RECORD, Volume 24, No. 1*

Maui I Spring Meeting
June 15–17, 1998

Session 95PD
Variable Annuity Product Design

Track: Product Development
Key words: Product Development, Variable Annuities

Moderator: DEANNE L. OSGOOD
Panelists: JEFFREY K. DELLINGER
LILIA M. SHAM
TERRY J. SIMPSON
Recorder: DEANNE L. OSGOOD

Summary: In a continuing bullish stock market, variable annuities have sustained their popularity. However, the changes in state and tax regulation, as well as the search for new marketing opportunities, impact product design. In this session, the presenters discuss the following topics:

- *The expected impact on product design of recent changes in tax legislation.*
- *The expected impact to compensation patterns and product design as a result of changes to New York Regulation 4228 allowing asset-based commissions.*
- *Variable immediate annuities as a new equity investment opportunity.*

Ms. Deanne L. Osgood: In one word the variable annuity (VA) marketplace and VA product development is "hot," which makes it a very exciting time to be a product development actuary. We've experienced an explosive growth in VA sales in recent years, achieving an all-time high of $87 billion in 1997. This has been primarily due to the low level of interest rates and to the relatively strong performance of the equity markets. This has resulted in a flurry of product development activity. While preparing for this session we tried to determine the most important things to talk about. There were so many different things that we could talk about, but we finally decided to focus on the guarantees that are being developed and provided in VAs; the unbundling concept, which does relate pretty strongly with the guarantees as a lot of the guaranteed benefits are being provided on an unbundled basis; the enhanced rate dollar cost averaging subaccounts, although you'll find out that there aren't very many people talking about those anymore because features like guarantees and unbundling have become much more important; asset-based compensation, including the New York Regulation 4228 information; and finally some immediate annuities and variable annuitizations.

I work in the Chicago office of Milliman & Robertson (M&R). I have over 13 years of life insurance and annuity product development and management experience. I've been with M&R for two years specializing in life insurance and annuity, both fixed and variable, product development.

Jeff Dellinger is vice president at Lincoln National Life Insurance Company with responsibility for the $20 billion plus individual annuity line of business. As the individual annuity profit center manager, he oversees all aspects of Lincoln National Life's individual annuity operations. He previously served as actuarial director for Annuities Product Management where he directed the product development, pricing, actuarial, and asset/liability management (ALM) functions. Lincoln National Life manufactures fixed and variable deferred and immediate annuity products for the retirement savings markets. He is in his 17th year with Lincoln National Life. Mr. Dellinger is a Phil Beta Kappa graduate of Indiana University holding a bachelor's and master's degree in mathematics. He is an FSA and a MAAA. He holds Series 6 and 26 securities licenses. Mr. Dellinger is the author of articles featuring annuities that have been published in *Best's Review*, *Life Insurance Selling*, the *Vard's Report,* the *Reinsurance Reporter*, and numerous other publications. His advice is solicited for articles on annuities appearing in publications such as *The Wall Street Journal* and *National Underwriter*. He is a frequent speaker at national variable and fixed annuity conferences. Jeff is going to be talking about asset-based compensation. He will then pass the baton to Terry Simpson.

Terry Simpson is an assistant vice president for the Lincoln National Life Insurance Company. He is responsible for product design and development of fixed and variable annuities with an extensive background in annuities encompassing such topics as in-force management issues, ALM, immediate annuities, and contract state filing requirements. Terry received a Bachelor's of Science in Actuarial Science from the University of Iowa and came to Lincoln in 1991 following graduation and a previous actuarial summer internship with Lincoln. He has spent his entire career at Lincoln working in the annuity field. Terry is an FSA and a MAAA. Terry's going to talk about New York Regulation 4228.

Lilia Sham is going to wrap it up by talking about immediate VAs. We all know that with the changing demographics and the shifting focus from accumulation to payout many companies are interested in changing their focus to payout products as well.

Lilia's going to bring us up to speed on some of the product development activity that has occurred with immediate VAs. Lilia's currently working with Tillinghast, where she has been for four years. She specializes in fixed and variable life insurance and annuity product development. Lilia and I are also FSAs and MAAA.

I'd like to start off by talking about guaranteed minimum death benefits (GMDBs). The big news with GMDBs is that mutual fund companies are now starting to provide death benefits on their mutual funds, which further blurs the lines and the distinctions between VAs and mutual funds. Although GMDBs are demanded by distribution outlets, particularly the wire houses, the richness of the benefit appears to have plateaued. We are seeing the charge for the death benefit become unbundled from the base mortality & expense (M&E) charge and a way to be able to provide a lower cost VA. For those who are really interested in being able to have a richer GMDB, it can be added for an additional fee, which brings up a lot of pricing issues. We're also seeing some companies start to price the GMDB with the price varying by age, and that will hopefully reduce some of the cost of antiselection. However, it can be a little bit more difficult to price.

Related to that is reinsurance. We conducted a survey of 16 of the top VA writers recently and I was surprised as to the number of companies that were not reinsuring the GMDB. There were a couple of companies that said, "Yes, we reinsure it 100%." There are reasons for that, be it related to not wanting to have any mortality risk on the books, for management reasons, or for profit-sharing arrangements they have set up with distribution outlets. Other companies are saying they are comfortable with the volumes they have so far. They are in constant contact with the reinsurers, but right now they really don't feel the need. This is something that surprised me a little bit, and I think we may be seeing a little more activity there, particularly if there are some antiselection issues and depending on how the benefits are priced.

The mutual fund death benefits. American Skandia and SunAmerica both have introduced death benefits on their mutual funds. In American Skandia's design, they guarantee the larger of the current fund value, the highest fund value on any anniversary prior to death, and a 5% annual growth to a maximum of 200%. One of the interesting issues that arises there is if the market continues to perform as it has, there may not be a minimum death benefit. So, the question becomes how can you charge for it, and how does that all work? Those are some interesting issues that are being worked through as these benefits are being designed.

SunAmerica's product design is a little bit different. It guarantees the larger of the current fund value or 4% annual growth to a maximum of 200%. So, it's slightly different. With that, I'd like to lead into what the current activity is, and provide an indication of how the landscape has changed over the past six weeks. About six weeks ago there wasn't any standard industry lingo associated with these guaranteed living benefits that are being provided and designed for VA, and now there is. There's an AAA VA Guaranteed Living Benefits Work Group that is actually working through many of the reserve and nonforfeiture issues related to these living benefits. One of the fallouts of most of the work groups we have is there are a lot of acronyms that are used, and some lingo has become standardized. One of them is the guaranteed minimum accumulation benefit (GMAB).

One of the reasons it's been developed is in response to the equity-indexed annuities (EIAs) that have emerged. The EIAs were introduced into the marketplace with the idea of being able to have access to the equity markets with some downside protection, and some of the VA providers decided they didn't need to develop EIAs. They have a field force that is registered and can sell VAs, but recognize the fact that they need to be able to offer some kind of guarantee. Companies actually are getting very creative. So far there aren't any benefits that are identical; they all have a unique twist to them. The designs are very innovative but some of them are in response to the EIAs, and what they're saying is we can provide you the full, upside potential. You give up a little bit of the return in the form of a basis-point charge, but you do have some floor of protection.

The GMAB provides a guaranteed account value if the contract remains in force for a specified period of time, currently ranging from 8 to 20 years. One product offers a guaranteed account value that is 90%, 100%, or 115% of the premium that's paid. Another product offers a guaranteed account value that is 100% of the premium. The third product offers an accumulation of the premium at 3% per year. Three companies have introduced this benefit to date: Travelers, Citicorp, and Indianapolis Life. Several more are in the design phase and getting close to introduction. Reinsurers are getting inundated with requests from companies to look at the designs that they're developing and try to determine some prices for the benefits.

The second guaranteed benefit I'd like to talk about is the guaranteed minimum income benefits (GMIBs). This was the first benefit design that hit the street. Some of you may be aware of Equitable's product. They were the first company to introduce one, and they've actually achieved a great deal of success with their product design, which I think has prompted a lot of companies to take a look at what they could provide and hopefully achieve some of that same degree of success. Anecdotally, we have heard that about 70% of Equitable's VA sales include the GMIB. There are four companies that have launched GMIB, and those companies are Equitable, Allstate through Kemper, Manulife Financial, and Citicorp. Again, each of these designs is a little bit different. The basic requirement is that the contract remain in force for a specified period of time, 7–20 years. If the contract is annuitized after the specified period elapses, a guaranteed accumulation value is used in conjunction with the guaranteed purchase rate to determine the amount of the income payment. There are a couple of different designs out there. One company provides the higher of the current fund value applied to the current purchase rate, and the guaranteed fund value with the guaranteed purchase rate.

The advocates of this benefit, the people who really like it, are excited about it because it focuses on the income side of the product. There are many people who feel that that is where the industry is headed, that a lot of money has been accumulated, and there will be a greater focus on the income payment products.

The target market for this benefit is the customer who believes that the market is going to continue on an upward trend, but, just in case, they do want to have some floor protection. The charge is significantly less than that for the GMABs, ranging from 13 basis points to 50 basis points. The charge for the GMABs ranges from maybe 80 or 100 basis points up to 200 basis points at the maximum. So the owner is giving up quite a bit more potential return for the accumulation benefit. One of the reasons people are really excited about the GMIB is because the customer doesn't have to give up a great deal of return in order to have that guarantee.

I'd like to talk briefly about unbundling. We did talk to the 16 companies, and there were very different schools of thought on the unbundling concept. There were some companies who really didn't want to go down that path. They thought that the administration problems would be much greater than the benefits received from unbundling. One company said that they hope the other companies spend an awful lot of time and money getting their products able to handle unbundling because they felt that they would be able to take over some market share by not focusing on that aspect. The benefit of unbundling from the carrier perspective is that one product chassis could meet the distribution needs of several distribution channels. Some of the state filing concerns and the length of time it takes to get contracts filed can be alleviated if there is a chassis that can handle multiple products through the technique of unbundling. The product could actually drill down to the policyholder level by letting the policyholder pick and choose which benefits they're willing to pay for. Companies are somewhat worried about the market conduct concerns related to unbundling. Will customers really understand what they're buying? When they are buying a benefit do they know they're buying a benefit?

The features being unbundled are the guaranteed living benefits that I talked about. Some conditional guarantees are being considered such as benefits that will provide guaranteed values if critical illness occurs or if the owner enters a nursing home.

Providing a guarantee that is conditional on the occurrence of a specified event can reduce the cost of the benefit dramatically.

Dollar cost averaging (DCA) was a very, very hot topic back in late 1997 and early 1998. Companies are offering DCA subaccounts with very attractive interest rates. They feel that it's a way to ease the concerns of a consumer who is worried about losing some of their money if the market performs poorly shortly after their VA purchase. They have an interest in entering the equity marketplace, but they're still a little bit unsure. These DCA subaccounts are offering rates as high as 10% over a six-month period, where an owner can allocate a portion of their money to the DCA subaccount and have it moved systematically into the variable accounts over a six-month period of time. While it is in the DCA subaccount, it is earning an attractive interest rate, and that is bridges the gap and helps consumers move from the fixed to the equity marketplace. Some of the other companies feel that they have to provide an attractive DCA subaccount just to stay competitive. The distribution channels are really excited about the competitive DCA subaccounts and feel that they are an important consumer benefit. What many companies thought would be a very temporary, promotional-type product feature have become a benefit that appears to be here to stay. I'm aware of a couple of companies that are actually putting it in their contracts and into their prospectuses. Some companies have decided not to offer a competitive DCA subaccount. I think it depends on the distribution channel, the competition, and the shelf space that a company hopes to gain or maintain.

Mr. Jeffrey K. Dellinger: I'm going to discuss asset-based compensation or maybe more appropriately subtitled, "How a producer can dip his ladle in the M&E risk charge revenue stream and continually redirect a portion his way."

Asset-based compensation can be defined as any form of compensation such as commissions, agency revenue, or the so-called revenue-sharing by insurers with broker dealers that varies directly with the total account value of a product or with some subset of that account value.

Asset-based compensation is often referred to as trail compensation, or simply trails. This is to be distinguished from the deposit-based, cash-flow commissions. VA products may pay exclusively cash-flow commissions. They may pay exclusively asset-based trail commissions, or they may pay a combination of a cash-flow commission followed by an ongoing series of trail commissions. Twenty years ago, VAs were of the front-end load variety. This is what we call an A-share product today. The salesperson's commission was based on deposits and paid out of that front-end load. Around 1980 the industry moved to VAs without a front-end load. This had the marketing advantage that customers perceived that 100% of their deposit was going to work for them, not 100% of the deposit minus some front-end load. However, salespeople were used to being paid on deposits at the time new business was written, and there was no longer this front-end load to fund that. To allow this precedent of paying the salespeople at the time the deposit came in, a back-end load, also known as a contingent-deferred sales charge or a surrender charge, was introduced, and insurers recovered the commissions and other acquisition expenses via a spread introduced into the product for customers who persisted and via surrender charges for those who lapsed prematurely. These back-end load annuities are what we call a B-share product today.

Even in 1985 VAs paid exclusively deposit-based, cash-flow commissions. Asset-based trail commissions had not yet come into vogue. As VA business moved beyond the surrender charge period, agents and brokers were free to redirect this business into other products and earn another large front-end commission. Both to encourage persistency and to provide agents and brokers with some ongoing revenue with which to meet their expenses of perhaps holding annual checkups or counseling sessions with their clients, there was a desire to pay some small amount of annual compensation on in-force business long after the initial sale took place.

This compensation was more in the nature of a servicing fee because there was no selling really going on at that point. Sales representatives were now being compensated for servicing existing business. This contrasted with the prior state where sales representatives were compensated exclusively for generating new business. It's no surprise that as larger volumes of VA business were placed on the books, insurers realized that this was an assets-under-management game, and retaining existing business was as valuable as soliciting new business. The older products never envisioned a payment of asset-based compensation beyond the surrender-charge period, and most were not equipped to pay it and still meet profitability goals. One approach to remedy this situation was to pay persistency-based trail commissions. The thinking here was that if the payment of the trail commissions created better persistency than had been assumed in pricing, this incremental revenue could be used to pay those trail commissions that led to greater persistency. As newer VA products were introduced in the late 1980s, these envisioned the payment of trail commissions in the original pricing and were no longer simply an afterthought.

Annuity product versions that pay exclusively asset-based compensation are known as C shares. In reality these C-share annuities typically pay on the order of a 1% commission on the initial deposit, and then beginning in the second year a 1% asset-based commission with payments occurring in 25 basis point quarterly installments usually based on the end-of-quarter account value.

Insurance companies have an interest in trail commissions for a number of reasons. First, to the extent that the presence of trail commissions reduces the front-end, deposit-based commission and, therefore, acquisition expenses. This reduces persistency risk. This is because the acquisition expense recovery period now generally exceeds the surrender charge period. There is less unrecovered acquisition expense on lapses that occur in the first few years after the surrender charges expire when the presence of trail commissions allows for those lower front-end commissions.

Insurers also benefit from a regulatory compliance standpoint when the presence of trail commissions reduces the economic incentive for agents to replace business either internally or externally, thereby running afoul of rules against churning. Insurers benefit by their ability to attract distributors when their products allow for a variety of compensation arrangements to meet the diverse needs of producers. For example, inexperienced producers tend to need more money now and, therefore, place a higher value on the cash-flow commissions based on deposits. Experienced producers may have all the income they need right now, and they place a higher value on the trail commissions. In effect, by selling annuities to others they wish to create an annuity for themselves via the trail commissions.

Producers are also interested in asset-based compensation for a number of reasons. As was mentioned, having a choice between exclusively up-front deposit-based commissions, exclusively asset-based trail commissions, or some combination allows producers to tailor their compensation program to their own personal needs, and those personal needs can change over time. Producers who formally schedule annual planning meetings with clients appreciate having the revenue provided by the ongoing trail commissions to pair with their post-sales servicing expenses.
The so-called C-share version of annuity products that pay exclusively asset-based trail compensation hold an interest with producers for several reasons. First, these give producers an attractive 1035 exchange takeover vehicle. This is because there is no reimposition of surrender charges on C-share product sales. The levelized trail commissions have reduced the acquisition expenses so no surrender charges are needed. Second, for original annuity sales the C-share version paying only trail commissions can win a sale should a customer show resistance to the illiquidity associated with any annuity product that has surrender charges. And, third, the asset-based compensation can be a sales motivator. An agency head’s pitch to a prospective new agent recruit might be something along the lines of: Your target goal should be $100 million of assets under management by age 45 or age 50, on which you will receive your cut of the 1% annual trails. Well, 1% on $100 million that you've accumulated by age 45 or 50, yields $1 million a year, and if your cut is 65–70% of that, you have got this nice, enticing target out there of $650,000 or

$700,000 of annual income. Fourth, asset-based compensation allows producers to participate in a bull stock market.

It is equally important to note, however, that there are producers who do resist asset-based compensation. For some of them, perhaps many of them, money now is preferable to money later. A quote from a producer who is reluctant to accept asset-based compensation goes something like this: "Even though you tell me that the present value of the compensation under the asset-based trails option is higher than that of just the standard cash-flow commission option, asset-based trails must somehow be better for the insurer and worse for me as the agent or you wouldn't be pushing them so hard." So you're not going to win everybody over with asset-based compensation, but there are producers out there who like it. Some producers, whether they're agents or planners or brokers, resist asset-based trail compensation for sales to clients at advanced ages because sales at advanced ages put the agents on some of the same risks that an insurance company incurs. For example, they put the agent on the persistency risk. If some of those assets depart from the VA, either because of the death or the health-care needs of the annuity owner, the trails to the producer terminate.

The use of asset-based trail compensation for immediate annuities or annuitizations of deferred annuities puts the producer on the mortality risk; that is, for a pure life contingent payout option, trails end on the death of the annuitant no matter how quickly this occurs. Some producers resist sharing in this risk, and they desire to shun the asset-based trail commissions on immediate annuities in favor of an up-front commission at the point of the immediate annuity sale or the annuitization.

Across the VA industry there is no one standard compensation arrangement. The so-called normal range might be something on the order of 6% for an exclusively up-front cash-flow commission, something on the order of 1% for exclusively asset-based trail commissions, and something in between, for example, 4.75%, followed by 25 basis point annual trails under the combination approach.

There are definitely both richer and less rich compensation packages than the so-called normal ones that I just quoted. In October 1996 the SEC changed its approach to the limitation on the VA product fees and charges. Where we used to have the 1.25% cap on the M&E risk charge, now the charges just need to be reasonable in relation to the risks assumed and the benefits offered, etc. We have seen a slight rise in total product charges associated with the collection of VAs showing the highest sales volumes. You read a lot in the financial press as well about VA products with lower product charges. If the best-selling annuities in America by volume tend to be slightly increasing in their level of charges, but you also have a reduction in some VA products, those are the ones that seem to make the financial press a little more. There's a wider range now of product charges; therefore, there's going to be a wider level of trail compensation arrangements that can be afforded under those charge schedules.

To ensure that brokers base decisions solely on what's in the best interest of the clients, some firms require all of the VAs they distribute, regardless of the product manufacturer, to pay identical compensation. This uniform compensation program that they demand from their product manufacturers typically includes some level of asset-based trail commissions, usually 25 basis points per year, and sometimes this steps up a little bit after the surrender charge period.

Trail compensation on the base-deferred annuity product is paid on the total-account value. Sometimes if there are riders, such as the enhanced death benefits that Deanne mentioned, where the incremental charge may apply only to the variable account value, trail commissions funded by that charge are paid only on the variable account value and exclude any of the fixed account value. What is the right level of asset-based compensation? There is no one right level. From the perspective of the insurance company the right level is that which is just high enough to do two things: Attract distributors to the product initially and encourage persistency over rewrites to gain another front-end commission.

Financial planners prefer asset-based compensation because this pairs the revenue flow with their ongoing servicing expenses, and the absence of any large front-end commission is consistent with their role of providing fairly independent financial planning advice rather than making a onetime commission sale, which thereby raises questions of product selection in the minds of their clients. As was mentioned, some brokerage firms establish a uniform compensation program for all of the VAs they distribute regardless of product manufacturer. For those firms that do not, there tends to be a preference again for more money now; that is, the deposit-based, cash-flow commissions tend to be preferred relative to an actuarially equivalent or even an actuarially superior stream of asset-based commissions. Some level of trail compensation is still expected, and that's probably based on the 12(b)(1) fee precedent established by the mutual funds, since both the VAs and mutual funds are perceived as asset accumulation products.

Insurers have historically compensated their own career agents for displaying asset-gathering behavior rather than asset retention behavior. So, therefore, the commissions have tended to be associated with the point in time at which that asset-gathering activity occurred. This historical pattern and the compensation expectations that it generated continue today; that is, exclusively cash-flow commissions or a combination of cash-flow and trail commission arrangements with a much heavier emphasis on the cash-flow commission element still prevail today.

What's the conclusion and the outlook? It's that asset-based compensation is here to stay. When looking at the VA businesses and assets-under-management game that produces fee income for the insurer, asset-based compensation aligns the interest of the producer and the insurance company shareholders. Both prosper from persistent assets under management. Therefore, both have an incentive to desire the continued availability of asset-based compensation programs.

Asset-based compensation, therefore, achieves the following: It aligns the interests of the VA producers and the insurance company shareholders. It offers increased flexibility for VA producers to select the compensation arrangement specific to their needs, including letting VA producers who don't need current income defer this into the future, thereby creating an annuity for themselves. Asset-based compensation allows insurers to offer VA products with more value to the ultimate consumer, since that portion of the margin needed to defray those large, up-front, acquisition expenses can be eliminated resulting in a less expensive product, they can be used to provide additional product features resulting in a more attractive product, or they can even be used to acquire additional distribution to increase economies of scale, which allows for a more efficient product.

Asset-based compensation allows the construction of more capital-efficient VAs because less persistency risk and less fund performance risk are borne by the insurance company. So, you have to put up less surplus. It allows for VA sales to customers who are resistant to either a front-end load or a back-end load if you have an exclusive C-share product that pays only asset-based trail commissions. Asset-based compensation allows VA customers unhappy with the fund performance or the customer service of their existing VA provider to exchange to a better performing product without having to incur new surrender charges.

Asset-based compensation will complement and, again, not replace cash-flow compensation. Young, inexperienced producers need more front-end compensation until they build their book of business. Other producers simply have a motivational preference to be paid as handsomely as possible right at the point in time when they achieve a successful sales event. Asset-based compensation does not appear to be gravitating toward any single, well-defined trend. This is attributable to a variety of distribution channels employed and the variety of situations in which VAs are used, from a stand-alone annuity in the nontax qualified market to their inclusion in wrap accounts, and to their use in charitable remainder trusts, and to their use in the 403(b) periodic annuity market.

If, however, we had to try to put asset-based compensation programs into a couple boxes today, there might be four. The first box would be none. That would just be the continued use of exclusively deposit-based cash-flow commissions. The second box might be the combination program with the cash-flow commissions up front, followed by a series of level trails, generally 25 basis points a year. The third box might be the cash-flow commission/trail commission combination, but this time the trails are stepped up, generally starting at 25 basis points and increasing somewhat after the surrender-charge period. The fourth box is the exclusively trail compensation program, typically 1% a year.

Mr. Terry J. Simpson: I'll be discussing New York trail compensation. As most of you are aware, New York has been historically difficult to deal with from a regulatory perspective. Compensation regulation on insurance products has its roots as far back as the early 1900s with the Armstrong investigation. In the 1920s regulations became even more stringent with the introduction of inside limits on compensation.

In recent years, however, New York has taken a more pro-business attitude. They have reevaluated their regulatory position on many aspects regarding insurance products, including compensation issues. For example, Circular Letter #7 was released in 1996 that allowed for greater flexibility in compensation plans, and a new expense limitation law, Section 4228, was introduced in 1997 that would ease expense limitations. It's becoming clear that New York is starting to loosen its regulatory stranglehold.

Circular Letter #7, titled "Fund-Based Compensation and Expense Allowances," was released on April 11, 1996, and allowed for greater flexibility in the design of fund-based commissions and fund-based expense allowances. The impetus for such change was twofold. First was simply the fact that other states were allowing asset-based compensation. Insurers began to complain to the New York Insurance Department (NYID) that they were at a competitive disadvantage with insurers from other states since they were able to offer such programs. There was also competition from banks that sold annuity products with asset-based compensation. The second argument lobbied by the insurers was that asset-based compensation would provide an incentive for agents to keep the contract in force and would reduce churning, thus better serving the public. The NYID agreed with these arguments, and the result was Circular Letter #7.

The circular letter described two methodologies for converting premium-based commission and expense allowances into fund-based or asset-based commission and expense allowances. One conversion method was for level, asset-based compensation, and the other was for nonlevel asset-based or the step-up compensation. There were, however, some problems with these methods. The stepped-up method could be numerically complex, involving present value calculations with outdated sources and could produce conservative results. The shortcomings were corrected in 1997 with the introduction of the new Section 4228. The new 4228 entirely repealed the old law and any related regulations and circular letters. That would imply the repeal of Circular Letter #7, 1998 although it did not specifically state that. The new 4228 became effective January 1 of this year and not only changed the methodology for calculating asset-based compensation but also changed the expense limitation on insurance products sold in New York.

For those of you unfamiliar with Section 4228, one of its purposes is to define two different expense limitations. The first is an aggregate selling expense limit that sets some maximum expense level for the sum of many defined selling expenses such as commissions, training allowances, and marketing expenses. The second is an inside limit that is applied individually to each one of those expense sources. My discussion will focus on the inside limits.

For purposes of illustration I'll assume a single premium deferred annuity that is sold through an agent versus a general agent where slightly higher limits are allowed. Briefly summarizing the limits of 4228 under these assumptions, 4228 will define the limits only for the first four contract years. It will state that the maximum deposit-based compensation is 7%. The maximum trade-off for asset-based compensation is 30 basis points for every 1% in deposit-based compensation that otherwise could have been paid. This implies a maximum asset-based compensation payment of 2.10% in years 1–4. For contract years beyond year 4 4228 sets no inside limit on the actual amount of the deposit-based or asset-based compensation that can be paid. We'll come back to that in a little bit.

Calculations for determining the maximum asset-based payment in the first four years are quite simple. The maximum payment is simply the difference between the inside limit and the actual premium-based compensation that's paid multiplied by 30 basis points. For example, if we paid a 5% premium-based compensation, and, as I mentioned, 7% is our inside limit, we can convert 2% of that into an asset-based compensation by multiplying the 2% by the 30 basis points, or 60 basis points.

A couple other examples. If we paid a 2.50% premium-based compensation, the maximum trail would be 1.35%. Again, if we pay no up-front commission, we could pay a maximum trail of 2.10% in the first 4 years. As you can see from these examples, New York will allow for an adequate stream of asset-based payments. In fact, most non-New York compensation schedules that do contain trails would not work in New York. These above limits appear to leave the door wide open for setting compensation, especially trail compensation, at very high levels, especially in years beyond year four, but this is not the case. There are safeguards in place to keep compensation within reasonable levels.

Aggregate expense limits are always applicable, even though there may not be an individual inside limit, and this is applicable even beyond year four. This will implicitly establish a limit on compensation. Any plan where asset-based compensation is greater than 2% in any of the first 4 years will require a filing before use but not necessarily approval of that plan before use. For compensation in contract years five and beyond, any plan where the deposit-based or converted asset-based compensation is greater than the inside limit defined for the fourth contract year will also require filing before use but not necessarily approval of that plan before use. And, last, there does need to be a certification that states that the product will be self-supporting.

Two of these above points that I've mentioned concern filing requirements, and, in general, the new 4228 makes filing of these plans much simpler and easier than in the past. Any plans that are clearly within the limits required by 4228 only need to do an annual filing for that plan. Any other plan will, at a minimum, require an annual filing before use.

How will these changes impact New York product design? It's very likely that companies will start to increase the use of asset-based compensation in their plans, especially given that the new 4228 has made the filing of these plans much easier and faster. The New York actuarial consulting firm that I spoke with about a month and a half ago said that there has not been a large exodus away from the cash-flow or deposit-based compensation to the trail compensation so far. It is gradually starting and it's at a pretty slow pace right now, but they feel that pace will start to pick up. Perhaps the biggest change to product design will be the standardization of compensation structures with non-New York products. Companies may no longer need a compensation structure just for New York and will be able to offer their standard compensation arrangements that are available in the other states. This will save a little time and effort with the New York filing.

Some of the newer products may have lower M&E charges. This is really the result of two different reductions. The first is the reduction in the persistency risk that Jeff mentioned earlier. Some companies may be willing to accept slightly lower profit to offset the decrease in the persistency risk associated with the product. Second, when asset-based compensation replaces deposit-based compensation there is a reduction in the amount of acquisition expense and, thus, a reduction in any interest charges associated with that expense. Surrender charges could also decrease because of the reduction in the acquisition expense. In fact, we could even see C-share type products that have no surrender charges and pay exclusively asset-based compensation.

In summary, it can be seen that the move toward products with asset-based compensation could be beneficial for the insurance industry in New York. Customers will have access to products with potentially lower M&E charges and lower surrender charges. Insurance companies will be able to offer a uniform compensation structure with a less risky New York product. Agents should approve, for reasons previously mentioned, mainly that there now could be a variety of compensation schedules available to them to better fit their needs. Finally, the NYID will now have products that could better serve the public that would not encourage churning. We'll have to keep a close eye on New York to see how these products evolve.

Ms. Lilia M. Sham: I would like to switch gears just for a second. Instead of talking about compensation, let's look at variable immediate annunity (VIA) design and what's happening in the marketplace. First, let's take a look at some of the forces that are behind the enormous potential of immediate annuities, not just the variable but also fixed immediate annuities. There are some observations that have been made by the industry, some sociologists and some demographic trend experts that the baby boom generation is really transitioning from the wealth accumulation phase to the retirement income phase. As the oldest baby boomer is entering his or her early 50s, in about 10 years time they should be ready to draw their retirement income based on the wealth that they have accumulated during their work life. The lifetime retirement income from employer-sponsored pension plans is of decreasing importance. Over the last decade, or so, we have witnessed employer-sponsored pension plans converted from defined benefit to defined contribution plans. We have also seen higher mobility in the workforce than there ever was, and, of course, this looming cloud over our heads, the uncertainty with respect to Social Security benefits. Will we ever be able to collect Social Security benefits under the current system? On the qualified deferred annuities there are certain liquidation requirements, and if people invest in deferred annuities, there are some situations when they have to draw the money out. The liquidation aspect would help the immediate annuity sales. Because of the mortality improvements of the general population it is expected that our retirement periods are going to be longer, and there is more of a risk that we're going to outlive our assets.

With all these forces working behind it, VIAs should be a good product to offer at this point, first of all, because of the continued success of the variable deferred annuities. As Deanne has mentioned, the growth in variable deferred annuities is just phenomenal. It grew from just $20 billion in 1990 to over $85 billion in 1997. The rate of growth in 1996 and 1997 was 50% and 17%, respectively. So, you can see that is quite phenomenal. It has attracted a lot of attention, and people realize that VAs really are the way to go. People have also realized that they offer inflation protection. Mutual fund sales have been even more phenomenal than the variable deferred annuities and the public is aware that the only way to hedge inflation is to invest in equities. But, of course, there are some negative forces working behind this as well. In general, people do not like the fluctuation in income level, especially when it goes down. When it goes up, of course, they like it, but when it goes down they don't like it at all. They're afraid that if they're going to have a VIA, then in some situations their income may be lower than what they had originally. Also, most of the products right now don't really have a minimum-floor guarantee. I guess the biggest hurdle for immediate annuities, both fixed and variable, is the loss of liquidity. Once you give the money to the insurance company, you don't have control over what is going to happen to it. I think a lot of companies are thinking that the answer to the negative forces would be to have VIAs with some kind of guarantees. That means you are going to have a benefit floor with some liquidity options.

Let's look at the pros and cons for these products from the insurance company's point of view. Of course, as an insurance company we would like to keep the assets on our books. Since a lot of companies have grown the variable deferred annuity to such a large chunk of the assets, they would want to keep these assets in-house when it comes to the liquidation phase. This would be an excellent product to introduce to round out a product portfolio, and if companies introduce their products now, they would be considered an early market entrant because right now there aren't that many VIA products around. A downside is that you may need special consumer education and also distributor education for this product, and you may also have to consider a dedicated wholesaler to sell these products because this product would require a different distribution strategy and also different consumer education to sell. Another challenge to the company would be administration, especially if you're going to install benefit floors and guarantees. There is also the issue of issuing fund reports and benefit statements.

From the consumer's perspective it seems that there are a lot of reasons why they should buy this product. If it's a life annuity, then they would have lifetime income protection. If they allocate the funds properly, the inflation hedge would be achieved because of equity participation, and there also will be somewhat favorable taxation treatment on the annuity benefits. There's also the ability for them to customize the investment mix, and they also can use this plan to meet the qualified plan distributions. The weaknesses were mentioned before. There is the payment amount volatility, the lack of guarantees, and the loss of liquidity. From the distributor's perspective this would be an excellent fit with most of the client's needs, and the target market is enormous. As we mentioned before, if a baby boomer is entering into the retirement phase, it will be at least 20–30 years that the boomer would need this type of product. A downside is that there's a loss of asset control, and the compensation that they receive is relatively low compared to the service that they have to provide to their clients because it's supposed to be for life. Right now there are not that many products to choose from. Again, there is extensive buyer education that they would have to go through, especially for some of the products, which have a very complex design. It's very difficult to explain to an average consumer.

Before I talk about trends, I would like to look at a sample of the current product designs. We will then transition to what we think the future product designs or the near-term product designs will be. One VIA product design is a certain annuity with some kind of stabilization of benefit payments, and there is also one that's a life annuity with some stabilization of benefit payments. There's another kind that's a life annuity with a minimum benefit floor. There is another one that's a life annuity with a certain period, and there is a GMDB during this certain period. The level of liquidity really varies by design, and we will go through that as we talk about the four designs.

First, for the certain annuity with some kind of stabilization of benefit payments, the product is structured in a series of target periods. During a target period the annuity payments would be level, except for extreme investment conditions, and if the investment conditions are extremely favorable, then there would be an increase in the payment amount. If it's extremely adverse, then there would be a decrease in the payment amount. There is complete liquidity in this product. The weakness of this product is that it's a certain annuity, so it doesn't have a life option, and also there is still this downside to it because if the investment conditions are poor, you can still transition to a lower payout amount, and the design is quite complex.

The second type of product is a life annuity with some kind of stabilization of payments. The concept, again, is like a target period. You would have a target period subject to a minimum and a maximum. The minimum of course would be zero, and during the target period the annuity payments would be level, except for extreme conditions. If the investment conditions are favorable, then the target period may be lengthened, so that means your payment would stay level for a longer period of time than originally anticipated. If the investment conditions are adverse, then your target period may reduce to zero. That means after that time your payments would be subject to any investment conditions underlying the product. There is liquidity on full surrenders, equal to the commuted value of the target period payments reduced by a surrender charge, so there's limited liquidity. The weakness of this product is that there's no minimum annuity payment, and the inflation protection is somewhat reduced. During the so-called target period the payments are level, so it's not really increasing.

The third design that I'm going to talk about is the life annuity with the minimum benefit floor. The product would provide a minimum floor on the annuity payment that's equal to *x* percent of the initial annuity payment. It also provides liquidity during the cash-value period which is equal to the commuted value of the certain payments reduced by a surrender charge. The weakness of this design is that right now it's only available on one investment fund which is an index fund, and there's also a high guaranteed maximum asset-based charge. As you would imagine, in order to provide a minimum benefit floor they have an asset-based charge, and there is a ceiling attached to it. Right now it's considered to be pretty high, and there's also a front-end load associated with this product.

The fourth one, a life annuity with a certain period and a GMDB in the certain period, doesn't really give you any type of income protection, but it's more in line with the GMDB concept under the deferred annuity. What the GMDB provides is the highest anniversary account value reduced by annuity payments since that anniversary, and it also provides liquidity that's equal to the commuted value of the certain payments reduced by a surrender charge.

What are some possible designs that you can think of if you're going to design a payout annuity? Well, first of all, you can expand the choices for the assumed investment return (AIR), and through that maybe you can stabilize the annuity payments. I think the benefit floor is one of the most important features that you have to add to your new product if you want to attract any attention at all. You can provide an optional wrap-around general account guarantee, you can provide a minimum floor with inflation protection, or you can provide a ratchet floor, but this may be expensive, and also you may have to offer that on the multifund product. Other than a benefit floor, liquidity is very important. You may want to allow access to contingent payments with underwriting, but this may have some legal ramifications, because this is an annuity product. You may want to allow access to part of the contingent payments upon occurrence of a critical event such as nursing home care confinement or total disability, but, of course, you will have to assess a risk charge. Also you may allow the benefit payment to increase upon a critical event, with a charge. On compensation, as Jeff has talked about, you can consider paying trails, but then the producers may not like it because they have to share in the mortality risk. Also you need to set up the basis for trails because as the annuitant draws down the account value, the asset base is decreasing all the time. So, if you only have a level asset-based trail in terms of basis points, the actual amounts received by the producers will actually decrease. So, they may not like it. You really have to be innovative in terms of paying trails on these products.

I think that we could have sessions for each of these primary topics that we've talked about today and still not get into the level of detail that we'd like to. One of them is the compensation issues. Jeff mentioned that some distribution outlets are interested in trails and some are not. There is one comment that I'd like to add regarding banks. Banks are very interested in trail compensation until they realize that means they have to take a lower up-front commission. They think that the 25-basis-point trail can just somehow magically appear, and their up-front commission can stay. They struggle with wanting that up-front fee income but also are very interested in the trail compensation. To date, most banks have not been willing to give up what they need to give up in order to have the trail.

Jeff mentioned that there are multiple commission options available, some combination of total up-front commission, a lesser up-front commission combined with a trail, and then all trail. What we have found is that most of the producers who are interested in trail commission are taking that middle option, which is a somewhat lower up-front commission and then a level of trail that's right around the 20–25 basis point range. Actually the producers are being encouraged to build their assets under management and to receive that compensation, as Jeff was alluding to. What we've seen is that producers are moving business from one company to another company if the new company is offering a trail because then they're building their assets under management and receiving a 25-basis-point trail on those assets. Actually, one company that I've spoken with has seen 1035 exchange activity into a new product with this trail option as high as 50–60%. Some of the activity is attributed to new brokers who are writing the business, as well as some that are just starting to move blocks of business over. That might be something that you want to keep an eye on. Those are a few of the interesting things that I've seen on the compensation front.

Mr. Michael E. Dubois: I have a couple of comments and then some observations. With respect to the trail options, one that we're actually using on a couple of our products takes that combined front-end and the trail, you have a front-end that grades down over time so that you're essentially lessening the surplus strain on your renewal compensation. This works especially well on a product that does not have the rolling surrender charges, and you have your trails grade up over time. It's just, again, another variation on what you can see with the trail compensation options. The second thing is when Lilia mentioned the question of how would you go about finding a basis for paying trails on the VIA, we're taking a look at that, and one thing that we put out on the table is the idea of having a trail that's somehow related to the income benefit being paid. Again, whether that's workable or not, we haven't gotten to that point, but that's one thing to look at. And, finally, it was just a clarification on the GMIB. If I'm correctly understanding that, is that only guaranteeing the level of the initial payment at this stage of the game?

Ms. Osgood: It's guaranteeing the amounts that are used to determine the initial payment, yes.

From the Floor: So, there is no guarantee on the GMIB that there'd be any minimum payment going forward. It would have to be a combination of that and that third option that you mentioned.

Ms. Osgood: Right. With the GMIB most of the payment options that are being offered with that are a life with a period certain of, say, 10 or 20 years. One of the other interesting things that we're seeing with the GMIB, and something to look at carefully when you're designing those benefits and determining if yours is competitive or not, is the interest rate that's being used in the annuity purchase rate guarantee. We're seeing rates that are as low as 2.5% and as high as maybe 4 or 4.5%, and it can vary whether a 10-year or a 20-year option is chosen, whether it happens before or after 10 years that the contract has been in force. These benefits can be very confusing in the way that the riders or the contracts are drafted, and you really need to weed through a lot of things to determine what that actual guarantee is and how your product compares with the competition.

Mr. Kevin F. Leavy: Just a clarification for his question. What I've seen so far in the GMIBs is that the guaranteed benefit is a fixed payment only. So, it's not really setting a minimum value. It's fixed.

Ms. Osgood: Right. The current GMIBs offer a payment that is fixed in amount.

From the Floor: You're taking that benefit and applying it to the guaranteed rate. So, it's not something that's a variable payout.

Mr. Dellinger: I have a question for Lilia. You mentioned that liquidity was one of the design considerations. When we have a deferred VA that's still in the active accumulation stage and you make a withdrawal, that's the taxable event. It's appreciation out first, followed by deposits, in the nontax qualified market. But then with an immediate annuity you get the more favorable immediate annuity tax treatment. Each payment is part return of principal which is nontaxable, in the nontax qualified market, and part appreciation. If liquidity is offered in a variable payout, after the point of annuitization, is the tax treatment of that clear? It seems that perhaps such a design would no longer qualify for the more favorable immediate annuity tax treatment because you can get your money all out in one lump sum at any time just like a deferred annuity. Do you have a comment on the tax treatment?

Ms. Sham: I think your observations are absolutely correct. That's why there hasn't been a life annuity that provides complete liquidity. And also the antiselection surrounding the issue of allowing the withdrawal of the remainder of payments in a lump sum needs to be considered, as less healthy individuals may be more likely to withdraw lump sums. But I think both issues are still uncertain at this point.

Mr. Dellinger: The last I heard was that one company had applied for a private letter ruling to get the issue that I brought up clarified, and it came back adverse to them that a design where you had a VIA payment that did have liquidity did not qualify for the favorable immediate annuity tax treatment. I heard that company felt the IRS didn't really understand what they were asking or weren't interpreting it correctly, so they were going to redesign their private letter ruling request and resubmit it, and that's all I know on that subject.

Ms. Osgood: That's pretty much right on from what was presented recently. It is unclear, and the disclosures are being made that it is unclear, but the products are still being sold, so thanks for that observation.