is still about 30% of the original DAC.

This is obviously a key issue for companies that are doing financials on a GAAP basis; as a result, we are seeing more companies starting to write off the DAC over the surrender charge period, especially those that are in stockbroker distribution or some other distribution where persistency is a question after the surrender charge period.

The next point is that if lapses are 40% higher than was assumed in the original pricing (in other words you multiply your pricing lapse rates by 1.4), that has the impact of stripping about five basis points of after-tax return on assets away from our sample product, or you lose about a point in return on equity or internal rate of return, depending on which measure you're using. You can see that you have a fairly significant impact on the pricing results. The 40% increase in lapse rates in this example will be clarified later when we talk about the new persistency study that LIMRA and the Society have put out, which has some interesting results in it.

The issue of persistency is not an isolated factor. It has some implications that are a function of what has been happening in the interest rate market. Given our history of interest rates over the last three to five years, the interest rate trend has really proven to be a boon for the profitability of in-force business. Companies who have sizeable amounts of in-force book value products have been able to enjoy the benefits of managing to profits on the in-force block. Obviously, one has to look out at what happens at the end of the surrender charge period; prior to that, companies have enjoyed the ability to manage to profitability. Relative to new business, though, and in specific circumstances relative to equity-based products, new sales have suffered, as Eric told us. For business coming out of surrender charge periods, it has proven to be very problematic as the alternative equity-based investments have proven to be more attractive. Companies that have been able to put book value, fixed products on the books that are early in the surrender charge period, have had the opportunity to manage some spread profits out of that. But as we've said, at the end of the surrender charge period, there are some major issues to deal with.

Tenet #2 is that recent persistency experience data would suggest that the actual persistency in the industry has been less favorable than many company's pricing assumptions. Tenet #2 is based upon both anecdotal information and other companies around the industry who have done internal studies on their persistency versus pricing. Generally speaking, persistency has been less favorable. This is true despite the favorable interest rate environment that we've had, where companies have been able to take a little extra spread on some of their in-force book value business; however, those crediting rates are still more attractive than can be earned on fresh new business on the fixed side.

The new persistency study from LIMRA and the Society provides some interesting information as to how the business persists over various durations and over various distribution outlets. We see that, at the end of the surrender charge period, depending on how you carve out the data, we could see lapses easily on the order of 50%, and in some distribution outlets, even higher in that first year following the end of the surrender charge period.

To be specific, the study shows that business sold through independent agents realized lapse rates of about 47%, stockbrokers about 52%, and banks about 36%. Some of the hope for loyalty of the bank market, at least based on the initial studies, has not been as encouraging as we had first hoped. The stockbroker experience on products that have one year or less interest rate guarantees is even worse, where 90% of the business goes away in that first year following the surrender charge period. One can debate the data a bit, but the main point is the fact that the results we're seeing imply that this business is being sold and managed by the distribution looking to the date when charges are gone and the business can be moved. With the exception of the career agent marketplace, three of the other major distribution avenues—independent agents, banks, and wirehouses—are showing a propensity to want to move the business at the end of the surrender charge period.

The spike year lapses are the biggest problem. It highlights how annuities, unfortunately, are being sold in many distribution outlets today. Also of interest is the stockbroker experience after the first year that you're penalty free; it continues to show that the lapse rates continue to be high after that point, even for the small amount of business that's still there.

If you haven't seen the study, I would encourage you to get a copy of it. There’s a lot of interesting data in it, and there are clearly many ways to slice it. We are drawing the conclusion that even in a good environment, companies have generally been unable to hold the business much beyond the surrender charge period, which is not very encouraging. After analyzing the data, it appears that lapse rates are about 40% higher than what we would have reasonably priced for, which is how I got to the 40% number earlier.

Tenet #3. If the volume of business that we were talking about was small, the response to all this would be “so what?” But that's really not the case. The volume of mature in-force business is becoming quite significant and sizeable dollars are at stake. We looked at the volume of in-force fixed annuity business, as of the year-end 1996 total, and came up with about $430 billion. Working backwards, we tried to estimate what portion of that could be considered as being outside of the surrender charge period and therefore, “ripe” or mature annuities. We came up with around $125 billion. These are somewhat crude numbers and a much more detailed study would have to be done, but the bottom line is that there's a lot of business out there that's beyond the surrender charge period, and five years from now, we estimate that this amount could easily be triple the $125 billion number. We're talking about real money here.

Tenet #4: The manner in which annuities are sold seems to serve to de-emphasize their use as a long-term retirement vehicle, and positions them instead as tax-deferred interest-bearing accounts. Given the persistency numbers we just discussed, it's hard to imagine seeing those types of numbers if the buyers and the sellers of these products were really envisioning these products as a long-term retirement vehicle that will ultimately be used to provide life-time income to the customer. Unfortunately, that's not the way, in many cases, they're being sold. Instead, we have a tax-deferred certificate of deposit (CD) mentality in certain situations. Both the agent and the customer is ingrained with the idea that, at the end of the surrender charge period, something has to be done. They think, “I have to either renew this contract with the same company or I have to go elsewhere,” which is very much a CD mentality. A fair amount of this is distributor positioning. Either consciously or unconsciously, distributors structure the sale in such a way that they are in line for compensation five or seven years from now.

In a way, it's sad that we see as much comparison as we do between fixed annuities and CDs, or between variable annuities and mutual funds. They should be quite different animals that aren't even susceptible to this kind of comparison. The current sales pitch tends to lead to that fact and leaves business susceptible to churning at the end of the surrender charge period.

Tenet #5: Certain carriers have structured replacement programs that target mature contracts, where some have surrender charges restarting and some don’t. As a side point, it's interesting that we have begun to see companies who have set up dedicated areas to handle the conservation of their in-force business. This is a relatively new phenomenon, with units that consist of anywhere from 5 to 20 people, whose sole function is to try to retain the in-force business. There are many different approaches to the conservation process. Perhaps the first place to start would be a strategy that doesn't really involve any great new product initiatives, but rather puts a full court service press on the customer. Send them a lot of information. Do a lot of backslapping over the mail. Tell them over and over again how lucky they are to be in your product. Do a lot of enhanced service items in order to keep them aware that they have a very valuable financial package with you. That, in and of itself, probably is not sufficient.

If you have a lot of mature business, you are probably not going to want to wait until that business is at the end of the surrender charge period to act. At that point, it's probably too late. You want to begin visiting this business prior to the end of the surrender charge period. One of the things that's occurring in the industry right now is carriers who are actively promoting external exchange programs, using commission dial ups and dial downs. If your business still has a 3% surrender charge, some of the competing companies will come in, offer a 3% bonus on one of those annuities plus a bonus on top of that. The agent dials down their commission and your business gets replaced. The customer is generally where they would be had they had no surrender charge. Everyone is happy except you because you've lost the business. It points out the fact that you really want to start looking at this before the end of the surrender charge period.

We are seeing a lot of internal programs being developed where insurers are looking to send their fixed annuity business to another fixed product within the same company, usually with some sort of bonus rate or enhanced rate, and generally not just for one year. Many companies believe that you tell the customer “come over to our great new product and we'll give you this great rate.” If it's only for a year, there would be some natural concern about the bait-and-switch approach. We're seeing many more two-year or longer guarantees of an attractive rate on these internal replacements.

The longer you can guarantee an enhanced rate that's above market, the better it is, but clearly you get into some reserve issues at that point. Typically, when customers are encouraged to move over, there would be a restart of the surrender charge, either at the same level that original contract had or whatever the going surrender charge would be, if it's a brand new design that you're moving them into. An interesting question is what do you do about commissions? For most programs we've seen, commissions are paid at this internal replacement point, particularly if the producer has a big role in the process. If they don't have a big role in the process, a partial commission might be paid to the producer on the order of two-thirds of a fresh new business commission, even if they haven't done a whole lot. You're sort of buying their loyalty in a way. If the producer has had a big part in the process, most companies are paying something very close to a brand new commission.

One of the other big issues going on is that companies are internally replacing business from the fixed side to the variable side. It's probably a lot easier sale versus going fixed to fixed. While that has been successful at many companies, part of the issue is the suitability question. Some customers may not be fully aware of the differences between variable and fixed business, and may not be happy if their timing was wrong and the variable accounts tank shortly after they do the internal replacement.

A key issue, again, is the role of the producer. Some companies try to get their producers actively involved in the process. Some producers don't want to be actively involved in the process, though they're happy to take the commission. There are many instances where the relationship between the company and the producer has deteriorated since the original product was issued or else there is no relationship; those situations can get quite contentious. We've seen producers argue, “This is ‘our customer.’ You don't have the right to talk to them without our prior approval or knowledge.” We've seen companies come back and say, “They're your customer. They're also our customer and Sears’ customer and Wendy's customer and everyone else’s customer.” There are a number of interesting political issues that can go on with that, but we have seen a little bit of a trend in companies tending to initiate more action without producer involvement. It'll be interesting to see if that continues in the long term.

The impact of the conservation issue on pricing has been interesting. We are seeing more companies who are anticipating the conservation program when they're pricing the original product. At the end of the surrender charge period, there will be some sort of reoffer made, and then the pricing is looked at in terms of what if *X*% take this deal and *Y*% take that deal and *Z*% stay in the existing contract. It has gotten to the point where companies are anticipating all of this upfront.

One last comment on macro pricing and the whole issue of conserving business. In the environment that we're in right now, there is a significant advantage to companies that have sizeable amounts of fixed business on the books. We've seen situations where companies have been able to stay in the market, attract new business and re-up business successfully by subsidizing some of the in-force business that is still within surrender charge. We can trim five basis points off of the crediting rate on the in-force business, and use that to subsidize our exchange program or subsidize new business rates. It's clear that a company that has a lot of in-force business can manage to do that on a macro level, and wind up in a decent place.

The flip side of that is, when rates spike and they go up dramatically for long periods, these same companies are going to be in a far less advantageous position than a company that has very little in-force business. Right now, as it relates to a mature block of business, a company that has a lot of in-force business has certain advantages in constructing these re-up programs or replacement programs.

Ms. Streck: Our next speaker is Tom Foley. Tom is a life and health actuary with the North Dakota Department of Insurance. He has 25 years of experience as an actuary, including ten years as a chief actuary. Having served at several companies as director of product development, vice president, and actuary, Tom has been responsible for developing products and pricing. He has been responsible for all actuarial functions, including creating life, term, and health plans.

Tom is an Associate of the SOA and a member of the AAA. He's the vice chair of the NAIC Life Disclosure Working Group, which just had a meeting last week. We're going to be getting the most up-to-date information on where we are on the proposed model regulation for annuity disclosure. I remind you, obviously, this is U.S. content.

Mr. Thomas C. Foley: As I'm sure you're aware, in 1995 the Life Disclosure Working Group of the NAIC developed the Life Insurance Sales Illustration Model that has been adopted in several states or is in the process of being adopted. We think that it helped clean up some of the sales illustration activities for nonvariable life insurance. That was finished in December 1995. The next task to be given to this working group was what are we going to do for annuities and for variable life?

So we developed two separate working groups. One was a variable group, and we've had several conversations with the Securities and Exchange Commission (SEC) about interacting with them with regard to what our requirements would be for both life and annuity variable products because we feel like we have to do those in conjunction with the SEC. Unfortunately, a key stamper with the SEC was killed in 1996 and that set the process back significantly. We hear from the SEC that they anticipate coming out with another round of potential disclosure documents for variable products sometime this year, for both life and annuities.

With regard to fixed annuities, the working group developed a subgroup early in 1996 to develop a corresponding annuity disclosure model. That has gone through several different evolutionary stages. The initial stage that came out in 1996 basically said that we're going to have an annuity model consisting of annuity disclosure and illustration, not unlike what we have with the life model. That is, companies will be able to choose for any given annuity whether they're going to illustrate or not, but if they decide to illustrate an annuity, all products that are sold are going to have to be sold with an illustration. There's going to be a self-supported test and a lapse-supported test. In fact, the meeting that was held in June 1996 to discuss this was a very contentious meeting.

From there, what we call the Technical Resource Group , which represents the industry, has taken the ball at the request of the working group. Basically, that group has come back to us and said the following: "What we should do for fixed annuities is have a disclosure requirement," and that's basically all. They want no illustrations. They said, “If we want to illustrate, we'll illustrate, but we want no required illustration.”

That happened late in 1996 and early 1997, and we've evolved to the point where there's going to be a more detailed disclosure documents required, but illustrations are going to be optional.

Let's talk a little bit about some of the nuts and bolts of this. The following products will be excluded from the annuity model:

- registered products
- products with no nonguaranteed elements
- products sold with government disclosure
- Employee Retirement Income Security Act of 1974 (ERISA) products
- qualified products
- structured settlements

As I said a while ago, I don't think illustrations will be required. However, there are certain products that the working group is in a quandary about how to handle, how to disclose, how to get meaningful information across to consumers so that they can make good choices. There are advantages to the company for consumers knowing how our products work. As a regulator, we continue to hear examples of sales people directing consumers in ways that aren't necessarily beneficial to consumers. Similarly, they may not be necessarily beneficial to the company either. We might all be better off if consumers are really empowered to make good decisions for themselves because then we can design products that work, not only for consumers, but ultimately for all of us. I would contend that the companies in our business that consistently are successful are the ones who put the consumer first. They really try to design products that work for their whole collection of consumers. They don't just favor people when they buy products and then put it to them later. Think about that. Will illustrations be required? These three products, EIA, two-tiered annuities and annuity life combination, may require illustrations.

If we're going to have a disclosure/illustration model, what would be the general overall format of this model? There's a title page. There's a narrative summary, the purpose of which is to go through all of the key components of the policy and describe them, in laymen's terms, so the consumers have a much better idea when they ultimately look at the numeric summary and the tabular detail, how the components fit together. The purpose of the numeric summary is to put a relatively small number of values in one concise table that illustrates key concepts for the consumer. For the life model, this is where you show guaranteed values, current values, and midpoint values for years 5, 10, 20, and age 70. There's also the signature of the agent and the applicant. The tabular detail that follows is the pages that are what we usually think of when we think of an illustration.

Those of you who are familiar with the life model know that these are the key ingredients to the life model, and it is the format we anticipate having for the annuity model. The question is whether all these components are going to be required for an annuity. The answer is, probably not. We would guess that the plain vanilla annuity is going to have the title page and a narrative summary, but the numeric summary and tabular detail may well be optional. Now, if a company chooses to illustrate an annuity, then there's certain guidelines that they're going to have to follow, including a self-supported test and a lapse-supported test. In fact, at the meeting last week in Chicago, the Academy was requested to begin work on a self-supported test and lapse-supported test for fixed annuity illustrations. Again, illustrations are not going to be required for declared rate fixed annuities. But if a company chooses to illustrate, then there are certain requirements they're going to have to follow.

What are some key issues remaining to be determined? The largest complaint I've gotten from agents is the number of pages is too great. It turns out that they end up with a life illustration with 10–15 pages. They have to make two copies because they have to leave one with the applicant and send a signed copy to the home office, so now we're up to 30 pages. If they end up selling something other than the original illustration, then they have to go through this process again. We never anticipated that to be the case.

One of the challenges we presented to the life illustration group was to see if there was some way to shorten the illustrations that are being required. One way that we can accomplish that is to include the narrative summary section in the form of a buyer's guide. In fact, we're going to have an interim meeting of this group and several other groups, and there will be a discussion about the buyers' guide at that point. It's conceivable that, for a fixed annuity, what could be required is a title page, a buyers' guide, and, if the company wants to provide it, some sort of specifications page that shows what the interest rate is.

Another key issue is something that we're calling *real disclosure*. I would like you to think in terms of a friend or a cousin or someone who is not in this business but who reads our disclosure document. All too often we spend too much time around people who are in the business. They're the ones who write the disclosure documents. They're the ones who review them. We can't get outside of our own heads to realize that we should be writing these for our friends and our cousins. Real disclosure is an attempt to get us to understand that we shouldn't be putting down the words on the page as they are in the contract with no real intention of trying to get the concept across. I read advertising documents and actuarial memorandum and material all day long. Some of you write tremendously well, and some of you are horrible writers. But some companies have a propensity to write down all the key items in such a way that I don't have a clue what it is they're talking about, and I know my friend wouldn't have a clue either. Let me try to give you an example of what I'm talking about.

Here we have a couple of examples that happen to come from the averaging concept from an EIA. The concept we're trying to get across here is one of real disclosure. Now, let's suppose on an EIA disclosure document that this is all we put down: "Averaging of index values greatly enhances your earnings."

Have we told the whole story? No. Have we told it in a way that my friend might have an opportunity to understand what it means? I would say no.

Let's look at the following. "Averaging of the index values provides higher values to you during a period when index values are decreasing. The average of the values 5, 3 and 1 is 3. The average is higher than the ending value. If they're decreasing, the average is higher. On the other hand, if the values are going up, the average turns out to provide a smaller value."

This is an attempt to both tell the whole story and tell it so that my friend might understand it. It's an attempt to have balancing language. If there's a plus, you have to also talk about the minus. That's basically what balancing language is. In this example, there's some real effort being made by the company in order to get this concept across to the applicant.

Again, the companies that try to do the right thing for all consumers, which includes disclosing to them how their products really work, are the ones that are consistently successful. The problems we're having with sales, that Eric talked about, and the problems we're having with mature business, as Tim talked about, come from misunderstanding by consumers and/or consumers being run over by producers.

The last key concept that I want to talk about is one that is very controversial. Let's suppose that we agree that we want to try to design and market annuities to be used for the classic purpose, that is supplementing retirement. If that's the case, then applicants aren't concerned with the level or duration of surrender charges because their intent is to annuitize at some point in time, unless it turns out that we mislead them initially with regard to our intention for crediting interest in renewal years.

If I'm planning to annuitize, then what I want to do is give you my money and see you in 20 years. On the other hand, if I get a bonus or get a high initial interest rate, but by year four the current rate that I'm receiving is very close to the guaranteed rate, then I'm going to feel like I was misled.

Now the surrender charges become a problem, as Tim talked about. Profitability becomes a problem. The question is, should we, as companies, disclose our intentions to consumers with regard to the level of crediting renewal rates?

I would contend if I wanted to buy a fixed annuity, the only thing I would ask of the company is that the crediting rates in renewal years have the same basic relationship to the financial marketplace as they did at issue. That's all I can ask for. I'm not saying that the crediting rate has to be guaranteed. That's absurd. What we are saying is, if the financial marketplace generally goes up, then the crediting rate generally should go up. It shouldn't go to the guaranteed rate. In fact, as applicants, we should know that before we buy a policy. This is a controversial issue, but it is my sense that this concept is going to be required and, in fact, we may end up with self-supported and lapse-supported tests for it. Let me give you an example.

The technical resource working group that's helping us develop this model gave us about 15 examples of annuity disclosure documents that various companies have put together. I reviewed the interest rate section of all 15 examples. Now keep in mind, this is the annuity disclosure document that companies are proposing that they will use with their consumers. All but one or two of those basically say the same thing—"trust us; we're going to pay a current rate in renewal years." There was one example that said the initial rates that ABC pays are self-supporting and could be paid indefinitely, assuming that the current experience continues. That is, the expected renewal rate would be equal to the current new money rate if current experience continues.

We think that applicants have a right to know what the company's intention is with regard to crediting renewal rates. This dovetails very nicely with what the other speakers have talked about in this whole profitability/market share concept. Now, I don’t know how this is going to be handled. We'll probably have a much better sense after the August interim meeting. It could be that if a company is unwilling to make a statement generally like this one, then they'll have to provide an illustration. Or maybe the lapse-supported and self-supported tests are going to play a role.

To summarize, I would anticipate that we will have an annuity model by the end of this year. I would anticipate that it's going to be primarily one of disclosure and that it can be done in a relatively small number of pages. The buyers’ guide is going to be important. Illustrations are going to be optional. If an illustration is provided, then something analogous to the current lapse-supported and self-supported test will have to be included in it.

Ms. Streck: It will be interesting to see how that all shakes out. We wanted to spend just a few minutes talking about current annuity product development trends. We felt that a session entitled “Keeping Current on Fixed Annuities” wouldn't be complete without talking about what some of the new activities and trends are in the new product development arena.

Mr. Timothy C. Pfeifer: These are in no particular order. I would say nonregistered MVAs are an item of interest for companies, with the focus on five- to seven-year guarantee periods. Some of the new MVAs include bonus rates in the first year, which is a little bit different from the way MVAs have been structured in the past.

One area that is getting a lot more attention recently is immediate annuities. I'd say in the last six to nine months, we've seen a number of companies become very aware and very committed to jazzing up their immediate annuity programs with higher commissions, liquidity options. These companies are also offering some ability to commute payments, even on a life contingent type of benefit structure. I think this is a real plus, and something that the industry really needs to do to get the payout annuity track bolstered a bit.

On the deferred side, I see more enhanced liquidity options. We're not seeing cumulative free withdrawals much anymore, with the industry standard being 10%, noncumulative. But things like nursing home waivers, terminal illness waivers, critical illness waivers, and unemployment waivers are all becoming more popular. We continue to see bonus rates on the standard fixed side, anywhere from 50 basis points to 200 basis points, and the dial-a-commission approach that I mentioned before is used in certain situations.

Another interesting thing that's happening is that companies are coming under increasing pressure to let somebody else run the money, like the distribution avenue, banks, or money managers who have their own access to distribution. This would be subject to company guidelines of course, but I think this is a trend that's going to emerge strongly over the next few years.

Last, on the investment portfolio side, companies are looking to bolster their yields a bit more. It's hard to do that; simply extending your maturities and going to double-B or single-B instruments hammers you on the capital side. We are seeing more companies that are revisiting commercial mortgages, up to 15% of their portfolio. Companies are getting into private placements, placing up to 20% of their portfolio if they're in the private placement loop.

Ms. Streck: We all agreed earlier that Tom usually doesn't see the trends until they're going out the door.

Mr. Foley: The only thing I want to say about Tim's list is, as a regulator, the dial-a-commission option, just sends chills down my spine. Some of you well know that I was the regulator in Florida for four years when the chief of staff in Florida had us go on the warpath with regard to annuities. One of the primary reasons for that is that we continued to see ads in national publications that said, "pay the client *I* and pay yourself *Y*, or pay the client *Z* and pay yourself *R*." Folks, please don't do that. Just think about that from the client's position. Think about it from the applicant's position, and think about it from the agent's position. You're going to take value away from an applicant to pay the agent. What's the justification for that?

Mr. Glen Salisbury: Isn't dial-a-commission rebating? Isn't that prohibited, or did I miss something?

Mr. Pfeifer: It comes very close to that issue. There are some companies that have had to address questions from insurance departments as to whether or not this is rebating and what is the justification for arguing that it's not rebating. There are states that don't have anti-rebating laws, so even if it is rebating, it's not an issue. But, when you try to come up with justifications to argue why it's not rebating, it's a very difficult thing to do unless there's some other product differentiators between paying an 8% bonus and a 2% commission, versus a 5% bonus and a 5% commission. If there's some other difference, that's fine, but if the only thing that's different is the combination of commission and rate, it's a very difficult thing to argue. I'd be interested if anyone has any great arguments. We've had trouble coming up with a good argument, and the controversy typically surrounds the rebating issue.

From the Floor: I haven't reviewed Eric's report yet, but I just wondered if there was any data available on different commission structures such as levelization or trailers related to account values? How does that tend to work on persistency?

Mr. Sondergeld: In the annuity persistency study, there were several products that had trail commissions, but they weren't implemented until either late in the study period or afterward. It has been a relatively new phenomenon, and hasn't really picked up a lot of steam. It's going to take a while to see the impact of asset-based or trail commissions on persistency. I'm hoping that it will have an impact, especially on some of the channels like stockbrokers, where they're really selling to get that commission and they may move it again when the surrender charges are gone. I don't know what the effect of levelized commissions or paying an asset-based trail for stockbrokers will do, but I'm hoping that it will work.

A study that LIMRA is about to roll out fairly soon is an annuity compensation study. We'll be able to find out what the prevalence of the various commission structures are in the annuity marketplace.

Mr. Daniel Theodore: With regard to waiving surrender charges for various personal circumstances, it seemed that some of them had a very hard time trying to get evidence to support them. Are they taken on faith, like unemployment?

Mr. Pfeifer: There would have to be proof provided that you filed for unemployment, etc. An interesting issue with the unemployment benefit is the reserving issue. If you have a waiver upon unemployment, is that a voluntary or an involuntary contingency? If you take the position that someone can choose to be unemployed, you presumably have to hold full fund value for everybody, which kills the pricing. You generally have to provide written documentation that you filed.

Mr. Theodore: You mentioned commutation of life contingent immediate annuities. What you're really commuting is the period certain and then just bringing the life part back to the beginning and reducing it? Or can you really commute a life annuity?

Mr. Pfeifer: There is actually a product out there now that commutes life only payments, for example, and others that will probably follow up soon. From a company perspective, you don't want to commute the payments if the person is on their death bed. Your pricing assumes that those people are subsidizing those that are going to live. There needs to be some sort of back-end underwriting performed. You don't necessarily guarantee the ability to commute, but it's commutable subject to some sort of underwriting on the back end.

From the Floor: I was just wondering, Tom, on the life side, if you're providing an illustration at sale, there's a requirement to be able to provide an in force illustration at points in time thereafter. Do you anticipate that a similar requirement will be applicable to the annuities where illustrations are used?

Mr. Foley: Yes. And that raises another related issue. I also anticipate that annual reports will be an integral part of the disclosure document. But in-force illustrations would only be required if a company chooses to illustrate. In fact, it may turn out to be the case that a company can illustrate not on a policy form basis, but on an individual policy basis. We haven't gotten to that point yet, but we will at the next meeting.

Mr. Michael J. Villa: It seems like a lot of the persistency problems that we've had lately have occurred when we started adding a lot of bells and whistles to the policies to have people market them for us. In your persistency study, is there some relationship to the persistency on those policies that don't have a lot of bells and whistles? Is it better or not? What about those with MVA?

Mr. Sondergeld: Regarding bells and whistles, other than the MVA, we collected that information but did not do any analysis to determine whether that specific bell or whistle, (or whether having several) had an impact. We certainly could use some analysis to do that. Some of the bells and whistles are hard to determine if it truly is a bell or a whistle. For example, some of the annuity death benefit guarantees are better than others or more enhanced than others, and where you draw the line to determine if that is or is not a bell or whistle hasn’t been done. We do have the data, if you want to call me to discuss it. MVAs are included in that study and we did analyze those.

Mr. Bruce J. Crozier: I have a comment about persistency once you get out of the penalty period. One of the problems we have is not only how the product is sold, but how the products have been designed. Once you have a product that's out of penalty, you have a very short liability, which means you have to shorten your portfolio if you're going to be prudent in terms of matching assets/liabilities, which in any sort of normal yield curve environment, provides for a much lower rate for business out of penalty than business within penalty.

So when I look at the disclosure being suggested with respect to crediting rates, saying that my renewal rates will continue to be relatively the same if my positions won't change, is going to be very difficult to do if I have business that still has a five- or seven- year penalty versus business that's out of penalty. Yet that may be a very difficult thing to describe to a purchasing client.

Mr. Foley: Maybe what we should do is design more noncash value annuities.