RECORD, Volume 23, No. 3*

Washington Annual Meeting
October 26–29, 1997

Session 138PD
An Immediate Annuity with Cash-Out Rights?

Track: Product Development
Key words: Annuities, Investments

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Summary: With our world changing at an ever-increasing pace, many people are unwilling to commit to an immediate annuity payout. In this session, the panel explores product development considerations of developing a single premium immediate annuity that offers liquidity options. Items discussed include:

- *design alternatives to be provided,*
- *investment considerations,*
- *underwriting/mortality considerations, and*
- *marketing issues/commissions*

Mr. Timothy C. Pfeifer: Our panel is going to address a topic that, for many of us, is becoming an increasingly hot item, and that is, offering payout annuities with some form of commutations rights. Before we do that, we're going to briefly cover the background of the immediate annuities in general, and some of the problems that these products have been having in terms of generating a large market share. For years we've been talking about predictions of the growth in the immediate annuity market and everyone, including me, stands up at these meetings and says, that the immediate annuity market is just around the corner from really becoming a burgeoning new market. Everyone says the demographics are in our favor, and we're going to see it happen. So far we haven't seen it happen.

The focus of this presentation will be on stand-alone immediate annuity contracts, both fixed and variable, although much of what we will say will be applicable to

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annuitizations of deferred annuities or life insurance contracts as well. We are not going to talk about structured settlement annuities, lottery-type annuities, and systematic withdrawals from deferred annuities.

As I mentioned before, this concept is not totally new. As you sell variable immediate annuities now, and you have period certain options, the Securities and Exchange Commission (SEC) requires that you allow commutations from those products. We know of a number of companies that, on an ad hoc basis, would allow for payout annuities to be commuted if someone made a request or if a person is in dire straits or whatever.

I would like to begin with some general background about immediate annuities, talking about where the market is, and where it has comes from. We'll talk about the market demand for cash-out rights and whether there is a demand from the agents' perspective and the customers' perspective. We'll talk about product design and pricing of liquidity options. We'll deal with the question of whether offering a liquidity benefit would make a single premium deferred annuity (SPDA) more attractive? I would assert yes. Is offering liquidity a new risk for the insurance industry? I'd answer, yes. Are we in the business of taking risks? Yes. Can we quantify the risk? Yes. Can we charge for the risk? Yes. I hope that will lead us to looking at this as a viable feature to put into contracts.

There are some tax issues that we'll want to talk about from both the policyholder standpoint and from the insurance company's standpoint these are perhaps unique considerations in light of commutability of the payout product. Then we'll touch just briefly on some of the administrative aspects that you might have to deal with if you offer a product that does allow for cash values on a payout annuity.

I'm going to set the stage with a general overview of what the issues are. Then we have two fine speakers who will followup with more specific information. Let me do the introductions now and give you an idea of what's to come.

Jeff Drake is a vice president of financial services with Golden Rule Insurance Company. Jeff is formerly a consulting actuary. He is currently in charge of all actuarial aspects of the life and annuity operations at Golden Rule. Golden Rule currently markets a fixed SPDA product that does allow for commutation rights to customers. Jeff will present the fixed side and elaborate on some of the considerations they've had to deal with.

Rob Scheinerman is an assistant vice president with Keyport Life. Rob is responsible for pricing and product development of all annuity products within the Keyport operation. He has been with Keyport for about six years. Many of you are

aware that Keyport has made a very big commitment to the payout annuity markets over the last year or so, and I view that as a strategic focus for them going forward. Rob is really in the center of that issue. He will be focusing on the issue of cash-out from the variable payout perspective.

Let’s talk about where the market has been. I thought this information would be fairly easy to get a hold of, but it is actually not that easy to obtain. I'd like to thank Eric Sondergeld at the Life Insurance Marketing and Research Association (LIMRA) for helping sort through some of the issues as to what had been the sales of stand-alone immediate annuities over the last few years. In 1993 and 1994, sales were at about $2.5 billion and in 1995 and 1996 sales were at about $2.75 billion. There has not been a nice, desirable pattern. We can ask questions as to why sales have been as weak as they have been. We always talk about the three-legged stool and how the customer, the agent, and the company all have to benefit. In many ways, we've broken all three legs of the stool when it comes to immediate annuities, where customers aren't very thrilled with the product, agents perhaps don't see that it's worth their time to push the product, and many companies aren't all that excited about some of the financial aspects. I think we can change that. Hopefully the liquidity feature is one of the things that will address that.

We did a recent survey of pricing practices on immediate annuities. The target samples consisted of companies that were very big deferred annuity writers. What we found is that some of the big SPDA writers really haven't looked at their immediate annuity pricing in some time. In some cases, it has been more than a year. They weren't able to tell you things like production levels, commissions , profit growths, or even their pricing assumptions. The fact that you're a big deferred annuity writer doesn't necessarily translate into having your arms around the immediate annuity side.

The fact that these production numbers are estimated is maybe even a bigger indication of the state of the immediate annuities business within some companies in that they weren't able to get very good numbers as to the level of sales. Sales have been fairly flat and these do not include the structured settlements or lotteries. I’m referring to the stand-alone SPDAs that are sold to retail customers.

So why have sales been an issue? First, I would assert that agents look at commissions that are typically paid on SPDA business, and they view them as weak in relation to alternatives. The 1–5% compensation they receive on a SPDA doesn't compare that well with the 5–7% commission they could receive on a deferred annuity from which they intend to encourage systematic withdrawals. The deferred annuity may also include some trail compensation. Agents might not tell you publicly, but they might tell you privately about their belief that once they put their

clients into an immediate annuity, there's no opportunity for them to earn any more commission from that business.

As a result, in many cases, clients are never told about immediate annuities by their producers; therefore, producers never get to first base with the concept of the payout annuity because the agent never lists it as one of the options. Another issue that has been driving the low level of sales has been the recent level of market interest rates, at least on the fixed side where payouts have been relatively unattractive. I think the issue here may be perception as much as realization that customers tend to be quoted a payout per month or per thousand, as opposed to anything that has an interest rate. It's simply the perception that they're going to be locked into what they think is a fairly low and unattractive payout given current levels of rates.

Do customers in this situation postpone buying until interest rates to go up? Generally no. If they're going to be committed to the payoff market, they're likely to go to a variable environment. The issue of benefit volatility is an important one. Some customers who might be tempted to buy a payout annuity, don't want to see their benefits jump up and down a lot. That's certainly an issue with variable payoffs, not an issue with fixed payoffs. One thing is that if you're selling a variable immediate annuity, you'd certainly have to deal with and perhaps consider some way to eliminate that volatility.

The lack of inflation protection is one concern that you'll hear a lot with regard to fixed payouts. Variable immediate yields and equity-indexed payouts, which help deal with that concern, are elements of a product that we're starting to see emerge in some channels. Another concern for the payout annuity purchaser is the lack of liquidity. There is typically no means to gain access to the money used to purchase the annuity except perhaps the death on period certain, or companies that may allow for it on an ad hoc basis. Those companies that allow for it on an ad hoc basis probably don't promote it, and the customer may or may not be aware that they have access to that money. The natural concern for a customer is, what if he or she needs this money? He or she has given you $50,000, but what if an emergency comes up and this person needs access to it? The typical SPDA would not allow them to have access to that money, certainly in the event of a life contingent payout.

We're also facing media influences. Many media articles that have been published regarding payout never fail to mention the fact that your payment is locked in on a fixed payout. The media also says that if you die one day after you purchase the policy, the insurance company takes your money and runs, and you're left with nothing. That seems unfair to the public, although from our actuarial perspective,

that seems to be the entire reason why we can give customers more generous payoffs to begin with.

These are all issues that we have to deal with. Should we throw up our hands to conclude the SPDAs are unsaleable? If I say yes, it's a short presentation. The four issues that I just went through to deal with the question of why SPDA sales have been difficult are important and all have to be addressed. However, this presentation, and those of Jeff and Rob, will focus on the last item, and that is liquidity. Here comes an opinion, that I don't know if you'll all agree with, and if you don't I'm sure you'll tell me. The immediate annuity market, in my opinion, will never be a significant force in our industry unless and until two things happen. The first is, the commissions must increase on some present-value basis. I do not necessarily mean upfront commissions have to increase, but the total package, including perhaps some trail commissions, needs to be higher than where it is today.

I believe that's true because I don't think that many products can be sold without a professional's help. Agents have to be on board with the idea that this is a product that makes sense. Until they do, producers will prefer deferred contracts that have systematic withdrawals or some other options. I'm not necessarily saying that I think commissions have to increase to the level of the deferred products; I think they have to be more rich than they are today.

The second issue is that I think liquidity features need to be prevalent. This will get producers to talk about the product. The perception of liquidity will make the product more agreeable. Policyholders have the perception of their money being put into a black hole with a big insurance company. I think that can be alleviated. I think there is a need to change perception so that people believe that the money is obtainable.

Why is liquidity important to customers? Before I discuss that, let me just define liquidity as the ability to convert all or a part of your periodic benefits into a lump sum. It is almost a securitization type concept. Why is that important to customers? I think it's a perception issue. It gives the product a certain feel. It will get producers to talk to policyholders about this product. It will give the customers a feeling of more control. In real terms, it also increases the policyholders financial flexibility. It will allow them, if needed, the option of taking partial commutations. If they have lifestyle situations where a member of their family needs money or they need to help finance a college education, commuting some of the remaining payments can help deal with those issues. There may be emergency needs—a nonlife-threatening medical situation, a need for a new car or a new water heater. This can be a source of funds to help them through those difficult situations. It can

be a remedy for a poor financial decision. If you purchased the immediate annuity and you shouldn't have, but you're into it for three years, this is a way to get out. Apart from that, if there are other financial decisions that you made, where you need to plant money somewhere else, having the liquidity feature allows you a lot more flexibility than the current situation does.

There are a few market segments that would find liquidity important. The elderly are certainly one segment. When we're talking about single premium immediate annuities, by definition, we tend to be looking to that age group. We are especially looking to those that may be financially unsophisticated and are nervous about any financial product that they might be buying from a life insurance company. I think that allowing them the ability to move out, if necessary, will be very attractive. Apart from the elderly, policyholders who have modest financial means will certainly like having the ability to tap into that money. This could also be an advantage to customers who do not work with an agent or are perhaps unsure about what they buy. They could be made more comfortable with the fact that the product has some commutation ability. The advantage of SPDAs, in general, is that they are tax-advantaged payouts. I think this could appeal to a number of different demographic groups.

When we talk about liquidity, there are a number of issues that we can think about. One is full versus partial liquidity. Do you allow somebody to commute all of their payments only? Or would they be permitted to take half of their remaining benefits and commute simply the half. Then you would presumably readjust the remaining payment. There are some tax issues that we'll mention in a minute. If you allow for commutations from a fixed payout, how do you deal with the investment risks? Presumably the company has invested in 20- or 30-year or long- term corporate bonds or something like that. Just allowing someone to surrender their contract early on, could create an investment risk if rates have spiked, for example.

One can consider a market-value adjustment. This is perhaps similar to what you do on a deferred annuity, which is perhaps a little bit different. It essentially works in the same way. If interest rates had gone up, the market-value adjustment would reduce the value, otherwise commuted. If the price had gone down, it would presumably increase the values otherwise commuted.

Conditional or absolute would be another issue. Do you allow anyone who requested the commutation to get it? Or do you only allow those who can indicate that they have a financial need—those with a specific illness, for example? Are there some casualty losses or has some specific lifestyle situation emerged. Do you allow customers to commute only on policy anniversaries or quarterly anniversaries or every two years? Or is it a continuous commutation capability? That's another

thing to consider when deciding on the restrictions you might place on the timing and circumstances for commutation.

One of the things we're seeing a lot more interest in now would be allowing for commutation from life contingent payouts. It's not at all uncommon to allow commutations from period certain. When you bring in life contingent payouts, you deal with potentially the antiselection risk of someone who is on their death bed, who has a payout annuity and now suddenly wants to commute the remaining payments. There are obviously some safeguards that you would want to put in place to deal with that possibility. Perhaps you could include back-ended underwriting and present values based on current mortality situations, which kind of builds that concept into it. It brings up the issue of whether you should, as a company, guarantee the ability to commute life contingent payments, or should you promote it as something that's available provided that you meet certain health conditions. Jeff will talk a little bit about that.

What about compensation? If you allow for increased liquidity, will that impact agent compensation? I guess I would say, yes and no. I think commissions need to go up anyway for them to be saleable. I would say that, in concert with the liquidity right, commissions are probably going to go up, which includes the idea that you'd probably want to include a surrender charge of some type to amortize those upfront commissions in the event of an early surrender. A charge back that could extend beyond one year could be levied as well. These are other ways to deal with allowing commutation early on in the contract.

Will we see increased use of trail compensation? We are already seeing this. Companies are paying compensation on payout annuities as an ongoing percentage of the initial premium or a percentage of the implied account value. So that's already happening.

This is a little bit off the compensation point. A product that allows for a commutation right is going to still meet the definition of an immediate annuity. You're not changing that structure of a 13-month requirement. From a regulation perspective, this product is still an immediate annuity, which means that it's not subject, at least currently, to the standard nonforfeiture law. Any cash-out benefit that you're providing is more generous than what would be required under the current nonforfeiture law.

What about some of the pricing risks? You want to deal with the mortality risk. Will the unhealthy commute disproportionately? I think the answer there is probably yes. The issue though is how to deal with that risk of antiselection. And there are several ways to do it. I think back-end underwriting is one possibility.

You could use health questionnaires of some kind and build in some general assumption in your commutation. You could use a formula that assumes a certain percentage will be of poor health. The distraction of that is that you are imposing the poor mortality on the healthy lot as well. I think there are ways to deal with that risk. Perhaps the fairest is to do some sort of individual health assessment.

There is also the asset/liability mismatch. Perhaps the use of market value adjustments (MVA) on commutations is a possibility. Unlike a deferred annuity, where there's a fixed term, and you have a fixed interest rate over that term that was crediting, here you might have to define the market value adjustment, in terms of the ten-year Treasury at the time the product was purchased versus what the ten-year treasury is now at the time of commutation. It could be weighted across different maturities of Treasury or something like that. But you can get to a similar point of defining an MVA that will ratchet the benefit up or down. Hopefully, you'll be able to deal with that asset/liability risk.

If you go the MVA route, both New York Regulation 127 and the National Association of Insurance Commissioners' Model Modified Guaranteed Annuity (MGA) regulation do not include immediate annuities within their scope. So they are completely defined in terms of deferred MGA contracts. So these products would fall between the cracks if you had an MVA.

Is the capital risk material? From an NAIC risk-based capital (RBC) perspective, there's essentially no difference between a product that offers no commutation or withdrawal rights, and one that levies an MVA continuously. You may find, at least from an NAIC perspective, that your RBC is not significantly affected.

There are clearly some valuation and accounting issues when offering a commutation right. Your ultimate statutory reserves certainly could not be lower than the amount receivable at commutation. There are some interesting issues that you apply in an MVA. Should you do the accounting at market? Should you do it at book? It seems more logical to think in terms of doing it at market because it alleviates some of the chances of having an instant asset/liability treatment. If you still decided to go the book route, I think these contracts would maintain a Type A valuation rate (if you have an MVA on it) because part of the Type A definition is a continuous MVA.

Do we have distribution risks? I do think that to the extent that you will have commutations from these products it opens the door a bit more to the ability to churn the business, in the event rates have gone up and there are more attractive payout rates across the street. Surrender charges of MDA can help deal with that, to a certain extent. I do think you do face the risk of producers specifically trying to

encourage some of the business to move, to get another commission. However, there is an issue with a payout that you don't have on deferred annuities, and that is that the customer presumably has been receiving a monthly check for the last three years. That can be real evidence that you're providing value to them. It might be a little bit tougher to get that customer to go across the street if they've actually been receiving income and they see it as a tangible benefit.

For that reason, you may want to consider commuting only after the policy has been in force for a couple of years. You can make sure that the customer has gotten the benefit and the taste of the regular income.

I think that there are certain tax issues that are relatively clear, relative to the payout side and the commutations on the payout side. Tax-qualified commutations will be taxed with any associated penalties. Full withdrawals from nonqualified business will be taxed to the extent that you are not recovering your basis. What is cloudy would be partial withdrawals from a nonqualified payout. Is it all income? Is it part income and part principal? If so, how is that delineation actually made? Right now there is a consortium of life companies who are seeking a private letter ruling from the IRS on the tax treatment of partial withdrawals. At this point, they do not have a favorable ruling. However, they're hopeful that they can get favorable treatment, meaning that it would not be considered all income. This is still in the works and something that you might want to pay some attention to.

One other issue on the tax side has to do with life company taxation. And that is the issue of tax reserves. One of the problems in selling fixed payouts in the past has been if rates spike up, and the statutory rate doesn't keep pace; then you can have tax reserves free falling, and you're advancing a lot of taxable income in advance of statutory income. To the extent that you have a cash value on the product, one could argue that there's a cash value floor, and the tax laws say your reserves can't drop below the cash value. It may alleviate some of the problems in having a tax reserve that's dropping into the depths at a time when interest rates are going up.

Just a few comments on administration. I think we need to be careful in how we present commutation on payout annuities. There needs to be upfront disclosure. Frankly, many companies that are considering this hope that it will be a feature that is marketed and found to be attractive, but not necessarily used very much. I think the upfront disclosure needs to be very truthful and expectations must be set accordingly. If you are having back-end underwriting or some sort of health assessment before you'll commute a life contingent benefit, it needs to be made clear that the commutation is not necessarily guaranteed. Perhaps there needs to be

some sort of statement signed or disclosure by the customer stating that they understand the nature of the commutation ability.

If you have an MVA within the contract, the system obviously needs to be able to support that and to produce 1099s on the tax side, to the extent there are commutations that are taken. It may also be a new challenge for your system to pay trail commissions on SPDAs, especially if those trails are a function of some sort of inherent account value. I think you need to set up procedures for what you're going to do when there is a request for a commutation. You must handle those in an expedient yet prudent way, so that, the customers understand what might happen to their remaining payments if it's a partial commutation, or that they will have no more payments if it's a full commutation.

I've given a little bit of a background on some of the issues that you have to deal if you're considering commuting any kind of payout annuity. We're going to get into a more focused part of the presentation now. We'll start with Jeff Drake, who's going to talk a bit about the fixed side and commutations for the fixed payout.

Mr. Jeffrey S. Drake: As Tim said, we have been offering this for a while. I'll interject a few things about what our contract has and a little bit about our experience as we go along. As I looked at this thing, I realize it is a back-end option. It's an option to exchange a guaranteed payout for a single premium. I'm not sure how many of you are aware that there is a fairly active market in the private industry, if you were going out and buying immediate annuities. In the lottery market people are going out and they're exchanging these. There's some good returns from the investment side. They're paying a substantial penalty for that withdrawal.

I think we also have to look at what a policyholder would pay for this policy? Golden Rule was mentioned in Kiplinger's magazine and Kiplinger's view was they wouldn't pay full house. Looking at our rate relative to the industry, we find it wasn't a very positive experience. We really have to look at this from a company-side basis. That's our responsibility as actuaries. We work for the companies, so we decide what to charge for those options.

As a consumer, why would you elect the option? What is most paramount to me is, if somebody is really watching the interest rate, the person is going to look at the change in interest rate and elect that as soon as the option has more value when it is exchanged, which puts us at a terrible disadvantage. A change in health creates the same situation. The most valuable one, which is an uninsurable risk, is the occasional need for cash. I think others will be most important to the consumer. As

Tim said, we need to bring around a perception that there's flexibility in this contract.

Product availability. We chose not to make this an optional benefit on our contract. We were pretty successful in getting through in all the states. While we've done it as a rider, we sell it as an integrated benefit. We looked at this primarily so that the consumer really couldn't come in, just take an explicit cost, and make a comparison. The alternative, of course, is to make that policyholder elected at that time; therefore, you have an explicit cost and they're going to make a comparison or make a value judgment.

As you go about designing these, you need to consider whether you would allow a full withdrawal or would allow for partial withdrawals to address a need for cash? You might allow 50%, 45% or 40%. Some percentage of the whole benefit could be commuted. Some companies are looking at this, and they're only going to allow a certain portion of the annuity. Life contingent period certain, they're only to going to commute a certain period. This might be another option. If you're commuting a life contingent portion, you're really going to have to decide whether you're looking at original mortality, or whether you're going to look at the current morality of the insured, or the block of insureds on the whole. There are a couple of different ways to look at it.

Are you going to look at this as a limited period, or is it a forever option? When you put an annuity on the books, you're still going to be having this flock of people who are eligible 20 years later. Maybe it's something you would do for 10 or 15 years. As Tim suggested, maybe you don't allow it until they had the contract for two or three years.

As I went through and looked at these things, my concern was, who do I want to pay for these things? Do I want to let all policyholders have the option on the contract? I can really have two options. I can have explicit options and explicit properties. Should I fund it in a different manner? Those who do not exercise the option are going to try to get the cost based on those who will exercise the option. No matter what we do, the only entity left is going to be the company. We really have to look at this whole issue of variability and how we are pricing these options.

If you look at all policyholders or the ones who are going to pay, we look at doing a predefined schedule. Would we actually publish, in a contract, what the future commutation cash value would be, or would we leave it through a formula? It is something to consider. When you're doing that you're going to have to make a lot of assumptions as to what the future discount rates are, and what the mortality expected antiselection is. We have even explored bringing in reinsurance. Would

we be better off spreading that mortality risk across a broader universe? As more companies offer this, the Reinsurers might want to take this on to help out the direct company.

Those who elect are going to pay. How did Golden Rule look at doing this? In our contract we did not have a real charge up front; the charges all come in at the back end. Tim talked about the mortality and the asset issues. You might do different things within product design. One other big issue that I think is important is expenses.

On mortality, you can look at those who want to elect this option and only allow those who are in good health to commute. That's what we choose to do at Golden Rule. We did not want to get into substandard underwriting. We didn't want to make it a future assumption of what happens. So we're only allowing those who have good health, and that's going to require a judgment call. What is normal health? The alternative is to look for an expected level of antiselection. How many years forward are you going to move those debts. You're looking at a block of business that's significantly impacted by future mortality improvements. Most companies are practicing that way today. I think all of us recognize that it's getting more prevalent to price that way. You're now going to have antiselection on an improving mortality schedule. It is very difficult to look at. Alternatively, you can get into and actually do individual underwriting at that time. I think that would go from expense issues later on.

On the asset side. The big issue is, who would elect these? It's going to be those who see a big change in interest rates, and a big opportunity to get a larger payout. We've approached it with a market value adjustment. We do look at this and the option is available forever. The market value adjustment is a big issue. We actually have a little leverage in that market value adjustment. If we take a test and make assumptions as to the number of people electing, we may be more profitable on the block as whole because of the market value.

Alternatively, if you look at this and you prepare and you think that you will be using some of these, you make an assumption as to what the election rates may be, and when it will take place, and you end up investing in shorter assets. The shorter part of the yield curve typically has lower earnings. Now so you increase your reinvestment rates at the same time as when you're taking down the amount of investment income you have available. I think it increases the cost significantly if you're going to be funded by the insured.

Product design. Many immediate annuities do not have an explicit load for the commission charges and expenses. They amortize those costs over the whole life of

the book. If that's the kind of product you need for writing, then what happens if I have the commutations early on and I haven't taken care of all the other elements. I may not have recovered my commission cost, profit, or the types of other costs you're taking. If you do have front-end load, you may be in a better position to recover your acquisition cost and probably a profit.

Our typical administrative expenses are related to making the annuity payments. We know the mode, the frequency, and the condition. We start to make those payments in our systems, and we're pretty well set to do that. At some point you need to do an investigation. Is this the same person you've been paying for the last five years or ten years? Those are not new costs to you, but they are ones that I think we don't always recognize depending on how we look at our system. The cash-out rights are going to bring in significant new expenses to companies. People are going to call up and ask, "What's my commutable value right now?" That's a new inquiry. We're not used to dealing with the policyholders who have annuities. We change their address, we change the bank number, but we don't deal with those people very often. The inquiry will be a big expense.

Regarding market value adjustments, not many systems can handle a lot of product value adjustment, let alone the type of adjustment you may want to put into these products. At the time of cash-out, you may have to go through an underwriter.

There are some additional expenses. The first is approval, which is new to the states. We were very fortunate that two-thirds of the states approved it as filed without a lot of questions. We did get some good questions from states. It will raise your cost.

There's the disclosure issue. As Tim mentioned, you want to really make sure this is disclosed at the front end. Companies may have to decide whether they want to disclose this on an annual report. It's a new expense. This would be all new to the systems and would require systems changes. We kind of talked about underwriting costs at the time when you have a system in place, and you do that cost. There will be a lot of people who will call in a month and say, "What would I get? Well, that doesn't sound like very much." You've just gone through all the calculations, and you may have expended money for underwriting. So as part of your product design, you might want to limit this option to once in a given period—once per year or once every two years. It could be done on an anniversary week. I think you'll see a lot of expenses incurred for contracts you don't use. People see what that cost is, but they may not want to take it.

Golden Rule has had this product on the market about 12 months. We have sold less than 100 contracts. We have no requests yet. It has been kind of a surprise.

We're not a big writer. We're a very small part of that $3 billion market out there. It's interesting.

As we look at what we expected to sell in this portion of our business, we have noted that we have picked up in sales. Part of our design, though, was to bring in commission issues to make the product more saleable. I think sales are still driven by the agent.

Market conduct is going to be a real issue. A policyholder, five or ten years later, might not remember the good health requirement. All he knows is he's going in the nursing home, and his fixed expenses just tripled. He thought he had something that was going to let him tap into the rest of his cash. The policyholders don't understand it. If they push the issue, and it ends up in courts, will it really matter what that level of disclosure was five or ten years ago? I think we're going to be held to a higher standard, and even on immediate annuities, we're going to have exposure through the beneficiaries. If they could have commuted that policy six months before he died, they might have had a nice benefit. So now we're going to deal with the beneficiaries in these issues. On an ongoing basis, I think we open ourselves up to more utilization on the option, although that's another alternative. I think that might be a bit costly.

Mr. Robert J. Scheinerman: You can guess which of the three panelists has never been a consultant. I'll start with a few general comments that will mostly echo what Tim said. I agree with his opinion that this market won't take off until we solve the liquidity and commission problems. I also think that education is required of the buyer and of the agent. We talked about the fact that this doesn't get to the policyholder or to the customer and there are reasons why. There's not a good sense of the value of annuitization. What's the need that's being met? Until we see that, it's going to be a third leg in the stool that we're going to have to stabilize.

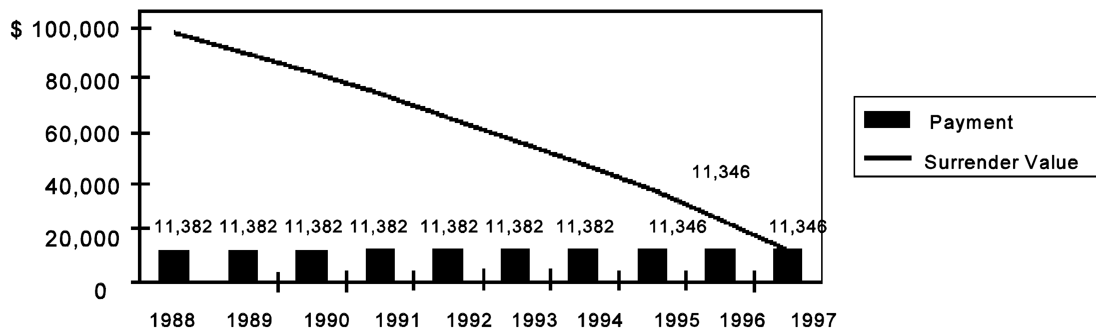
The value of the variable product is, of course, that steady growth and inflation potentially never drop. I think we'd put the variable ahead of the fixed any day of the week. Liquidity and control are going to be important, not just for the policyholder but for the agent. The liquidity question is a hurdle. It is a point-of-sale question that needs to be answered. As Tim alluded to, after the agent has made the sale, he has lost control of the client. This might be especially true in a variable payout product, where it's not always certain how this is going to be used in the sale. One could see it as the core income provider for an individual, but because of the volatility and the variable market, it might be supplemental from other income sources and it sort of enhances returns as a way to get a little more money out.

Compensation is a door opener towards distribution. If you don't open the door, you're not going to see any sales. I would propose that we'll be doing the accumulation side. It will not necessarily work on the payoff side, since the product has different needs. It has a different sales process, and therefore, it should be compensated differently and it needs to provide the appropriate incentives.

The mechanics behind the variable payout are well established. You set an assumed interest rate, hoping that the markets or the funds that are invested will match that growth or exceed that growth and determine the number of units to be paid out each period. Those units multiplied by the adjusted unit value, adjusted for the assumed interest rate (AIR), will determine what the total payment is. The mechanics are what leads to the ability to provide a cash surrender value.

A few illustrations will help clarify. Chart 1 is my perfect foresight model. We assumed an AIR of 3%, and the market actually had 3% interest rates throughout the ten-year payoff period.

CHART 1
VARIABLE PAYOUT PRODUCT ILLUSTRATION
PREFERRED INCOME PLAN 1O-YEAR ANNUAL PAYOUT



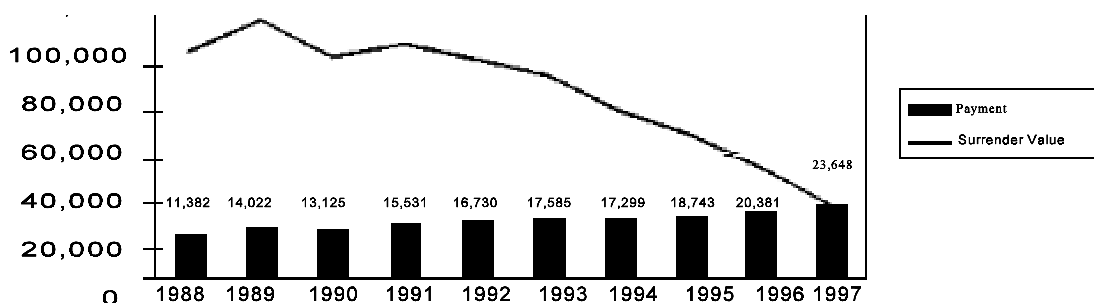
Note—Premium = $100,000 Assumed Interest Rate = 3% Assumes fund earn 3%

You can see the payments stayed level, and that the cash surrender value declines smoothly throughout the period. It is neither interesting nor realistic.

Chart 2 is based on an actual fund over the last ten years. As you can see, both the cash payments and the cash surrender value are volatile. I propose that twice every ten years the market drops. They were covered for the next five. Going from 1988–89, you see the market was up strongly. The payment went up significantly from $11,382 to about $14,000, and the cash value went up from $93,000 to $106,000. I find it interesting that a year into the product you can receive payments and get back as your surrender value more than you put in. That's one of the

benefits of the variable payout. As you look forward, you can see it dropping and then rising again. So there's no illusion that it is a certainty that you're going to have better cash surrender value in the variable payout, but there is more variability and the hope of upward moving markets. You should be able to see stronger cash value for longer periods of time.

CHART 2
VARIABLE PAYOUT PRODUCT ILLUSTRATION
PREFERRED INCOME PLAN 10-YEAR ANNUAL PAYOUT—ACTUAL FUND



Note—Premium = $100,000 assumed interest rate = 3% Assumes funds invested in Stein Roe Managed Assets funds

The payout option is the same for the variable market as it would be for the fixed market. You have a term length so you can set your payment frequencies, monthly, quarterly, or annually. The levelized payment is a feature we offer in our variable payoff product. I think it addresses one of the needs that we talked about. If somebody chooses monthly payments, rather than give them the monthly payment from a standard form, we set an annual payout. At the beginning of the year, we take the full payment and levelize it over 12 monthly payments. What's beneficial about that? They know for the next 12 months that their payments aren't going to change. That really helps in getting through some of the market volatility. When you look at what's going to drive surrenders in this product, one of them will be market performance. If people see the markets declining, and they see their payments declining, they're going to be disappointed. If you can see payments stay smooth for a period of time, there's a higher likelihood that the market will be up year after year, month after month. It could help guide customer behavior.

An example of a variable payout product design is life and joint life. We only offer period certain in our variable payout. I think most of the issues that Jeff talked about would apply as well. Another feature is the possibility of guaranteeing that the payment can't go down as a supplemental guarantee.

The design is no different than the accumulation base; you need to set up a portfolio of funds. There are various investment options and a possible need for a fixed account. Does somebody in the variable payout phase need a fixed payout? Then, if you do need that, you're going to have to think about the previous presenters' comments and how you're going to make that liquid to parallel the variable payout. The death benefit is a form of liquidity that exists in these contracts. Cash value is obvious. Annual reset is another because we've seen it in the accumulation phase. I'm not sure what it would mean, but I think it can be done in this type of a product. I don't know whether that would be considered a value in the payout market, necessarily, but again it's a market guarantee of protection that people might be looking for.

In setting up pricing, the first thing we have to worry about is, why and when would people use the cash-out? You need to do this in the pricing. If you don't understand what drives the policyholder behavior, you're not going to be able to figure out the right cost of it. A couple of the reasons have been mentioned, including no longer needing the stream of income. In the variable product, I propose that you'd be satisfied with the return and no longer want this type of product. There's also the emergency cash needs. I'd also add that lack of guarantees could drive policyholder behavior. Jeff's talked about the fact that the company has to figure how much it should charge, and people have to figure out how much to pay for it. The worth of something might be more than what someone is willing to pay for it. But when those guarantees are holding, people are going to want them.

The second question, is where will they go? In any consideration of what is going to drive policyholder behavior, you must determine what are they going to do with the money? First off, they can take the money and run. They no longer need the payout or the emergency requirement. The other possibility is an exchange for another policy. When we first looked at the payoff phase, we thought, "This is a great idea. They can't go anywhere. They can't exchange them. They don't exchange them, and it's not the most active market, but it's certainly not beyond the possibility to do a life to life from one payout to another. It's a little bit dicey for the policyholder because if you change the terms, like who the parties are, what the payoff stream is, and the timing of the payout, you could incur tax penalties and adverse tax treatment. I also think that this is where the question of compensation comes in the most. If we get the compensation right, we should be able to dissuade agents from looking at this as a possibility for moving policyholders.

The death benefit is guaranteed but really is not one of the options of the policyholder, and beneficiaries take the money. They could continue the payments, but people might look at this as a windfall and take the liquidity at that point. One

of the reserve implications is that any guarantees made by the company are going to require reserves; for example, there is a minimum payment, and a minimum cash surrender value, meaning the amount you receive back can't be less than the amount you put in. There could be situations with variable products, where, due to the poor market performance, payments returned in the cash surrender value are going to be less than what was put in. That, as well as our monthly payment, might be a guarantee that would be provided. The levelized payment, once it is pulled out of the variable account, becomes a general account liability and would drive some reserve requirements.

Another consideration is the recovery of acquisition expenses. As you set up this payout situation, you have to worry about people surrendering early and not having an opportunity to recover your commissions and other set-up charges. There are three possible ways you can do that. You have surrender charges, commission chargebacks, and front-end loads. The question about commission charge-backs is how long to have them. Certainly five or six years of commission charge-backs might not be a very effective way of covering your expenses. The front-end load in a fixed payout isn't so transparent, but in a variable payout, it's going to go right through to the statements, and that might be a difficult challenge.

What are some of the expenses? You are going to be interested in being able to make regular distributions sufficiently and make intentional direct-deposit distributions to accounts. I think the service and training issues are very important to the administrative areas. In the past, you needed to tell people how much they are going to get and when they are going to get it. Occasionally you're going to need to change the name or address. In addition to being able to provide cash surrender value information, you need to have more people to service calls who can explain the impact of surrender, the possibility of taxation, and the fact that surrendering will stop the payment from coming. That may seem trivial, but the people are used to getting the payment.

On the revenue side, there are the mortality and expense charges, either a spread concept or a fee-based charge. These administrative charges could be basis points or dollar amounts. It's support from the mutual funds within the contract of marketing.

One of the most important considerations is going to be fund performance. What is it that's going to drive this person to dissatisfaction with the policy and make the person want to leave? It also drives your pricing in that you collect less money when the funds go down, so you have a double whammy going on there. Another important consideration is how an account that is declining over time drives the

pricing issues. But a surrender drives it to zero, so you need to make sure that you're recovering costs along the way.

Compensation, again, may not want to follow the accumulation side. Encourage the ongoing relationship between the agent and the policyholder. Connect the interest of the agent to the policyholder.

The valuation and capital needs for variable products are not the most difficult, but they need to hold the accumulated value or at least the cash surrender value that you're going to pay out. Additional reserves wouldn't be needed for the death benefit if it was above and beyond just the cash surrender value. This would also apply to any other guarantees that are provided in the product, such as the levelized payment or a guarantee that payments can't go down. The capital needs, because the investment risk is passed onto the policyholder, keep that relatively low. I would propose that is similar to variable annuities (VA), probably in the area of 0.75–1% range. Any mortality risk with guarantees in the payment, especially if those guarantees are going to translate through to the cash surrender value, are going to require additional reserves.

At first I thought there were no investment issues with respect to liquidity in a variable payout product. In thinking about it, I realized that there actually are a few things that are really important. It's trivial to say that the funds need to meet the expectations and the objectives that are set in them, but fund management is going to be affected by the liquidity option. In addition to the regular payout, the fund manager has to be prepared for potential surrenders and have cash on hand for those situations. When the market is down and the funds are down, surrenders are going to be at their worst. It's somewhat of a double whammy that, as markets are declining in value, you're also going to be required to be moving into cash to anticipate those surrenders. So there is a little bit of impact on the investment strategy there.

The guarantees will be in the general account. You have to have shorter matching for monthly payments over the course of a year. Special enhancements to the death benefit or guaranteed payments would require a different investment strategy. Put options might work for guarantees that state payments could not go down.

I'll do justice to the topic of taxation in a short while. Let's move on to the exclusion ratio. We set an amount that won't get taxed and spread out the premium, which is the main advantage to the payout. I think when the person surrenders, he or she will that advantage no longer exists. They're going to pay all the taxes at that point. It is somewhat of a big topic because of the change in the capital gains tax. I think as long as the policyholder keeps the contract, there's still

a good argument as to why the taxation within the variable annuity is well advanced compared to a mutual fund. There's a managers' trading behavior with respect to the 18-month-hold rule, and the ability to make tax-free transfers. But if you are promoting a liquidity feature, and people are going to be taking surrenders, that money will be taxed as income, which means that the advantages of taking surrenders might not be there.

As far as the cash-out goes, the earnings are fully taxed to the extent of earnings, and we talked a little bit about partials being taxed as income first. We restrict partial withdrawals in our product for obvious reasons. I think there are administrative implications and taxation issues.

We talked about a lot of the administrative needs for this product. You need to be able to support the annuity unit values in the AIR for each fund, so there is a fair amount of data and calculation. You will need to support the various payment options, period frequencies, and be able to change along the way. The other part is the fact that you're going to get the phone calls, and you're going to have to be able to explain the cash surrender value and the impact of liquidity.

I'd like to make a few comments about equity-indexed payouts. It is definitely relevant under the variable payout part because there's a definite analogy between the two. There is one indexed payout product on the market today, but I do not know how it has been doing. There are a number of ways you can approach it. I think the most obvious is to follow the variable immediate annuity approach. You can use similar math and potentially build, but not unitize it. You create units behind the scenes. You can create a 3% payout for example, and you can use the excess money based on higher interest rates to perk this equity participation.

If you could set the AIR at zero, that would give you maximum participation. I'm not sure whether that would be supportable, but it certainly would give you the most money left over for purchasing options. If you did not guarantee that minimum of 3%, in accordance with the AIR, you would have the potential of payments going down from one year to the next. I think that significantly contradicts the goal of the equity-indexed product. Even though the payout stage is a little different, I would propose that having a payout, that could go down, in the equity-indexed annuity would not be a good idea.

One of the issues that you're going to run into is what kind of crediting method you're going to use. If you've seen some of the presentations on equity-indexed annuities, you know that the great thing about them is that no two are alike. That proliferates into the payoff market, which can guarantee that confusion will reign. You could potentially use any crediting method—it's just a matter of how much

complexity you want to introduce into your product and what the term rates will be. The simplest example would be to have a one-year term rate where people can see the impact right away, but I don't think that would preclude having longer term rates available.

Another issue would be parts of the stationary guarantee. If you don't guarantee the participation rate, the liquidity feature becomes all the more important. One of the things that is true in all the payouts that we talked about so far is the lack of control by the companies. In a variable payout, there is no control, other than what's happening in the fund, over what the rates are going to be. In a fixed product, if you guarantee the payment, you also have removed control from the company. I think if you change anything on the customer along the way, the liquidity will become more important.

The next question is, what do you pay as recognition of index gains to date or do you spread them out over the remaining future payments? That's a question that would need to be answered. It would also be driven by whether you are comfortable with payments going down from one year to the next. There is also the question of how you do liquidity. I would say that a market-value adjustment just wouldn't make sense here because you are really in a fixed realm. It is not so bad for the fixed component. You have interest rates. I don’t think it’s so bad on the index component. You just put a Black Scholes formula in the contract, and people will understand.

I think the equity market will arise. I don't know how it will manifest itself or what will come first as a successful product in the payoff market. There are many questions for which we need the answers before this product could actually take off.

Mr. C. Phil Elam: I just have an observation and maybe the panel will want to react to it. Insurers often do no formal underwriting upfront with planned contingent annuities. We assume that the applicant is doing that and is thinking about how good a risk he is before he decides he should buy a life annuity. It seems to me that the insurer will be vulnerable to embarrassing criticism, after the fact, if the back-end underwriting is more stringent then the front-end underwriting. It seems to me this will push us to more detailed SPDA underwriting on the front end.

Mr. Drake: That's a good point. We have looked at whether we needed to get at least some statements on the front end. We decided we did not. I think you're completely correct that we're opening ourselves up to some comments on that. Again, it's an open question as what is good health at that time? It is going to be determined on a relatively individual basis, so I don't disagree with you at all.

Mr. Richard J. Tucker: Can full cash-outs from an immediate annuity be applied as a 1035 exchange to another annuity?

Mr. Scheinerman: Since I brought that up, I'll add my comments first. I assume you mean not taking the money, but doing an exchange. I don't think you could go from a payout back to a deferred stage. I spoke to our legal counsel and they saw no reasons within the regulations why it couldn't go from one payout to another, maintaining the terms, so that the principal is basically being taken at the same rate. Anything that accelerates taxation will be acceptable, and anything that slows down taxation would not be acceptable.

Mr. Drake: Right, you must avoid the taxable event at the point of exchange.

Mr. Scheinerman: Right. Section 1035 is fairly vague. There is not a lot of detail when it talks about like for like and it has some restrictions. There's nothing in it that seems to exclude that.

Mr. Pfeifer: We've had some informal conversations with tax counsel and they said the same thing. It's not crystal clear but they believe that it would be fine.

Ms. Cathy H. Waldhauser: I have not been following this market closely, so some of my questions might be pretty simple. Isn't there a risk of jeopardizing the tax proration that annuity recipients have by allowing cash-out. I was particularly intrigued by Mr. Scheinerman's comment that you offer immediate annuities at a certain period only. What makes that an annuity that warrants a proration of tax on the payout?

Mr. Drake: With respect to the annuitization, as long as you are meeting the definitions and payout, you will get the exclusion ratio. As far as the surrender jeopardizing the exclusion ratio, I think as long as you're accelerating taxation, which is what you would be doing in surrender, the IRS would be perfectly content. Of course, the burden of proof would be on us to accept that.

Mr. Pfeifer: Yes, I see that as the main issue too. Many of the tax issues and the valuation categorization issues kind of blend in terms of how much this commutation feature becomes a prominent part of the sale. How much is the ancillary part of the sale? If these were still marketed primarily as payout annuities with the side feature of liquidity, I don't tend to think there's going to be a lot of different treatments on a regulatory side.

Mr. Drake: It would probably get most difficult if you had substantial partial withdrawals being taken. If people were just liquidating proceeds and clearly getting abusive, I think we might see the rules change.

Mr. Stephen G. Kellison: I'd like to address the question that has been posed about the compensation. There seems to be a theme here that we're going to need to pay the agents more in order to be able to give them the incentive to sell this business, and that's probably true. I also hear comments that we'll have to price for some other things, like some antiselections or possibly some other administrative expenses.

By the time all of this is done, of course, we're going to have a more expensive product than we have. I'm not sure whether the agent will be able to sell that in today's competitive marketplace. Maybe some will and maybe some won't. We're certainly not making it a cheaper product. I guess I would like to maybe try the compensation pressure from a little different slant. What is it that we're actually paying these people to do? Second, what is really going on in the marketplace? Basically the asset management business for people in retirement will be a huge business in the next 40 years. We can see this by looking at the demographics, the amount of money that's being accumulated by defined-contribution pension plans, and all the rest of it. There's a tremendous business potential in the future, in terms of managing money in retirement.

We're in competition with people outside the insurance industry. We're in competition with financial planners, stockbrokers, and others. Part of their pitch is to encourage consolidation of people's assets and manage their retirement. That's going to be a big business. How can we find the place in that? I'm not suggesting that we need to turn all the agency sellers into full-blown financial planners, but the decision about whether or not to buy an annuity or annuitize it in a deferred contract is, to some extent, part of a much bigger issue. That issue is how they manage their retirement and what their estate plan looks like. I think we have to, in talking about compensation to the agent, take a look at who we're really competing with. It's not always within the insurance area.

Mr. Pfeifer: Yes, that's a good point. I think the real challenge is simply getting producers to look at the product and getting them to talk about the product with their customers, but this is not happening now. I guess the other point I would make is somewhat related to what you were saying. I've heard people say, "Why are we worried about liquidity? Why don't we just sell products that have liquidity with a certain portion of the customers money, and put aliquot money in the payout annuity. Just do an asset allocation that way and don't worry about providing cash-outs from the payout." I think that works in theory, but in practice that's not what's

happening. It's clear that we can't get the agents to first base in terms of actively promoting these products.

Ms. Donna R. Claire: I'll give sort of a warning. Everyone thought that Actuarial Guideline ZZZ applied to just equity-indexed deferred annuities. It does not apply to only equity-indexed deferred annuities; it also applies to equity-indexed immediate annuities and guarantees on the variable payout at this point. Again, it is just a guideline, and it has not gone through the NAIC procedures; however, this could be the Illinois Halloween surprise this year.

Mr. David J. Christianson: Another question on the compensation. You mentioned trailer conditions with the risk that people will live too long. Would those tend to be permanent trailers that companies would like to look at or is it a fixed period thing?

Mr. Scheinerman: We've looked at it, and I kind of feel that I'd like to make it a limited period. As your total assets decline down into this product or an immediate annuity, I don't see that you have less of a margin for expenses. A suggestion could be that we do a ten-year period. We're not currently doing it, but I would look for a shorter period.

Mr. Pfeifer: Or you could make it permanent but scale it down almost like a service fee out on the tail.

From the Floor: I'll change the subject. You talked about reasons why people aren't buying. I'd throw out another hypothesis and look for a reaction. Harry Whitman wrote a paper few years back about the percentage of people at age 65 who were standard risks. It was about 60% of the applicants. If you look at age 80 or so, maybe 20% of the applicants might be considered standard. Is there another factor in the way that the product is designed that would indicate that it is geared towards people who would consider themselves to be a good mortality risk? Do we exclude a good portion of the market because we don't do anything for the people that are in poor health?

Mr. Drake: That maybe an area where you will see companies that have smoker immediate annuity rates in their portfolio. They are at a higher payout and an interesting way to look at it is to look at the immediate annuities and do underwriting at the front end, which might help the perception of the industry on the back end. You would then give the best quote. Steve Kellison asked about who we are competing against. I think we might not be discussing one of the most important issues. We're the only industry that could still offer the life contingent option. We can guarantee that we'll provide those funds throughout a lifetime. We

have to get our field forces to talk about it. The compensation issue, as we've addressed it, is such that the product will not come out of the briefcase unless it pays more. That's kind of the issue.

Mr. Scheinerman: I'll add to that a little bit. The question would start with how many cigarettes have you smoked in the last year? When you take a life payout as opposed to life insurance, where people seem to accept pooling of risk, it's a bad news/bad news situation. On the life insurance side, you don't get many complaints. If someone lives to be 100 and has paid you all this premium, and then does die early, there's a benefit that covers a risk there. However, in the past, you have had sort of the bad news/bad news situation. Once you've died, you lost your money to the insurance company to pool for the risk of people who are going to live longer. I think that tying both pieces of bad news together is really what hurts the market.

Mr. Pfeifer: I think that sometimes we have to put ourselves in our customers shoes, and this is one of those times. They don't appreciate the theory of Jordan that the reason they get the higher payout is the benefit of survivorship. It seems unfair to them, because they may have just given you $50,000, and if they die tomorrow, you keep the whole thing. Maybe that's a rise of cash refund annuity or something. We have to start looking at those things.

Mr. Drake: Just out of curiosity, how many people here would put a large chunk of their money in a pure life payout annuity? There's a few people. Even among those of us at this session, there are some questions about what's going to happen over the long haul.

Mr. Scheinerman: In my prior life as a consultant, I really had a hard time getting our companies to not offer the life only options, because I had the opportunity to see two cases of more than $100,000 of single premium where the annuitants died before the first monthly payout. That's difficult. In both situations, the company said it would rescind the contract.

Mr. Kenneth W. Faig, Jr.: In addition to a potentially broadening market for life annuities, underwriting life annuities in the front end would provide a potentially more equitable mechanism for say, annually requalifying the annuitant for the surrender benefit. The rated age concept, which is used very commonly in structured settlement underwriting, could be as simple as essentially a reappraisal of the rated age in each duration. It could almost be packaged with a health examination, which would have the additional benefit of providing a verification of the identity of the payee. I'm rather surprised that underwriting annuities has not spread from the structured settlement market into the annuity market in general.

Granted there's some loss of the tax spreading advantage if you underwrite and give it more favorable payment. Certainly if the only individuals who were motivated to apply were not the superselect group, there would be a broader market. I also think that the loss, the ability to recover an exclusion ratio free of tax over an entire lifetime, even after the principal has been fully recovered, was a very damaging event for this market. I believe that this occurred for contracts issued after 1986. I do agree that the straight life annuity is in need of a little bit of reengineering. I think that the addition of a certain percentage cash refund benefit, a death benefit, would cure a lot of these situations where a dramatically low return has been received. Maybe you'd have to appraise your market and decide whether you want a 10% cash refund or 50% cash refund. So those are just some thoughts. I'd value any comments the panelists might have regarding them.

Mr. Pfeifer: I agree with them all.

Mr. Scheinerman: If companies are going to get involved in this, they're going to have to see it as a larger potential market. This is a chicken-and-egg issue. This may help to get the market larger, but a lot of companies who have spent some money in the last few years on immediate annuities aren't seeing returns on them. Are they willing to go down that line again? It's a good idea.