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REGULATORY PROBLEMS OF LIFE INSURANCE COMPANIES vs. OTHER FINANCIAL INSTITUTIONS

by Richard V. Minck

The investment returns earned by life insurance companies over the past decade have permitted the sale of contracts guaranteeing relatively high rates of interest. The contracts have given rise to problems in the areas of the federal securities laws, of federal income taxes, and of state valuation requirements.

Traditionally, insurance contracts funding qualified pension and profit-sharing plans have not been regarded as securities to be regulated under the 1933 and 1934 acts. During the 1960's, insurance companies began to issue annuity contracts that provided for the allocation of contributions to separate accounts, thus enabling those contributions to be invested in common stocks. The SEC staff took the position that these separate account contracts came within the federal securities acts' definition of "securities." The issue was brought to the Congress which amended the securities laws so that participating interests in life insurance company separate accounts established in connection with qualified retirement plans were declared to be "exempted" securities. Recently, insurance companies have offered contracts to fund pension plans which *do not* utilize separate accounts and which provide for only minimum, if any, mortality guarantees. Questions have been raised by the SEC staff whether these contracts are entitled to exemption. However, on March 18, the SEC issued a "no-action" letter which set forth conditions which, if met, would lead the SEC not to recommend enforcement action if guaranteed interest contracts are sold by life insurance companies to corporate pension plans without registration of such contracts as securities.

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David Garrick Halmstad Memorial Fund

Contributions to the fund established to award annual prizes in memory of Dave Halmstad now total $4,000. The goal of $5,000 appears to be in sight. Tax-deductible contributions in the form of checks payable to the Society of Actuaries may be sent to the Chicago office.

SEX AND THE SINGLE TABLE REVISITED

by Barbara J. Lautzenheiser

Editor's Note: Barbara Lautzenheiser's excellent article "Sex and the Single Table" (see *The Actuary*, February 1977) indirectly gave rise to the following comment:

> *"The issue never was or is now whether women live longer than men. The issue is whether in a given group formed by common employment, benefits to one class within that group should differ because of race, sex, smoking, blood pressure — or eye color."*

Miss Lautzenheiser decided to reply to this comment and her reply is well worth reprinting:

"Although I agree with you that the issue never should have been nor should be now whether women live longer than men, I'm afraid in some people's minds that *is* the issue. I constantly receive questions and doubts about the credibility of the current statistics. People always question things they haven't developed themselves, and particularly things they don't understand or things that don't give the results that they want. And people questioning longevity data on men and

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JIMMY CARTER AND SOCIAL SECURITY

by Ronald G. Harris

On the same day that the "1977 Trustees Reports" were issued, the Carter Administration unveiled its financing program for the Social Security trust funds. The Administration presented a series of proposed changes designed to alleviate at least partially the financial problems of the programs. The proposal in total is rather complex and defies a simple explanation but there are basically eight major provisions:

—The first is that it would institute a special "counter-cyclical" system of financing from general revenues which is intended to replace social security taxes that are lost when the unemployment rate exceeds 6%. There is a retroactive feature on this provision going back to 1975.

—A second major characteristic of the proposal is that it would remove the ceiling on the amount of an individual's wage or salary on which the employer would pay social security taxes. This is proposed to be accomplished in three annual steps beginning in 1979 and ending in 1981.

—The third point, related to the second, would impose an increase in the maximum amount of wages or salary on which an employee would pay social security taxes and, of course, on which his benefits normally would be based. The proposed increases would be $600 in each of the four years 1979, 1981, 1983, and 1985. These would be increases that are in addition to the automatic increases that would result from current provisions of the law.

—The fourth item is a shift of some taxes from the HI program to the

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Competition No. 8

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The obvious solution is to lobby Congress to outlaw compound interest and all its "derivatives. Some sample slogans might be (i) think simple (ii) compound interest discriminates against women and minorities, (iii) compound interest causes cancer . . ."

We took due note of Mr. Rich's use of i to separate his slogans but wish to point out that elimination of compounding will make present value calculations so simple that accountants could pass the exams, thus further increasing the FSA population. Not for this flaw alone did we pass his solution and award the prize to Denise Fagerberg Roeder whose solution struck us as the most elegant:

> I would suggest that the Society immediately embark on a program of offering group therapy to new FSA's. This would help them re-enter the real world, something *which they have not been in touch* with since sitting for their first actuarial exam. After a period of such therapy, FSA's would once again be real people, and the problem would be eliminated.

We assume Ms. Roeder would go along with Bill Lane and offer an Individual option.

So, Mr. Mepham's solution notwithstanding, the females have it.

C.E.

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Regulatory Problems

(*Continued from page 1*)

The SEC staff, as a result of advertisements appearing in major newspapers, have examined contracts sold by insurance companies to individuals or groups to fund tax-qualified pension and profit-sharing plans, *other than qualified corporate plans*, and contracts sold to individuals not part of any pension or profit-sharing plan. In the SEC's view, the sales approach has been to emphasize strongly "investment" features rather than insurance and/or annuity features and the SEC feels that these products differ in material respects such as the absence of purchase rate guarantees and the high level and short term duration of interest rate guarantees from products traditionally offered by insurance companies. The questions asked by the SEC staff are: In what context are the contracts being sold? Are they being sold as an alternative form of investment?

This problem has been highlighted by advertising that heavily stresses the investment advantages of contracts with tax-deferred interest and makes little or no reference to the annuity aspects of the contracts. Such advertising will continue to capture the attention of the SEC, which is in the middle of a review of the questions raised above.

The Federal income tax laws have encouraged the elimination of traditional insurance-type guarantees.

The fundamental Federal income tax issue presented by these contracts concerns the amount that may be deducted with respect to interest credited under the contract. There are two basic possibilities:

(1) If the funds held under the contract are determined to constitute "life insurance reserves" the deduction is measured by the life insurance company's overall portfolio earnings rate, even though, as explained above, interest is actually credited at a higher rate.

(2) On the other hand, if the amounts credited are held to be in the nature of interest on funds which do not involve life contingencies, then the full amount of credited interest is deductible.

The problems described flow from the effort of insurance companies to compete for savings. Banks have diversified in the past several years and expanded their services; mutual funds have developed new mechanisms (e.g., money market funds and municipal bond funds). Insurance companies have also attempted to provide a greater variety of services to maintain or increase their share of the savings market. In doing so, they have come into conflict with the various federal regulatory agencies. The dilemma of the next several years is how to compete effectively and yet not be hamstrung by increasing federal involvement.

Editor's Note: We are indebted to the author for permission to excerpt these comments from his presentation at the "Open Forum One" session at Quebec City. □

Jimmy Carter

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OASI and DI programs. This would be considered feasible for a couple of reasons: (1) the reduction in HI expenditures that presumably would result from the enactment of the hospital cost containment proposal which the Administration is proposing and (2) the increased revenue to the program resulting from the higher wage bases and from the interjection of general revenue financing.

—The fifth point relates to the restoring of the OASDI tax that is paid by the self-employed to the traditional rate of 1½ times the employee rate.

—The sixth item is the only one that directly involves employer-employee tax rates. It advances the 1% increase in the OASDI rate that is currently scheduled to go into effect after the turn of the century. ¼ of 1% would be added in 1985 and the remaining ¾ of a percent in 1990 (employers and employees, each).

—The seventh item is to correct the over-indexing of benefits that occurred as a result of the automatic adjustment provisions in the 1972 amendments. This is commonly described as "decoupling."

—The eighth and last item in the Carter proposal would be to change the eligibility test for dependents' benefits to offset or approximately offset the financial impact of recent Supreme Court decisions relating to equal treatment of male and female dependents.

The net effect of all these proposals on the operation of the trust fund will be roughly to balance the income and outgo of the OASDI system during the next 25 years. It would, however, leave the OASDI system underfinanced after the turn of the century by about 1½% of taxable payroll for the first 25 years of the 21st century and by about 4½% for the second 25-year period of that century. And, finally, it would leave the HI system in slightly better financial condition that it would be if none of these proposals were adopted. Even so, the HI system would still be significantly underfinanced over the 25-year period.

The Carter Administration proposal departs from more traditional proposals

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PENSIONS AND THE U.S. SUPREME COURT

by Susan J. Velleman

In their recent decision in the case of *Alabama Power Co. vs. Davis,* the U.S. Supreme Court touched on a fundamental issue of employee benefits philosophy. The Court, in holding that defined benefit pension plans must grant benefit accrual credit for periods of military service, concluded that "pension payments are predominantly rewards for continuous employment with the same employer" as contrasted to "deferred compensation for a year of actual service."

This characterization of pensions as a reward for continuous employment seems contrary to current attitudes, as exemplified by the requirements in the ERISA to fund and vest accrued pensions after fairly short periods of service and by the acceptance of negotiated pension costs as part of a cents-per-hour wage settlement. □

Jimmy Carter

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or methods of financing the programs in two key areas. One is the interjection of general revenue funds rather than relying solely on payroll taxes. The other is the treatment of the wage base—removing any limitation from the wage base on which the employer would make contributions. This latter item itself involves a couple of major departures. First, it's really the first time that the wage base has been used strictly as a financing tool. Normally, an ad hoc change in the wage base would affect both benefit computations and revenue to the program. Secondly, and I'm sure most of you are aware of this, professional firms such as actuarial consultants who have relatively high average wages would be affected rather strongly without any corresponding increase in the benefits that their employees would receive.

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Sex and the Single Table

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woman are no exception. Since they feel the industry and our profession both have a vested interest in the results, there is the natural doubt in their minds as to whether or not that vested interest might have gotten in the way of the facts when we developed them. Fortunately, much of that data is census data and Social Security data, not developed by the industry, and therefore it's more credible.

Some of those who do accept the current data as credible, however, question whether or not the data will change with time. They're referring to the data equalizing, of course, rather than further separating as it has in the past. The beauty of the separate tables is that if they do change (hopefully the same way they have in the past, i.e. longer life for women, since in that respect I do have a vested interest) we can then reflect that in the rates in the future.

I sincerely wish that the issue you stated, i.e. "whether in a given group, formed by common employment, benefits to one class within that group should differ because of race, sex . . ." were the only real issue. If the issues were restricted only to this, I would have concern, but not nearly the concern I have for what I perceive the real issues to be. Unfortunately, the issues involve not only group insurance paid for by one employer, but also individual purchases for small groups paid for by many different buyers. In these latter cases equity and fair pricing, not just benefit structure, is absolutely necessary between different buyers.

It's also not just sex, but physical handicap and age as classifications, that are being challenged. It's the ability to assess the risk and charge a fair price for it, with no unfair overcharge for someone else's extra cost risk, that's being jeopardized. The proper assessment of the risk is a responsibility of the provider of the benefit, as well as a necessity, in a voluntary coverage system. Mandation of how to classify or rate policies, through unisex, or unihealth or uni-age tables, or just mandation of what benefits should be provided, reduces the options the public has because some insurers merely cease selling the coverage (as many have done in states where health benefits were mandated) and causes unfair charges to be made on the majority of the public — since low risks are forced to subsidize high risks. Ultimately this could cause elimination of the private insurance market with the necessity of a take-over by the government — a trend which is just the opposite of what the public and the President, appear to want.

It also involves not just annuities, but life insurance, health insurance and casualty insurance, where anti-selection is more prevalent. When an unlimited amount of insurance on a high risk coverage can be made at the same price as a low risk coverage, low risk coverage purchases will cease to be made. This will further spiral the costs and essentially make insurance unavailable at a price that's reasonable to the large majority of the population. This would just not be in the best interests of the public.

There's also the basic question of how to determine when benefits are equal. Paying one person $100 a month for 10 years provides the same monthly benefit as providing another person $100 a month for 20 years, but they don't have the same value. Providing one person a Cadillac to drive to work and another a VW gives them both equal transportation in terms of how long it will take the car to get them there too, but they don't have the same value. I've always measured equality and equity by cost, by value in dollars, because I don't have any other way to measure. And I use the same basis for annuities, i.e. the value of the benefits to be paid. And it's this present value of the payments to be made, not the payments individually, that should be equal.

I feel the profession's responsibility is to determine the facts, substitute them for appearances, and make sure those facts reach the persons responsible for making the decisions. If equality, not in terms of costs, and subsidization of one group by another is for the social good (and we have considered it so in cases such as cost of education for all children), that's for the public, through their representatives, to decide. But we, as professionals, as actuaries, have a responsibility to point out those consequences, costs and inequities (subsidization) that are caused by doing so, so that intelligent, informed decisions can be made." □