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Session 17OF
What's New and Exciting with Fixed Annuities?

Track: Product Development

Moderator: Abraham S. Gootzeit

Panelists: Eric J. Carlson
Dale Humphrey†
Richard J. Tucker

Summary: Insurers continue to sell large amounts of fixed annuities through various distribution outlets. The regulatory and economic environments remain dynamic, putting pressure on the product development actuary to design compliant products that are competitive and profitable.

MR. ABRAHAM S. GOOTZEIT: Good morning, and welcome to Session 17, "What's New and Exciting with Fixed Annuities?" We have terrific panelists today who have put a lot of effort into the program, and I'd like to introduce all three of them now. The first is Eric Carlson, a second VP and marketing actuary for Transamerica Re. Eric is responsible for combining risk transfer and risk-financing techniques to develop life reinsurance solutions that help insurers manage risk and improve capital efficiency. Prior to joining Transamerica Re this year, he worked in product development and implementation for some product lines including life, annuity and long-term care at Allianz. Eric has extensive regulatory experience with model law and model reg development, and he's a frequent speaker at these industry meetings, including the SOA, the Academy, the Conference of Consulting Actuaries and so on. He earned a bachelor's degree with honors from Gustavus Adolphus College in St. Peter, Minnesota. He's an F.S.A. and a member of the Academy.

Next we have Dale Humphrey. Dale is a senior VP for BISYS Insurance Services. It's the country's largest full-service managing general agent. He oversees life

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Note: All handout materials are available through the link on the table of contents.

products, annuities and settlements. His concentration is product design, distribution strategies and channel management. He is known nationally and sometimes locally and consults regularly on annuity product development, specializing especially in equity-indexed annuities (EIAs) and payout solutions. Dale was fortunate to be involved in the design and launch of the first equity-indexed products in the early 1990s, and today he concentrates on the next generation of consumer-friendly EIAs and expanding the understanding and adoption of immediate annuities, which is also a big deal. He's been in the financial services industry for about 15 years. He has an M.B.A. from the University of Wisconsin at Madison. Dale is not an actuary. We actually welcome those people. He's a marketing and sales guy and sincerely enjoys, it says right here, "casual and technical banter with the actuarial community, and, unlike most of his peers, he appreciates and understands the ultimate power actuaries have in guiding the health and well-being of the country's life insurers." We appreciate having Dale here today.

Last we have Rich Tucker. He's currently a VP at Ruark Insurance Advisors, which specializes in reinsurance intermediary work for traditional fixed annuities, EIAs and variable annuities (VAs), and payout annuities. For the prior five years Rich was responsible for marketing annuity reinsurance for an unnamed Bermuda reinsurer that you all have forgotten by now. Before moving to the dark side of reinsurance, Rich was the annuity and life insurance product actuary for two direct writers. He received a B.S. in applied math and business administration from Carnegie Mellon University in Pittsburgh.

My name is Abe Gootzeit. I'm a consultant with the insurance consulting services practice of Aon, located in St. Louis. Here's the agenda we intend to follow today. Eric will speak first on current regulatory issues with emphasis on the annuity nonforfeiture law. Dale will go next; he'll discuss current trends and product design, and he'll pay particular attention to EIAs and payout annuities, more on the equity-indexed side. Rich will follow and discuss how reinsurance can address the conflicting issues of competitiveness and profitability.

MR. ERIC J. CARLSON: I will be addressing both the annuity nonforfeiture law and the annuity nonforfeiture regulation. I'm going to cover them at a fairly high level. I'll go over what the law is, what some of the changes are, and what the regulation is trying to clarify in that. There's probably not time or interest in a session such as this to go into any great detail on any of the topics. However, if people do have any specific questions, at the end we'd be more than happy for you to step up and ask them, or I would be happy to take questions separately after the session or at any time during the meeting.

What I'm going to cover today is what led to the new law, what the new law is, and what the regulation is, and then I'll look at some timing issues. The new annuity nonforfeiture law was officially adopted by the NAIC in December 2002. That was following a period of 40-year lows in interest rates. I believe in the summer of

2002, the five-year Treasury got down to two-point-something percent. Interest rates obviously continued to be extremely low. That low-interest-rate environment presented solvency concerns with the 3 percent guarantee that existed under the old law. Many product designs were no longer viable, and, in fact, you saw many annuity writers pulling products off the market. Major changes in the new law are on the allowable front-end loads and the nonforfeiture rate and how those interact. There are some unique and special equity-indexed considerations now, and a new concept, redetermination, was introduced in this new law.

First of all, the loads went from having separate loads for flexible-premium annuities and single-premium annuities; and then on the flexible-premium annuities you could have different loads in the first year versus renewal years, but that's now been made uniform. There is a 12.5 percent allowable load for all annuity contracts, all policy years. Then there's the annuity interest rate. The nonforfeiture rate used to be fixed at 3 percent for all years. This now has gotten somewhat more complicated and is an indexed interest rate that is set at the issue date of the contract. It's based on the five-year constant maturity Treasury (CMT), which then is rounded to five basis points. The five-year CMT that it is based on has to have occurred within the previous 15 months. It can be a single point in time during the preceding 15 months, or it can be an average over any time period within those 15 months. There's an additional reduction of 125 basis points and then a cap and a floor of 3 percent and 1 percent correspondingly.

On the equity-indexed side it used to be that EIAs were treated no differently from any other fixed annuity. Under this new law EIAs do get special consideration. They have an additional reduction of an additional 100 basis points from the index, so you can have a total reduction of up to 225 basis points. It does have the same cap and floor, and so what that means is if you're in a higher-interest-rate environment, subtracting 225 basis points, you can still be at that 3 percent cap. This means that because of the reduction in allowable loads, EIAs can become much less competitive relative to what they were under the previous law. The market value of any equity guarantee must offset the additional reduction, and essentially what that means is that if a company goes out and spends at least 100 basis points a year on an annualized basis for buying options to support the contract, it will qualify for the additional reduction. You do need to provide some type of proof in both your initial filing of the product and in an annual certification.

Redetermination is a totally new concept that was introduced here. Redetermination is optional, meaning at the company's choice. It allows the company to better match its assets and liabilities, and if a company chooses to do redetermination, it gets to have a new nonforfeiture rate that will be applicable from the time of the redetermination forward. A simple example is that a company could redetermine every five or 10 years, whenever it chooses. Typically you would pick your redetermination period and have that be perhaps similar to your surrender charge period or something else so you get better asset-liability matching.

One of the questions, the balancing item on this, is flexibility versus simplicity. Redetermination provides a lot of flexibility for the company so that it can manage its risks. Unfortunately, consumer understanding and, to some extent, company understanding and regulator understanding of redetermination gets complicated, and so making sure everybody has essentially the same idea of what's going on can be challenging. Also you have to be able to describe how you're going to determine your new nonforfeiture rate in the contract, and companies need to determine for themselves if they want to put in their five-year CMT less 125 basis point spread and explain to their consumers what that means.

What the regulation does is try to clarify things that are a little bit confusing in the law. This regulation has some great challenges in front of it. It defines some allowable methods for setting both initial rate and the redetermined rate. It will define specifically what the minimum required nonforfeiture amount is, and it clarifies some of the equity-indexed considerations. For setting the initial rate a company can choose to have a strictly date-based method. What that means is that it is going to say that for all of its issues in this month, it will use the average of the CMT from the previous month. Each month that rate gets updated, and that is what determines the initial nonforfeiture rate.

Another way of doing that would be a method based upon the change in CMT levels. Continuing that example, a company would say it's going to base it on the previous month's average for all issues this month. However, it's going to update what the actual nonforfeiture rate is only if interest rates have moved by more than 25 or more than 50 basis points. What that does is try to reduce the number of times you have to have a new nonforfeiture rate. I hope that provides an administrative ease on your administration system, your communication to the field and your communication to policyholders while it still provides guarantees that reflect the current interest-rate environment because there are limits as to the variability of the interest rates before you have to update the nonforfeiture rate.

There is an allowance for any other method. At this point in time nobody's sure what another method might be, but we wanted to provide as much flexibility within the reg as possible. If you come up with some great new method that works for your company and get buy-in from the commissioner, there's no problem in using that. For a redetermination method, basically you have to state that method precisely in the contract so it's clear what the redetermined nonforfeiture rate will be and can be calculated externally, and it does need to be a date-based method.

For the minimum required nonforfeiture amount, all that requirement means is that the cash value of your annuity must meet or exceed the minimum nonforfeiture amount. An interesting thing to keep in mind is that the nonforfeiture rate is different from or does not have to be equal to the guaranteed credited rate, and then there's the current credited rate, which could be a different rate again. What that means is that you can credit zero in any particular year. Theoretically you could credit a negative amount in a year, or you can credit any positive amount as long as the accumulated cash value that you will pay out to the policyholder meets or exceeds the minimum required under the law.

There's basically one basis at any one point in time. For a fixed annuity there's only one nonforfeiture rate that's applicable at any point in time. For an EIA there's only one basis. If you had a fixed bucket within an EIA, you could have a separate rate for your fixed bucket and a separate rate for your equity-indexed bucket, and if you had multiple equity-indexed choices, and for whatever reason you did not qualify for the full 100 basis points additional offset—maybe one bucket qualified for only 50 basis points additional reduction, and one qualified for the full 100—you could end up with a few different nonforfeiture rates. There is a sample calculation in the regulation—I'm not going to walk through it during this session—to try to provide as much clarity as possible.

There are equity-indexed considerations. The definition of an equity-indexed benefit was a more interesting topic a couple months ago when EIAs could include any external index that did not need to necessarily be equity based. It's further been decided with input from the regulators that they want this to be strictly equity-based, so there are not options for other nonequity-indexed EIAs, as clear as that sounds.

Concerning the reduction to the nonforfeiture rate, essentially what the regulation tries to specify is if you're spending at least 100 basis points annualized cost on your options, you will qualify for the additional 100 points reduction. Some language in the regulation and in the certification tries to clarify that and gives some examples of how you need to demonstrate that. You will need to provide in your initial filing a demonstration that the policy form will qualify, and then there's an annual ongoing certification that essentially says for all of the EIAs that you have issued and that have renewed a new equity index term, you continue to qualify for that 100 basis points reduction.

There's a timeframe for adoption. Earlier in October the Life and Health Actuarial Task Force (LHATF) of the NAIC voted to expose the current draft of the annuity nonforfeiture regulation. There's going to be another conference call of the task force to continue to discuss some of the items within the current draft of the model reg, and the hope is that, with a little bit of luck, this will get adopted by the NAIC at the December NAIC meeting. That would provide the guidance to the states so that they could begin adopting that and have the regulation adopted in all the states where the law is adopted also.

Effective date refers to the law. Most states that have adopted the law have an effective date that was about two years from when they initially adopted the law. Since we're now two years out from the initial passage of the annuity nonforfeiture law, it's going to have a requirement in the states that you will have to comply with the new annuity nonforfeiture law. Getting the regulation passed in as many states as possible in a short timeframe is important to provide that type of clarity.

MR. DALE HUMPHREY: Today I want to adjust what you're probably used to listening to. I want to put a little bit of face to the distribution side of the equation. I'm out there on the equation between the producer and a life insurance company, as many of you in this room have been subject to my sales pitches over the years in terms of what products we hope will be designed and sold over a period of time. I also want to try to bring an historical perspective to EIAs. We're about 10 years into them now, so we've got an effective track record to operate under, we've got a performance to look at, and we've got, we hope, many satisfied customers. But as I touch on a little bit later in my presentation, one of my concerns is we may not have satisfied customers, and that lends a bit of caution to everything we do in the future with this product set.

In the beginning most of our heavy lifting with this product set was due to safe harbor regs—trying to take the Act of 1933 to find the exclusionary basis where you could have a product that has an equity component to it in terms of what we refer to as participation and then designing a wrapper around it through its various investment philosophies, nonforfeiture regs, etc., to provide a unique blend to a product set. We wanted something that is (and a basic premise is it is) a deferred annuity, with the same principles as a deferred annuity, but lending a crediting component to it in which the returns over a period of time would exceed that. That's typically available in our standard deferred product set. I think, and I'll get into this a little bit, that we've accomplished that objective.

The initial launch was about two years ago, when we had Keyport, now part of Sun Life, and Lincoln Benefit Life. Lincoln Benefit Life and Sun Life both have identical product sets in place. They've changed structurally primarily because of the interest-rate environment. However, those two products are still in force, still accumulating premium. They were basically built on the two tenants that exist today. You have different methodologies for crediting the indices over a period of time. You can have shorter periods of time, like what we refer to as an annual reset design, which customarily occurs over a 12-month period of time, or the Keyport type or a full point-to-point term, which you're measuring over a longer period of time, some up to the full term of the product of seven years.

After that initial introduction, market share was starting to be gained. We had a degree of momentum from a marketing standpoint within the space. Many carriers started to get on board, and product evolution eventually started to take its course. Today we've got greater exposure of the product set, and something we've always relied on heavily from a marketing and sales standpoint is education.

We've also got attractive results. What I define as attractive is that the products generally have behaved and performed according to what we originally specified. Today, we've got more than a few products out there. In fact, we've got too many, in my opinion: 209 products. We've got over 30 different crediting methodologies. The primary driver of that is the carriers, which are trying to seek differentiation. They came out with me-too products, annual reset-type products, point-to-point, high watermark to match the initial designs. They can separate themselves with their ratings and distribution systems and the way they segment their channels, but at the end of the day they've got identical products, so one thing EIAs have done is to have provided a degree of latitude that doesn't exist in typical deferred products. That is a huge amount of latitude in terms of design philosophy.

Statistics are respectable, though, in terms of the sales. I think the first year we closed the books at about $180 million of accumulated premium in the product segment. Today we're on track to $20 billion in annualized sales. It's an 80/10 rule right now. We've got several carriers that dominate the overriding market share. Many of the other carriers and products that I'll talk about a little bit later are falling by the wayside, but the field is highly dominated by one or two carriers right now, with the major segment being about six or seven carriers that capture most of the share. The sales continue to accelerate. We have, generally speaking, over the life of the product set 15 percent, 20 percent and in some years 25 percent compound annual growth in accumulated premiums.

One of the things we've looked at is that the product proliferation again has been primarily driven by a marketing advantage, not necessarily a performance advantage. We can't rewrite the basic physics, as I like to refer to it, of this product segment. We've done a lot of back-casting modeling. We've taken a look at performance and things like that. Again, the objective of the product set, generally speaking, is to offer a return to the retail client that exceeds that in available standard deferred products and meets somewhere in the middle between a full equity position. These are not VAs; they should not be sold as VAs; they do not perform like fully equity-positioned VAs over a period of time. They sit in a midband between a standard deferred product and a fully equity-loaded VA position.

We have as an artifact of all these different designs too many products and too many carriers capturing too little market share, and, as Eric highlighted earlier, we had an interest-rate environment that changed the product segment, as well. Now we've got a market share issue that's changing the product segment a bit, too. Carriers aren't selling product, so they're pulling it off the shelves. We're seeing a narrowing set of carriers and a narrowing set of products that are the overwhelming sales leaders. Leading to that, in our zest for growth, many producers, the people who are ultimately responsible for sitting in front of the retail client, are confused; they're a bit bewildered. We still have a long way to go in terms of producer adoption, but at the end of the day we've clouded the picture a bit.

We've got these producers whom I refer to as creatures of habit used to pulling out of their briefcase a deferred pitch. In some cases they're registered reps; they're comfortable with VAs. But to most producers, this is a fairly new pitch. Some are comfortable, but the majority that we deal with on a regular basis—and we deal with over 25,000 in the course of a year—are fairly uncomfortable or unknowing. We have to go back to the basic issue of education. Most of their questions are about where it fits and how it is unique. It's my position—I have somewhat of a vested interest in it—that there's a unique product set; there's nothing that replicates it. You can take various investment strategies to do what these product sets do, but in terms of a single-bundled, insurance-based product and the way it's distributed, there is nothing like it in this industry today. It is clearly unique. I think producers don't quite get that, though, in many cases.

Also of concern is how does it supplement my practice and not eat into it? That is something you have to be clear about with the producers. It is not a standard deferred product in terms of what its objective is, and it certainly, as I highlighted earlier, is not a VA and should not be sold as a VA. It should not be sold as being able to provide an equity position on a free ride with premium guarantee. It is something that fits in the midband between those two major product categories. One of my concerns, too, is to not forget about the consumer. This has been a fairly producer-oriented marketing situation over the past 10 years. I think that the consumer, to some extent, has been left by the wayside in terms of the product segment, not only from an awareness standpoint but also from the way the producers are positioning this product set.

Here's what we're seeing, and I hope we're just entering the initial phases of this. I think we went through four phases of the product segment. In my opinion, initially we had the new beginning. We had a genesis of the product set, and we had a number of carriers getting on board, developing me-too products. Then we had carriers developing product adoptions and different crediting methodologies, multibucket products, etc. We hope that we're now entering a phase in which we're starting to see the carriers back up a bit. The ones that are losing shelf space are exiting the market; the ones that command a good presence in the industry are starting to shift a little bit more toward the consumer. I talk to a lot of them, and they're divided on why they're doing this, but I hope that they think that market share overall can gain by doing that, orienting the products more toward the consumer, offering lower commission levels and shorter surrender periods. I see fewer carriers offering aggressive first-year bonuses. You people in this room are technically fluent and understand there is no free lunch. You give up something with those types of features, and generally the consumer, again from my standpoint, is at the losing end of that equation.

Regarding product reengineering, the pace of development has slowed down. Take a look at the number of designs out there. How many ways can you cut this loaf of bread? Not many. I think we're starting to cut through this confusion to some extent. The carriers are starting to focus on designs that are sound, that can be well-positioned to the client. Carriers are pursuing just slight adoptions of successful designs versus trying to find new ways to put in crediting methodologies and multibucket products or various tinkering with the bonus structure in the product, as well. The question always becomes, though, How does a carrier stay progressive? A carrier that either does not have market share today or is a new entrant into this space is always a fairly lively discussion. I think the emphasis on education is where we still need to center ourselves. We spent a great degree of time in education in the initial 1994–95 period. We're talking about seminars. We're talking about putting people in a room—not retail clients, but producers—and talking about how this product segment is still unique. That is still the case. That is still where we need to put a great degree of our work.

One of my concerns is what type of behavior is being driven through the product segment. You have a producer-oriented product, and I'm trying to be kind with that. You have high commissions and various product features that I think are tilted more toward the producer. You wonder who's benefiting in the end in terms of what happens with these sales and what happens to the set of expectations. What is driving sales? Is it a careful process of setting objectives for the client and trying to meet those objectives in terms of the way an EIA fits within their portfolio, or is it something else the producer's more interested in? Is there full disclosure? Are the producers doing a good enough job at describing EIAs to their clients? They may have the deferred annuity pitch down. They may have the VA pitch down. They may be able to work with those riders and describe how those work with the client. However, are EIAs being accurately described in position to the client?

I've dealt with a couple of regulatory bodies in the past four months and have had some troubling conversations. We have individuals who are raising their hands, retail consumers raising their hands, wondering about what happened. "What happened when Agent Smith came over to the house that night and described this product that was going to be the end-all for me? I don't think it's turned out the way I remember it being described." Those are difficult conversations, and from my standpoint and as far as carrier representatives are concerned, those are conversations we do not want to have. What is being sold? What is being described? One of the things that has been brought up in a fairly difficult way is that maybe we should require these people to be registered representatives.

While you work through the state insurance departments and things like that, you go through safe-harbor regulations and know, based on what we did in the early years when designing these product sets, that you do not have to be a registered representative. But a concern is that maybe we should have people who are more fluent in equities. Maybe we should have people who have to take a specific exam under National Association of Securities Dealers guidelines with respect to this product set. From our standpoint, that's bad business. It's bad news. We don't want that to occur. The thrust of growth and where we want the growth to remain is in the nonregistered agent population. Yes, there are registered products, and we have worked on registered products before, but overall the increasing share are nonregistered types of products. We would like the products to remain in that space.

I alluded to some of the more onerous steps. What are we talking about? We're talking about new licensing. We're talking about greater inspection in terms of what's going on at the retail level. I welcome an inspection of what's going on, but I'd like to head it off at the pass before dealing with state regulatory bodies on this issue. Setting expectations is where the key is. If producers are comfortable with the product, they understand its unique features, the way it evolves, the way it moves, etc. That has to be communicated at the retail client level.

As a distributor we can do the jobs all we want, all day long, making sure the producers are comfortable with what the product is doing and how it will perform over time. Our concern is whether that is being accurately communicated to the client. Is the producer taking the necessary steps to differentiate the product, understand how it fits in somebody's insurance and investment portfolio and accurately position it, making sure the client understands the performance attributes of these products and the risk and reward involved with that? Too many times risk does not become part of the sales equation. There is risk. Any time you have a crediting methodology linked to indices, we all know there is a degree of risk, and that underperformance could come back to haunt us in a big way if that is the case.

The first 10 years have been good to us despite turmoil in the past three years or the first years of this product in the equity climate. Generally speaking, I consider an EIA a fair-weather product. It works well in a variety of different markets. However, there's a degree of risk that I hope is being accurately described to the retail client. But as product designers and people in your line of work, we want to balance the two concerns. We're not talking about getting involved with scare tactics. I'm not trying to say this is a major issue. I'm trying to be a bit proactive in terms of what I think is happening out in the field.

We need to continue to educate the independent agent. Roughly speaking, we think we've got a hard degree of market share that can still be gained from the independent agent base. We have conversations each day with people who are still wedded to deferred annuities; EIAs are a fairly new conversation. We place more emphasis, as I indicated, on qualifying clients and understanding where this fits in the portfolio. The most unique conversations I'm having are with broker-dealers and wire houses. Their initial reaction is one of great suspicion: How in the world can an unregistered independent insurance agent go out there and sell anything that has anything to do with the stock market? On one hand there's a great degree of suspicion. You're out there in a space where you should not belong. The others are simply looking at the product as a way of eating into VA sales, not being able to be positioned correctly in their channel.

However, it is the most interesting conversation I'm having because it holds some of the greatest potential that we have, as well. We have the independent-agent base, but the broker-dealer channels and the wire houses are just starting to nibble at this product line. I'm hoping they're going to take full bites. I'm hoping that we can do enough groundwork and enough heavy lifting to get them to fully endorse the product segment. Some broker-dealers that we work with have. However, there's still a bit of an at-arms-length view to the type of sale that they're dealing with. We have to position it correctly. The key is to position it as additive market share, not taking away from standard deferred sales running through their grid and certainly not eroding VA sales.

We are having more conversations with large career companies that have by and large stayed away from this product segment. There's a variety of reasons that I don't want to detail, but those are good conversations, as well. It's also a good avenue for growth to get endorsement from more carriers. I'm not going to say that the carriers that are wedded to the product line today are second-rate carriers. They are not, but a whole series of top-flight companies are not involved with this space today.

To summarize, I'd like to see an even bigger shift to the consumer. We want to make sure that expectations are being set at the kitchen table, so to speak, and that carriers are going to continue to trim their portfolios based on market share loss. But I also think with the momentum of the overall industry that we need to enhance end-user communication. We may start seeing advertising to a greater extent. I'm referring to retail-level advertising, not producer-level advertising. Let's break down the barriers with the broker-dealers and gain a large career company carrier endorsement. We need to pursue more channels and product segments, attorneys, etc. A number of other channels can be pursued in addition to going after the independent-agent space in a more aggressive way. By and large, we need to bring more top-shelf companies into the segment with top-shelf product, products that I think meet the specifications that we talked about earlier.

MR. GOOTZEIT: Thank you. It's nice hearing a marketing guy talking about risk.

MR. RICHARD J. TUCKER: My topic this morning is how reinsurance can be utilized with fixed annuities. I'm going to be talking about the product lines of traditional deferred fixed annuities, which is the term I use to refer to single-premium deferred annuities (SPDAs) and traditional flexible-premium deferred annuities excluding EIAs. Then I'll talk about EIAs and about fixed payout.

Reinsurance for fixed annuities can help address risk management, capabilities and expertise, and profitability. If I put up a list for life reinsurance, I would have had a different list. My list would have been profitability, profitability, profitability. Life reinsurance in recent years has been a marketplace driven by profitability, where the inherent rates quoted by reinsurers were typically lower than a direct writer. For fixed annuities the reinsurance benefits are more balanced. There's a stronger emphasis on the risk management and on the assistance with the capabilities and expertise. Who remembers the Wendy's commercial, "Where's the beef?"

I hate to tell you, but it's been 20 years since those commercials. I did a Google image search looking for pictures of "Where's the beef?" I was having trouble finding them, and finally I started looking up articles. It's been 20 years. I think the pictures have deteriorated; they barely exist anymore. But I am old enough to remember it, so I can use this as my segue to "Where's the annuity reinsurance?"

The annuity reinsurance marketplace is not nearly as well-formed as life reinsurance within North America. Within North America the mortality covers are the dominant form of reinsurance. The recent consolidation of the reinsurers in North America has emphasized this core of strength. Just last week the newest announcement was ING Re selling its life reinsurance business to Scottish Re. It was a reinsurance transaction specifically, but effectively the company was selling it. There's still plenty of life reinsurance mortality business being done out there, and the existing North American reinsurers don't have a lot of incentive to go out into other business clients at the moment.

Another thing that was a setback to annuity reinsurance a couple of years ago was the application of Financial Accounting Standard (FAS) 133 to funds-withheld transactions. When it first came out, that created a lot of uncertainty as to how the FAS 133 would be practically applied to the funds withheld transactions. As a result, a lot of people just stepped back; specifically any reinsurers that were involved stepped back from funds withheld because they didn't know what the effect would be on their books and records. It has evolved now to the point where you can determine what the effect is going to be on your books and records, but it does create a volatility in GAAP earnings that is still of concern to a lot of people.

When reinsurance has been done with annuities recently, it's primarily been of what I call a traditional structure. By traditional structure, I mean a quota share of all the product risks in the product, meaning the investment results, persistency of the product, payment and amortization of acquisition expenses, payment of maintenance expenses and mortality or longevity risk, with that last risk being predominant just for the payout annuities. My opinion is that you don't need to confine yourself to such a traditional structure, and creative structuring is where you'll find the opportunities today to enter into reinsurance transactions that will benefit you as the ceding company and where you'll find reinsurance capacity.

I'll start with the traditional deferred fixed annuities, again, SPDA and the like. These transactions typically have to be done on either a coinsurance or a funds-withheld basis, and each has its own reactions. The reaction on coinsurance has often been a knee-jerk reaction on the part of the ceding company not to want to enter into it because it doesn't want to transfer assets to a reinsurer. However, if you look at it carefully and look at the alternatives, you should give it extra consideration. For example, you can make sure that a reinsurer segregates the assets backing your line of business. It could be in an escrow account, a custodial account or a trust, but it will earmark the assets, safeguard them and help mitigate the counterparty risk with the reinsurer. You can also agree to the investment guidelines to be followed on the assets managed by the reinsurer.

In most cases the ceding company still has an interest in how the product is going to perform postreinsurance because it's still their policyholders. The creation of the investment guidelines will help in the process of having a reasonable expectation of how the policies may continue to perform into the future. You can also even consider assigning the ceding company as investment manager for the assets held by the reinsurer. This could be of particular interest if the ceding company believes it has a particular expertise to offer in the management of these assets, and it's also important that the ceding company has a need or in some cases a requirement to continue the revenue that it would have otherwise gotten as investment managers of those assets.

On the other side we have the funds-withheld transactions, the modified coinsurance (modco) and the cofunds withheld. This marketplace had frozen up a couple of years ago because of the embedded-derivative accounting issues, but, again, if you look at it carefully, you don't necessarily need to rule it out entirely. If you want to pursue that type of transaction, what you'd most likely need to do is look for a reinsurer that is less sensitive to U.S. GAAP accounting issues. You could look toward Canadian companies, European companies or privately held companies, the common thread among them being that they are either insensitive or less sensitive to U.S. GAAP reporting requirements.

On a broader basis, as time passes and people become more comfortable with embedded-derivative accounting, the basic concerns that the volatility creates may abate. For example, many companies reporting on a GAAP basis report net operating income in addition to net income, net income being the GAAP definition of required income they need to report. But a lot of companies report operating income to stress what they feel is the true recurring income base of the company, and they take out things that they consider noise or one-time nonrecurring. I have seen companies that have this embedded derivative take the change-embedded derivative out of their net operating income. That identifies it, isolates it and allows their constituency to place their own valuation and determination.

Ceding companies, even after a reinsurance transaction, can influence the amortization of deferred acquisition cost (DAC) because they maintain the distributor relationship and the policyholder relationship. They have an influence over persistency, which is the primary determinant of the amortization schedule for DAC. The solution would be not to reinsure the acquisition cost. You can do that. You will get a different set of benefits as the ceding company, as if you had reinsured it. You will not get surplus strain relief in that situation, but you will get relief from other asset-related risks like the allocated capital, the risk-based capital. Correspondingly, the cost of the reinsurance program will be significantly less. You'll have to pay for what you're receiving, but the ceding company will retain a significant portion of the spread to pay for the amortization of the acquisition cost and, one hopes, for residual profit. An important reason to do this is that you may be able to find some reinsurance capacity that you couldn't otherwise find on a traditional basis.

Let's turn to equity indexed. Dale already talked about the history of the marketplace. It is a marketplace that has had a lot of buzz and a lot of premium growth of late, which is expected to continue. The product, the way I see it, has three major risk components: It has the funding of the guaranteed minimum interest, the funding of the equity participation and the acquisition cost. The question, if you're the ceding company, is which of these risks are you comfortable with, and which of these are you looking for help with?

I'll use the equity participation as an example. The equity participation is typically funded by buying derivatives from the capital markets. However, the equity participation can also be viewed as a natural product hedge against VA benefits and vice versa. This natural hedge can be attractive either to you as the direct writer or to a reinsurer.

Let me give you an example of how this natural hedge works. Tucker slide 1, page 7 shows the stochastic results of a guaranteed minimum withdrawal benefit (GMWB). As with many VA guaranteed benefits, it has a tail to it. On a stochastic generation it makes money 90 percent or 95 percent of the time, but 5 percent to 10 percent of the time, it's going to lose, and in some cases lose big.

Now let's look at the same type of analysis for an EIA. What I've done in Tucker slide 2, page 7 is isolate the present value of cash flows for just the EIA participation. The way I've done that is I've taken the hedge budget that's typically produced for an EIA and considered that a revenue and then have taken the results of the EIA participation formula and have considered that an expense. That gives me a net cash flow on the EIA participation, here on a run for 2,000 stochastic scenarios. You can see it has a tail, but the tail is on the other side. In capital markets parlance the VA benefits would be a put-based risk. These are call-based risks. In my language, that of noncapital markets, it means if the equity markets go down, the VA benefits are going to be costly, but the EIA benefits are not going to be costly. Conversely, if the equity markets go up, the EIA benefits will be costly, but the VAs will not. They will almost always work in opposite directions. The $64 question is, What happens if you put them together?

In a combination of GMWB and EIA together (see Tucker slide 1, page 8), you'll notice that there's still a curve, but the tail is virtually eliminated. In the modeling that I was doing, I ran 2,000 stochastic scenarios and had losses in three of them, hence a 99.85 percent probability that it would make money. I probably should have rounded it and had 99.9 percent; it would have sounded better. Note the relative impact of volume on these two types of benefits. I have combined $5 billion of withdrawal benefit with $1 billion of EIA. Per unit there's a much stronger impact on the EIA than on the withdrawal benefit.

The last product I'll talk about is fixed payout annuities, and this is a market that I, and probably most people, still consider a chicken and egg issue. As an industry, we've talked about it for a long time and continue to talk about it, but the retail volume is not there yet. Without that volume it creates a lack of longevity experience and data to work off of from an actuarial basis. If an individual writer wants to become more involved in retail payout annuities, he or she is often going to have trouble justifying the effort to become comfortable with the pricing, because to do that you're going to have to do research, you're going to have to allocate a fair amount of staff time, and the volume probably isn't enough in the short term to justify an allocation of resources to that.

A traditional solution would be to go and look for a reinsurer that has more knowledge and expertise and is more comfortable with the risk. However, in the current marketplace in North America I have yet to find a reinsurer that has that knowledge and comfort level. They are in the same predicament as the direct writers. There is not any significant industry experience to work with, so you don't have reinsurers jumping on the bandwagon to offer this type of coverage, although the marketplace would be ripe for it because direct writers seemingly would be asking for it.

If you want to continue pursuing the reinsurance option anyway, it is possible, but you need to set your expectations realistically. For example, don't go out there expecting to find what I call a longevity arbitrage. Unlike what I referred to earlier on the life side of the business, in recent years it's been common to be able to go out in the reinsurance marketplace and find a reinsurer that would value the cost of the mortality at less than what you are doing in-house. You're unlikely to find that situation with longevity. However, if you're willing to reinsure the asset side of the product line as well as the longevity side, that will increase your chances of finding a reinsurer that's willing to work with you. There are reinsurers that want the asset side, the asset growth, the asset management, and the fees and profits that come from the asset management, and they may be willing to take the longevity along with the asset management.

My last comment would be that you could consider reinsurers from a geographic region other than North America. Some look for a region where there is more experience with longevity. My example would be Europe. Within Europe the United Kingdom has significant longevity experience. It does, though, remain to be seen how easily and to what degree those data and that expertise can be transferred over to the North American marketplace.

MR. GOOTZEIT: I want to thank Eric, Dale and Rich for their comments. I have one question to start, and that's for Eric. We talked about the nonforfeiture law, and I'm curious whether you had some early indication of the financial impact the adoption of the law would have on companies relative to performance of product.

MR. CARLSON: The answer to that question's going to vary substantially with each company, but there's the potential to have a fairly significant impact on direct writing companies as far as the administration of that company. Having moved to a life reinsurance area, I'm less involved in it, but a lot of system requirements need to be put out there, and I think there are some additional certification and regulatory type of requirements. It will be a cost that could probably impact small employers more than the larger ones.

MR. DOUGLAS L. ROBBINS: Eric, you said something a couple times about the EIA part of the new nonforfeiture law. I want to make sure that what I heard you say is really what you said. You said that you get the extra 1 percent, and you have to establish that your equity guarantees are worth 1 percent. In a simple example I've got an annual reset product. I go out and buy options to back it, simple participation rate only, nothing else. I go out to the market with a participation rate of 50 percent, but my guarantee is 0 percent. Theoretically I could reduce my option costs in the future to nothing. Am I going to qualify based on my current budget and the fact that I'm now spending over a percent?

MR. CARLSON: That's a good question. I'm assuming that in that example you have an annual reset, and each year you establish your 50 percent participation or whatever the participation rate is, and then I assume that's guaranteed for the remainder of that year?

MR. ROBBINS: For one year, yes.

MR. CARLSON: In that case you would need to certify each year that you qualify for that additional reduction, and because the participation rate is guaranteed for the index term, you would be eligible to receive the additional reduction assuming everything else showed that your option costs exceeded the 100 basis points.

MR. ROBBINS: Okay, if I reset to zero in year three, does my nonforfeiture rate change retrospectively from issue then, or does it change just for that year?

MR. CARLSON: I'm not sure the extent to which that has been thought through in the regulation. My personal opinion is that should just be a perspective change. You shouldn't be penalized because you did provide that equity participation historically.

FROM THE FLOOR: I have a question for Dale. I'd like to ask for some help for the rest of the actuaries in this room to understand more about BISYS, which is a marketing organization that is quite prominent in the insurance industry. I think it would be interesting and helpful if you could describe the firm a bit for us.

MR. HUMPHREY: BISYS is a diversified financial services company. We work on an outsourcing basis in all our business units. Beginning in 1997 we acquired an organization, the Underwriters' Group in Harrisburg, Pennsylvania; some of you may be familiar with that company. That was our first Brokerage General Agent/Managing General Agent (BGA/MGA) acquisition. Since that period of time we've made 16 similar acquisitions in the BGA space. We brought those together, forming a single MGA entity that has two major epicenters: Salt Lake City, Utah, and Harrisburg. We work again primarily with independent agents, as well as some of the other channels I discussed.

We have two major client segments. The first is what we refer to as an affiliated client. A good example of that, and our most predominant client, is Lincoln Financial

Advisors. Lincoln manufactures an excellent proprietary product but is interested in using an outsource solution to provide nonproprietary product in a networked fashion. That is an endorsed sale of nonproprietary product within the Lincoln system. We have similar accounts with Prudential and others. The other side of the equation is unaffiliated producers, meaning independent agents. They're out there hanging their shingles, selling products to whomever. We focus on life insurance as the bulk of our distribution force, long-term care, annuities and disability.

FROM THE FLOOR: No actuaries work for the company, is that correct?

MR. HUMPHREY: No, I'm the closest to it.

MR. TRACY ANDERSON: I want to direct my question to Dale about the comment that he made regarding the 80/20 rule and the consolidation within the equity-indexed market. Could you address why companies are leaving the market now? My second question concerns a smaller company that doesn't have registered reps and that writes annuity business in the tens of millions as opposed to the hundreds of millions or billions. What would be the considerations of getting into the equity-indexed market?

MR. HUMPHREY: The issue that we face today is that the companies that are dominant in the EIA space are skilled marketers. Where they've made most of their inroads is with a type of seminar approach to the selling cycle. They have a large distributed field force. They are working one-on-one with producers, bringing them in a room such as this, putting a lot in front of them and pitching product pretty heavily at them, giving them the ammunition to go out in the field and communicate with the retail client. That type of marketing approach—that is, one that is very one-to-one, very centered on interaction of this nature—has been fairly successful for a few of these companies.

In addition to that—and I don't want to be critical, and I don't want to name any companies—they've had fairly producer-friendly product, too, because the commissions on some of these products far exceed what's available in the standard deferred product, and some producers are very much influenced by that. They've combined those two things, that is, heavy overrides: They allow their distribution force also the capability to do marketing of this nature. You need money to market, right? You need money to do seminars, put out flyers and do that type of thing. Operating off 200 or 300 basis points is different from operating off 50 basis points to market your plain vanilla deferred product. There's enough meat there for all these parties to get involved in that market equation. You could buy in the producer-oriented product set with the heavy marketing emphasis, and you've got a consolidation in the number of carriers that have dominated sales over the past couple of years, and one specifically.

When you talk about smaller companies that are trying to get involved in this business, and I have a lot of discussions with them, you can talk about niche-type sales opportunities, meaning maybe they deal with fraternal organizations, for example, or they have a smaller career system that is channel-specific, and they may believe that they're having a lot of bleed-off, that there are a lot of outside sales going to EIAs.

For the sake of arithmetic, let's say that the deferred market is $100 billion, and the EIAs have 20 percent or so of that. I don't think there's any argument at all that to some extent the EIAs have taken a lot of share away from deferred products. You could raise your hand and say the reason is the interest-rate environment. You can't sell standard deferred products in this rate environment, and that is true. If you look at the number of distributors in this country that are specialized in annuities, for example, and we are not absent from that, our sales would be down more if we didn't have a strong EIA base to our portfolio.

Those that are selling the EIAs pretty heavily have helped offset that, but in terms of overall share growth, we still have a large number of producers that have not entered the space and do not know enough about it. Talk to a consumer sometime. We don't do this, but poll people out on the street. *You* know about annuities. *I* know about annuities. You mention an EIA, and consumers are going to go cross-eyed on you. People are not familiar with this class. There are plenty of producers out there, and there are plenty of consumer groups, whether it be Niche or Finity or something like that, for which EIAs fit in their portfolio, and often companies that I engage with say, "We're losing share. We're losing it by the handful. We believe we need an EIA. We don't want to be on the cutting and bleeding edge of the design philosophy, however. We don't exactly want a me-too product. Give us something in between these. We can offer good value to our consumers. We can also offer a product to our producers combined with conference credits. The other benefits that we wrap in our distribution system will at least keep the sales contained within our system."

There are opportunities for that, and you don't need that type of premium force. When you're doing $125 to $130 million a year, you could financially justify the product set.

MR. DAVID J. MERKEL: I have two questions. Given the high commissions that are paid on EIAs, what do you think the odds are in the next five years of a market conduct investigation regarding EIAs? My second question is, about two or three years ago all the reinsurance capacity for VA benefits basically went poof. I thought that hedging idea was an interesting one. Are any reinsurers actively using that now, and are we seeing more reinsurance capacity coming into the VA market?

MR. HUMPHREY: I don't want to attach a probability to it, but let's say that it's too high. Discussions I've had with a couple of state insurance bodies are discussions that I hoped that I would never have. I think what we'll see is what happens over a period of time, maybe five to seven years; we just passed over the anniversary period of a majority of the products sold in the mid-1990s, and I would say for the carriers and the products sold at that time, most consumers are fairly happy. One company in particular allows a 45-day term or window for retail clients to essentially decide what they want to do with that contract. Some out of absence simply let it go when it renews, but many are aware of what the product's done and the way the product's performed and essentially decide to ante up again and allow the premium that accumulated in the first contract to go and roll into a second seven-year term, for example, and that ratio's been about 75 percent with this particular company. I think those people have generally been happy.

If you look at the rates of the return on the product, as well, they should be happy. We're talking about 6 percent, 6.5 percent and 7 percent if you got it in 1993 or 1994 on an annualized basis. It was a good deal and met its specifications. Where I think the wheels could potentially come off is when we talk about five or six years from now and some of the longer-term product that is being positioned today, or even some of the product that does require annuitization. My primary concern unwinds itself over that period of time. My major point today is let's try to be proactive. I'd like to see distribution shaped back to the consumer level as far as its market share growth versus the producer. I can't attach a probability, but I think any risk of that nature is way too high.

MR. GOOTZEIT: Rich, do you want to take the reinsurance question?

MR. TUCKER: My first question or comment is that more than a couple years ago VA reinsurance capacity went poof. It did, though I wouldn't characterize it as being entirely gone. It shrank dramatically, but there's always been a little bit of capacity out there, sometimes on structured terms, but it's been there. Will more capacity be coming into the marketplace? In terms of the EIA and the natural hedge, there are a lot of companies—reinsurers and a lot of direct writers—that have existing VA guaranteed business on the books, where the EIA participation now could be used as a hedge on either existing business or new business. The concept of the natural hedge with the EIA, when you combine it with the price hardening that's occurred on the VA benefits in the retail marketplace, may entice more reinsurance capacity into the market, meaning the price of the retail guarantees has gone up. Therefore, more money is available in the product to pursue reinsurance as it becomes available, and combined with the natural hedging that could occur now with the EIA participation, we might see more capacity into the marketplace.

MR. MICHAEL C. WARD: New EIA designs are emerging on the marketplace that are more complex and sophisticated than the first round that we saw, for instance, the monthly accumulator option types. How do the panelists see the new emerging types as posing risks and potential rewards for the carriers, and producers and buyers alike?

MR. TUCKER: I think that some proliferation of designs has been well-thought-out. I think they're oriented toward consumer value, they're something that can be described, and they're definitely seeking some form of performance advantage. You have to model these things over a period of time to understand how monthly averaging and other methodologies can work.

One company we work with recently introduced one of the most basic products available today, and if we talk about basics, we look at this as—again for a moment try to visualize this—a risk return profile. We have a return profile on one axis, and a risk profile on another axis in terms of defining risk is the probability of knowing at the outset what some expected return may be. If we take it to the upper-right-hand corner of this continuum, we'll have a fully loaded equity position. It could be in a VA. It could be in a simple Standard & Poor's (S&P) 500 Index account. We'll take the lower-left-hand corner, which would be an SPDA with a fully guaranteed interest rate over its full term: that is, for the client and with the contractual guarantees that exist in that, barring any unforeseen events in the life insurance company and otherwise, the return is going to be known at that time.

For the EIAs in between those two continuums, we try to map them from the standpoint of the next step up from a basic SPDA, which would be an annual reset product, a basic 12-month annual reset product, S&P 500, a stated participation rate and cap at the beginning of that term. One of the products recently introduced that I just alluded to used what we refer to as a binary hedge on-off the S&P 500, that is, it has a crediting rate start, stated at the beginning of the full term of the product. Let's take the six- or seven-year term product. It has a crediting rate. Let's say for the sake of argument it's 6 percent. What it states is that every year the S&P 500 will be measured over that year. If the S&P 500 is flat or has increased, it doesn't matter what percentage it has increased. That credited rate will be given to the contract holder. If the S&P 500 declines at any point in time during that term, no rate is credited. This continues over the full six- and seven-year term. That is the most basic EIA today, at least from the standpoint of being able to communicate, we hope, that to a retail client.

The next up is the annual reset that that I described. Lincoln Benefit Life Savers Index is an example of that. In between somewhere there would be the high-water-type design, like the Keyport, and on the upper-right-hand corner of that picture would be something that's a full end-to-end term product, meaning you do not know what the crediting rate of interest is going to be until that full seven-year term is over. The reason why we describe it as risk is it gets completely dependent on the performance of the indices. The others are, too, but you've got a longer measurement period of time.

When we talk about all these other iterations of the product designs, they all sit within these two continuums. They're just variations on design philosophies that are completely dependent on the performance of the index. We don't have enough mapping. We don't have enough time to describe what's going to happen to them because we don't have enough data to support it. We have enough data to take a look at today what basic annual reset products have done with an annual reset and participation and cap, as well as high-water designs in one full seven-year term-to-term product. Beyond that, we don't have enough performance history to indicate otherwise.

Where I think the actual risk is entailed is how that is communicated to the client. My litmus test to it is if I have to read a marketing brochure three times—and I'm not saying that I'm the end-all expert in this—I have no idea what's happening at the kitchen table. I would hope that we have the iterations of these types of designs, but I think most of the time they're multibucket designs, They are consumer-oriented because the multibucket designs will offer a fixed alternative to a client. They will offer them the two crediting methodologies that are, we hope, going to be actively positioned to the retail client by the producer of fitting their risk-reward continuum, meaning do you want to be in the unknown, or do you want to be in the known or somewhere in between? Are the producers skilled at being able to discuss all the attributes of the products in that frame?

I don't want to sit here and babble, but Life of Southwest was an early entrant into this space. It's done a good job as a smaller company to carve out its own niche. It's also been involved with universal life, a product variant of this type. But as far as the risk of the different crediting methodologies goes, it exists, but I think the risk primarily resides in the fact it is accurately described to the client. Are the client's expectations being properly set from this type of design? Is the producer in any way, shape or form guaranteeing out-performance based on the design? That is a major error, a major mistake, because out in the whole wide world that gets broker-dealers pretty freaked out: Are you selling a VA that has principal protection, because that's a pretty good song and dance. You don't do that. It's one of the cardinal rules. I think that the broker-dealers and some of the other channels I discussed are concerned about that. That's where the risk resides, in my opinion. I think the basic designs of these products are all fairly solid, but what is the consumer purchasing? What does the consumer understand, and what is the consumer going to think in seven or 10 years?

MR. GOOTZEIT: This has been an exciting session for me for a variety of reasons. These are interesting and hot topics in annuities. The annuity nonforfeiture law certainly will have a great deal of impact on the companies represented in this room. I think understanding that is quite significant, as is what the financial and competitive impact on the landscape has been and knowing that it's going to change. That will become available as this goes forward. I think the availability of reinsurance in the annuity space is something that is expanding and has more opportunity for companies than they currently take advantage of, so that was a useful topic as well for us. It's also useful to hear a nonactuary talk in technical terms and promote customer and consumer satisfaction rather than producer satisfaction. By the way, I think that actuaries should be working at companies like BISYS; there's something extraordinarily wrong about our absence.