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Session 64PD
Hot Topics in Fixed Annuities

Track: Health

Moderator: Douglas L. Robbins

Panelists: David J. Weinsier, Brent A. Mardis

Summary: This session provides an overview of the impact of changing operating environments affecting reinsurance transactions due to emerging International Accounting Standards (IAS) and changing reinsurance regulations in the United States and Europe.

Participants in this session improve their understanding of the following issues:

- *Impact of IAS on reinsurance transactions*
- *Changing federal and state insurance regulations impacting reinsurance*
- *Emerging European regulations related to reinsurance*

MR. DOUGLAS L. ROBBINS: I am Doug Robbins. I will be the moderator and the first speaker at today's session, which is called "Hot Topics in Fixed Annuities." I am at Pacific Life. That is my first joke, because we do not have any fixed annuities. Actually, I was at Tillinghast when I agreed to participate in this session, joined Pacific Life about a month after that, and I have been learning a lot about how to manage a block of variable annuities. I am going to give you what I know about fixed, and then I will introduce the two speakers who are the real experts on the block on the subject of fixed deferred annuities. I will talk a little bit in the introduction, and then I will talk about how one might sell a single premium immediate annuity (SPIA), because in the meeting agenda that the SOA handed out to you, we promised to talk some about SPIAs and what might be hot there.

I will start by showing you a pattern of recent annuity sales. This is information that our competition just got from the Life Insurance Marketing and Research Association (LIMRA). There are a few interesting patterns here that I will point out in chart 3. The first is the growth in the variable deferred. The second is the parallel growth in the equity index, which is the white trunk at the top of the fixed section. The third pattern is slippage definitely in the non–equity index fixed, because you can see the purplish blot growing as the market collapsed and then starting to narrow again as interest rates have dropped, and then finally the little fingernail-size sliver at the top, which are SPIAs and the consternation we all have about that. All those will be things that we talk about in my little introduction.

I will start with the popularity of variable annuities and lack of popularity of fixed, despite a lot of recent and misleading, I believe, criticism of variable annuities. I challenge you to do an Internet search of the top 10 investment scams, and probably variable annuities will come in somewhere around number six or seven. They appear in many of those lists, and there is an explanation. They are typically based on apples-to-oranges comparisons with mutual funds, because a lot of time they use a loaded variable annuity versus a no-load mutual fund. Usually they betray a lack of understanding of the complete variable annuity products by the writer, and they also sometimes involve statements that seem rather puzzling and contradictory. They say that variable annuities are bad because they have these guaranteed death benefits that you have to die to realize, so that is not a real guarantee. Then they are also critical that the product is sold to the older population, and I have trouble with that, because those are the people most likely to die. Also, let me take a quick survey. Raise your hand if you find out your company just sold a $10 million policy to an 85-year-old and you say, yes, we got just want we wanted there. Of course not. You have ROE probably very low, possibly negative, yet it is called a scam because it is sold to an 85-year-old. I think that is kind of funny.

Why are fixed annuities not similarly criticized, and how can we take advantage of that? Possibly it is because they are not a security, so they do not get compared to mutual funds. I think more likely it is because they offer something that is hard to

find in the long term anywhere else. When I say long term, I mean more than just a few years like a CD, and that is a guaranteed fixed return. In a pure bread-and-butter fixed annuity, especially a market value–adjusted (MVA) product, you can still get that and it can be better than a CD rate, especially if the yield curve is sloped. Even equity-indexed annuities offer a long-term guarantee, but on top of that they offer equity length gains, but they still have this long-term guarantee that the variable annuity does not have to prevent criticism.

We will talk about some of the hottest variations on this guaranteed fixed return, both fixed and equity indexed, later on. First Dave Weinsier is going to talk about ordinary fixed annuities. Dave is the person directly to my right. He is a senior consultant with Tillinghast Atlanta and specializes in product development, life insurance securitization and equity-indexed products. Prior to joining Tillinghast, Dave served as a director of product management for ING's Atlanta operations, and he also recently published an article entitled, "The Quest for Fixed Annuity Profits in a Low Interest Rate Environment." Next, we will hear about equity-indexed annuities from Brent Mardis to my far right. Brent is a second vice president actuarial at Midland National Life in Des Moines, Iowa. He is an expert in product development, financial reporting and operational functions. Prior to joining Midland National, Brent was for 7 years the vice president and chief actuary at American Equity Investment Life in Des Moines. He has participated in many sessions at the SOA meetings on fixed and equity-indexed annuities, and he has also recently written a small article for the small insurance company section called "Things You Need To Know Before Entering the EIA Markets." You will hear from both of them in detail on those deferred annuity products.

First, how might one sell a SPIA? I will talk about that. What are some of the factors driving the need in the industry for a sustained withdrawal vehicle? I think there are some demographic and some regulatory and tax factors. First, the baby boomer time is coming. In about 5 years in the wave that people refer to as the baby boom, the front end is going to turn 65 years old. That is driving the current interest in accumulation products, because all these people are in their 50s, maybe very early 60s, and they want to know how to save for retirement. They will want to have a means of withdrawing their income soon. Life expectancies are lengthening. Everyone knows that favors the concept of a SPIA. People are concerned about outliving their wealth, but you cannot outlive a life annuity. People are concerned about Social Security, as you hear everyday, about the system possibly not being solvent when we retire, and disappearance of defined benefit plans that guarantee an income for life, so there is a responsibility on a personal level for retirement and expansion of 401Ks and other qualified plans. This qualified money has to be withdrawn at a certain point, and it has to be done according to a set schedule that the IRS publishes. These withdrawals must start about 10 years from now, at age 75 years for the baby boomers, and the required minimum distributions are according to a set table, so they have to do it. Therefore, do we need to do anything to sell a SPIA, or is it just going to happen magically? Here is the case we would need to make, I think still. You should

consider a SPIA because, first, it removes the possibility of outliving income. For a fixed SPIA, which we are all familiar with, there is a fixed payment for a certain period and possibly for life, but longevity risks to the policyholder are obvious, and it is also obvious that this fixes it. If you have a fixed-level payment, you cannot outlive it; you just pool the risk with other people, and some might die early and some might die late. The risk is exacerbated in the variable case or with money held in mutual funds or stocks, and here is why.

How many of you have looked at dollar cost averaging (DCA)? Raise your hand. For those of you who have not, I put together an example of the kind of things you might see. I have a chart you might see at a financial planning firm with two sets of return, my level good return in blue and my variable-risk good return in purple. Raise your hand if you had $10,000 now to invest and if you could choose one of those strings, you would choose the purple. Raise your hand if you would choose the blue, just to see if everyone is listening. Most of you voted for at least one. That is correct. Here are your two streams, and in the first one of course you get an internal rate of return (IRR) of 8 percent because that is the level of return, and in the second one the IRR of 4.48 percent gets you to a much lower-ending fund. Now raise your hand if you had $1,000 a year to invest over the next 10 years if you would still choose the blue one. Who would choose the purple one? How many of you already know that is the right answer? Obviously I would not ask if it was not right, but also you might have heard that spiel before. In example two, if you invest this $1,000 a year over the 10 years, you get a higher IRR and a higher-ending fund, because you are buying many more shares at the market's low point. If it looks like it is at the low point near year 4, then you are buying at the high point, and then the average ends up being a higher number. The example will not work for every sort of variable return, as there are certain conditions, but I have devised one as your financial planner has where it works.

Have you looked at DCA in reverse? This is where we are going on SPIAs. Somebody in the back might have. For DCA in reverse, look at page 2 of my spreadsheet. For my first example, I have $1 million, and I want to invest it. I am 75 or 80 years old, and I think I will live 10 years. I think I am being conservative. I say I can take $149,000 plus some out a year, assuming a fixed return of 8 percent, and I will get my money out in 10 years and have a lot more than just one tenth. That is my financial planning. Now say I run into the same set of returns as I used in my DCA example. Look what happens. I run out of money briefly after the end of year 5, and I am still going negative, but after it happened you would starve or your kids have to take care of you or some other undesirable outcome happens. You might say that is because the market is only returning an average of 4.5 percent and not 8 percent, so obviously that is why. That is not exactly why. I have another example, but here, I will show you the formula bar. Going down the formula bar, I have added 8 percent to each of those returns, so now my IRR if the 10 year holds will be 12.75 percent, and I still run out of money before I should, somewhere in year 9. I am averaging a 12 percent return, and I planned for 8 percent, but because of reverse DCA where I sell the most shares when the market

is low, I run out of money well before I planned.

This is the kind of thing on which we as insurers need to be getting the word out there. I have heard it said, even by my own financial planner. I think when I retire I will ride the horse that got me to the end of the race, keep my money in mutual funds. There is a lack of understanding of what can happen if the market happens to have a downturn at the beginning of your retirement, and we need to get the information out there. That is an advantage of any kind of SPIA, variable or fixed. It is also the most efficient management, I think. I do not offer facts on this for federal income tax issues, because it handles required minimum deductions for you. The exclusion ratio that you get on a SPIA, in other words, that only a certain amount of the money taken out is taxable, does not apply if you take the money out of a mutual fund or a deferred annuity on your own. It also locks funds away, providing security on certain liability legal issues and security protection from yourself. This means you put the money where you cannot touch it, except the amount you need to live on a year, so when the grandkids come and say they need a new boat or whatever, you are not tempted to cosign or whatever. There are a couple of protection issues there.

Why isn't everyone out there now in retirement buying a SPIA? We know hardly anybody is. We know that from the statistics I showed you. One is a loss of control of funds. They do not like that protection from themselves. They do not like the money being locked away. The SPIA premiums are locked into the contract, allowing life contingent reserves to be withdrawn if the cash value would invite rampant anti-selection. Obviously anybody who found out they were going to die would take the money out right away. Clients are unwilling to commit to the long term. There is also a lack of inflation protection on fixed payouts. You could have a fixed annuity with rising payments, but for some reason those things have not really gained in popularity. Most people take the high fixed payouts that they can buy. The monies that you invest are invested for the long term by the insurance companies, but they are locked in. Take a period like the late 1970s or the early 1980s. You cannot outlive a life annuity, but you might be able to outlive its usefulness because if inflation was 10 percent for a number of years, your purchasing power would be greatly diminished.

On variable products, which by the way offer payouts that might go up over time, there is either a lack of or a tremendous expense of guarantees. The payments can decrease in the down market if you do not put a guarantee on it. The cost of minimum guarantees has seemed excessive to people.

MR. MICHAEL H. CRAWFORD: Could that be one of the reasons that people do not buy them? If I am so old that I do not even buy green bananas, can you tell me how much longer they will last?

MR. ROBBINS: That could be, and that is misestimation of longevity risk. Industry efforts, I think, to combat this have been via a variable SPIA, which I

covered a little bit there. It allows you two things. It allows you liquidity, so your funds are not locked away, because the automatic mark-to-market on separate accounts reduces the risk of market-based selection, and it allows for surrender or computation of the certain period. With a fixed annuity, you could not do that as easily, because you bought long bonds to back a fixed annuity, and in certain markets you would get killed if you allowed for index, so not many people do. There is also a growth potential, which is good. The benefits could increase over time. However, the guarantees that make policyholders interested in those have proven really expensive. I will not get into the math here, but I have stated some facts that show why it could cost 1 percent or more just to guarantee that your payment will never go down. If you want to guarantee something like if the payments go up and then ratchet and never go down, then the costs will tend to be much worse, so it is almost undoable. I think the reason for that on a variable product is that there is no effective way on a variable annuity to limit the upside to the policyholder in order to have something available for the company to cover the cost of putting a floor on the downside. I will offer a fixed solution that I think does that. Here is one last thought. Are guaranteed minimum withdrawal streams the answer? I would argue not yet, at least because the exclusion ratio does not apply. There are other issues with cost there too.

Because this is a fixed annuity session, I will recommend an equity-indexed SPIA as a compromise. You could allow liquidity via an MVA. That would take care of the liquidity issue in order to cover you when interest rates pop up, and you would have some account value growth potential with no loss potential. How would it work? You would have an initial floor of benefit, whatever you buy with your $1 million. That would be guaranteed. You could calculate it at a fairly conservative rate. If you want the most growth potential, you might calculate it with no interest, but you can also use 1.5 or 3 percent possibly, and then with whatever is left between this calculation rate and what you would calculate a fixed annuity, the margin would be used to buy options to back the equity-indexed growth. The benefits could increase over time. Once having increased, and this is the key, they would be locked in. I think you would soothe a lot of the nervousness of a policyholder that even if the benefit goes up, it could go down in the future. They would get used to living on a certain amount and then get that taken away from them. That could not happen on this product. The cost of the guarantees is built into the product, unlike a variable annuity. In an equity-indexed product, you are buying call options, not investing the money in a separate account. The upside would clearly be net of dividends like for a regular equity-indexed annuity, and depending on the way I am looking at it, it would probably include a cap. We could use a participation rate, but I would favor a cap and I will say why later. You would use a strike on the options you buy equal to the SPIA calculation rate. If you calculated at 3 percent, you would have a strike at 3 on the option you buy, because you would only have gains on the product if the market grew at more than 3 percent. You could do Asian or point-to-point, just like the equity-indexed products that are out there now.

Thinking about how one of these would perform, I put together a little example with

an equity-indexed payout. There is a lot on this formula, but I did some things to take the total returns that I had on the Standard & Poor's (S&P) 500 and make them indexed returns instead or at least estimate. I have a cap in there of 8 percent and a strike of course of 3 percent in this example. You see on the equity-indexed growth, since the cap is 8 percent and the strike is 3 percent, in a really good year you would have 5 percent growth these 2 years. In a really bad year you do not lose anything, and in a really in-between year, you have less than 5 percent growth. On a variable product, you have returns bouncing all over the place, so the policyholder would have a lower second-year return, but then his return would grow. This example makes a variable immediate look better, but if I look at 1972 or 1998, you see examples where someone who bought a variable SPIA and did not put guarantees on it would be sucking wind or looking for other people to file a class action law suit saying he did not understand the product. The equity-indexed person is doing well, is fairly happy, because he understood that he could only get 5 percent a year and he gets it some years, so his payout on his annuity is going up year by year.

Are there any difficulties with that approach? You probably have to lock in equity-linked parameters to make the sale. I just say that because on a deferred equity-indexed annuity, I am willing to let the company have the option to reset, because I can also surrender. On the SPIA, I cannot really surrender, at least the life contingent portion, so you would probably have to guarantee a cap no lower than 8 percent or something forever, but I think that is okay. Regarding the earned rate on your assets that you buy to back it, that is no difference in locking in a SPIA calculation rate forever. We all know that SPIAs do poorly if interest rates go down over time. We all accept that risk as an insurance company. You buy very long noncallable bonds to back it or some other asset that at least has long duration, so that your rate would not change for a while if that happened. The risks are common to SPIAs. You would have to allow for uncertainty of future option costs. I would argue that you could buy implied volatility hedges, but a better solution is just to assume that if I have an 8 percent cap and a 3 percent strike, there is not much that market volatility is going to do to your option costs there. It might vary by as much as 0.5 percent, maybe a little more, but it will not go all over the place, so you can afford that risk also. That is why I mentioned a cap rather than a participation rate as my most likely parameter. You would also probably have to spend a lot of time and money educating sellers, and that could be the toughest part about making this sale, so your product development folks have something to do. The bottom line the pizzazz factor. I would argue that the pizzazz factor is where the fixed-annuity branch of your company has the hardest time. It is bread and butter; you just have a fixed credited rate. I think the reason equity-indexed annuities have grown as a market segment is because they have incorporated the pizzazz factor. Perhaps making a SPIA with that same functionality as equity indexing could be the rainmaker that makes SPIAs exciting and yet safe enough so people would be willing to buy. That is the end of my presentation, and I will turn it over to David.

MR. DAVID J. WEINSIER: Thank you, Doug. Today I will talk about nonindexed fixed annuities. We will leave the index side to Brent. I have four subtopics that I would like to discuss. The first is some general annuity market trends. Second, we will talk about some perspectives from the asset and interest rate side, and I think I will include some policyholder behavior in there as well. Third is the impact of the standard nonforfeiture law, and I am not quite sure what that stands for. Finally, I will toss in a few processes just to keep in mind going forward, things to think about.

Slide 3 looks very similar to what Doug just provided, with some sales trends for the last 10 years or so. As Doug pointed out, variable was growing like a weed from about 1995 to the market peak in 2000. There was exponential, unprecedented growth, of course, and during that time, since the world was going variable if you will, fixed annuities lagged a bit. Of course, once the market dropped in 2000, variables came down with it. It has actually recovered quite nicely since, but fixed annuities have really picked up that gap in there, and you can see in the last 4 years that fixed annuities have just experienced tremendous growth.

The economic market in the last several years has catered very well to fixed annuities in that you have had low interest rates relative to the guarantees in these products, which of course were quite generous. Then take a look at what a fixed annuity typically competes with, short-term vehicles such as CDs that are crediting some very low interest rates. Then you have your fixed annuities out there with guarantees of 3, 4, or maybe even 4.5 percent. Obviously that will keep sales going and keep your persistency high as well. Add that to the concern for running the equity market, and you have a nice environment for fixed annuities. It is worth pointing out in 2004, bank sales, which have been growing steadily and nicely in the last several years, make up about 22 percent of overall sales, 30 percent of which are within fixed annuities. The bank channel is really becoming a significant force, especially in terms of sales of fixed annuities.

On the chart 4 that I borrowed from LIMRA, we have sales projections, variable and fixed, for 2005, 2006 and 2007. To be honest with you, I do not know a whole lot of background behind these slides. It is interesting that they projected a slight growth in variables over the last couple of years, but a pretty hardy growth in fixed annuities to say the least. The point that I have here is that we should understand the average age of your variable annuity. A person who buys a variable annuity is aggregated at about 48 years old, and for fixed annuities it is about 63 years old. As the baby boomer population continues to age and this huge block of folks continues to move up the age scale, there is reason to believe that they will be less interested in the volatile variable annuity and more interested in the fixed. I am not 100 percent sure that led LIMRA to their conclusions here, but those are my thoughts.

How about general factors driving the fixed annuity market? Fixed annuities are

primarily sold through two distribution channels, banks as I mentioned and managing general agencies (MGAs). Of course if you wanted to round out the list, you would throw in wire houses and captive agents as well. There are still a few carriers that sell annuities through captive agencies. It is interesting to note that the bank channel is really top-heavy. I do not like to offend anyone by mentioning anyone's name during these presentations, but there is one carrier that just flat out dominates the bank channel. They own 30 percent of the market share, which is more than the carriers ranked two, three and four combined. In fact, the top seven carriers in the bank channel own 70 percent of the market place, so I think there is room to play, but it is tough to get a foot in the door. Shelf space is tough to get, and once you get it, apparently companies grab hold and stick around for a while.

You have somewhat different issues for the two channels. In terms of the banks, they continue to favor products that are standard commissions, but not too high; I would say 5 or 6 percent is on the low side. With your MGAs, historically there is more focus on the high-commission products, those in the double digits. Of course you have to have corresponding product features to support those higher distribution expenses such as long surrender charges, strong surrender charges and high fees, although a few of the players recently have been successful in selling a lower-commission product on the MGA channel. I think the key drivers to success are pretty obvious. While bells and whistles will get you a few sales, it all comes down to that credited rate. The first-year bonus is important as well, and of course, the all-important access to distribution.

A few other factors include, how are you going to get that superior credit rate? I think I will talk more from the asset side later in the presentation, but there are a few areas that we have noticed when you have one carrier who is able to credit a higher rate than another carrier. Some carriers are willing to take risks on the quality and/or duration on the asset side of the balance sheet. You have the specialists in your house who do a good job of investing in a particular type of investment or somehow you can get away with a lower target spread, whether it be lower capital requirements or lower property requirements, and I think one key item missing from this list is expenses, particularly your distribution expenses. Ratings do continue to play an important role. Virtually all large distributors do apply the superior ratings. We have seen that smaller distribution outlets are willing to sell products from lower-rated companies. Of course, you might have to give them a little added incentive to do so, by means of a higher commission.

There is an increased effort to reduce capital requirements, because if you think about it, this is not universal life. There are only so many moving parts, so if you are going to compete, you have to do something on the asset side, you have to do something on the product side, including expenses, or you can go with your capital requirements. That is also another way to make waves in this industry. We see some companies trying to reduce such requirements using the covariance factor, and some carriers are doing their C3 phase I analysis, even though they are not required to, to see if they can get away with some diversification and lower those

all-important capital requirements.

Reinsurance is interesting. A couple years ago everybody was throwing this stuff offshore, because you had some carriers who virtually had no capital left, so they had no other choice. They were taking the business and tossing it offshore, wherever it would go. That is not so much the case today. Reinsurance is really due to consolidation, the reinsurer taking on less risk. There is not as much reinsurance as there was several years ago. There are some books of business out there that are looking to reinsure blocks, both in force and new business, but it certainly has dropped dramatically in the last few years, and reinsurers will probably attest to that. There have been some concerns regarding embedded derivatives that have led to macho deals, which were popular for a time.

In terms of profit measures, you have the traditional IRR measure, and most folks still take a look at that. It is important to note that the lower your capital strain, the less meaningful that IRR measure is, so we recommend that carriers take a look at at least one other profit measure. Profit margin is popular obviously, return on assets, GAAP ROE, and we actually saw a carrier that had a dollar amount of new business targets as their new business profit measure, which I had never seen before. Most folks are still shooting for that 12 percent IRR. If you are not making it, then you are not alone. There are probably a few folks around you today who are not making 12 percent either.

In terms of persistency trends, I think that in recent years policyholders figured out that that a 3 percent guarantee on fixed annuities was a pretty good deal relative to other comparable investments, and persistency has reflected that. I think I borrowed something else from LIMRA that companies were reporting a 4- to 6-percent annualized surrender rate. I think that could be misleading because that lumps everybody in, and that includes within the surrender charge and outside the surrender charge. Maybe that piece of information is interesting, although I would not take it too seriously.

From mid-2001 to mid-2003, variable annuities obviously experienced high lapse rates, as the equity market scared everybody. A lot of money came into fixed annuities, but this could easily reverse. Obviously the equities have an impact on persistency as low sales of course, and high interest rates bounce up and down and I think have an impact on fixed annuities as well. Bank sales are typically hot money. If you play in that channel, that money goes flying all over the place. Any little differential between what you credit and what else can be offered in the marketplace is money that is out the door, especially if you are offering a CD-type annuity where you get the surrender charge window to follow the same pattern as the guarantee. Then you will have a huge shock lapse at the end of that period, and so you will see higher lapse rates typically, especially the shock lapse rates, in the bank channel.

In terms of some product trends, we have seen a general movement back to 1-year

fixed annuities as opposed to the multiyear, again primarily in the bank channel. This has contributed to the decline of MVA product sales, which really peaked in 2002, and the MVA is great. For everybody in this room, how can you not love MVAs? You transfer interest rate risk to the policyholder, you have lower capital requirements, you have lower reserve requirements so you can credit a higher rate, and you can invest longer, because typically your liability duration is longer. Therefore when the yield curve is steep, which it has been recently, it allows you to take a bet on duration as well. I think that when you move back to the 1-year fixed annuities, the MVAs have been a little less popular. They are still out there, but we are not seeing as many products with them today. First-year bonuses are common. This is a must-have in the bank channel. There is more variety in the MGA channel, although it is still relatively common. The return of premium feature is also a must-have in the bank channel.

I have some more product notes. We have seen some more choices regarding death benefits. These are the bells and whistles I mentioned previously. We had at least one carrier trying something a little different, and there is nothing wrong with creativity. They offered a step-up minimum guarantee rate. What I mean by this is, say at a 5-year guarantee, the first-year guarantee is 1.5 percent, then it goes to 2 and 2.5 percent, and at the end of the 5-year period it was a pretty high rate, but the downside is from two perspectives. You have that initial rate that was well below market, and that did not help sales at all, and then we as the actuaries or risk managers have to hedge this increasing 5-year guaranteed increasing interest rate. That is no picnic either, so that company pulled this product, and while again nothing is wrong with some creativity, this idea did not take off, I think for obvious reasons.

We are seeing some policyholder options to trade off certain policy features, and companies continue to investigate combining fixed annuities with other features, which I think is a great idea. These include long-term care and nursing home and some terminal illness and unemployment labor-type benefits. Keep in mind the average age here is around 50 years, so these benefits are going to be quite valuable, or quite appealing, I should say.

Let's move on to assets, interest rates and policyholder behavior. I always think that chart 12 is good to step back and soak in where interest rates have been and where they are going. Back in spring of 2000, it was almost like a utopia. Equity markets were as an all-time high. No matter where you were on the yield curve, you were earning 6 or 7 percent plus spread, right? The yield curve was flat, and equities were sky high. Then fast-forward to what it looks like about summer of 2003, and folks were pulling their products off the shelves. The TIAA was first because they had no surrender charges, and then some major carriers with perfectly sound products were pulling their products off the shelves in summer of 2003, when you see that little dip. That was a rough time for the fixed annuity market. Since then rates have recovered a little bit, and I think that chart 13 is interesting, where we will take a look at slope. In July of 2000, back at the point of

utopia, you had a nice flat yield curve. It started to increase gently by the next summer, and the summer after that suddenly it was pretty steep, and folks were taking duration, and you wanted to do everything you could to invest long. Again, this coincides with the peak in those MVAs. Throw an MVA in there and you can justify investment as long as possible. July of 2003 is just as steep, although there is a nice parallel shift down. Then it starts to get a little funky, and the chart is going to get a little messy. July of 2004 is not quite as steep; it rises up a little bit. Then as recently as March of 2005, it is right in the middle there, and it is getting flatter. I have a little update to this. I did check briefly the paper today, and I might be off a bit, but the 10-year rate is down about 4.06 percent according to *USA Today* this morning, and the 90-day rate is 2.85 percent or so. The yield curve is flattening out, and it is certainly going to have an impact on the fixed annuities and your corresponding profits.

Take a look at credited rates. We have had chart 14 laying around for a while, as you can tell. It is probably time to cut off a left end at some point. Credited rates have been increasing down a number of years. Go back to 2000, because of that nice high flat yield curve. Your average credited rate on your single premium deferred annuities (SPDAs) was 6.5 percent, which is very generous. Nobody even considered that guarantees would ever come into play. Then move forward to that low point, summer of 2003, and your average credited rate is just barely above that guarantee. Nobody is taking their spreads, and if you are crediting 350 and guaranteeing 300, clearly you are not making your 200-basis point spread. Even today, the average credited rates are about 3.5 percent.

What about the impact of interest rates, obviously a key moving part to your fixed annuities? I think we all know that low rates cause spread compression. With a low sustained rate, your higher earning assets end by going over, you have to invest them low, that brings your portfolio yield down, and you are going to realize spread compression. On the other hand, a rapid rise in rates is no picnic either. If we see all of a sudden a very rapid rise, then you would likely get some surrender mediation occurring. You will probably see an increase in surrenders, and it will be hard to play catch-up with those new money rates. A slow rise in rates is typically the best scenario. Of course these first two can be hedged away, the swap options and futures, but it is our perception that due to expense, only the major players do a whole lot of hedging. A lot of folks do no hedging. Some folks do some hedging, but nobody does complete hedging, because it is too expensive, and so I think almost everybody out there has some vulnerability to interest rates and movements thereof.

What about variables that would determine how vulnerable or exposed you are to interest rates? The current yield curve, I think, is obvious. We talked about that. In the existing portfolio, where are you taking debts? Are you taking debts on duration? Are you taking debts on asset quality? Do you have a concentration risk, for example? How about product features? Where is your guarantee? Until recently that was a concern. How long and how strong is your surrender charge

schedule? Do you have an MVA feature? There is your crediting rate methodology, portfolio versus new money, and your company's spread requirements will probably be driven primarily by your distribution expenses. This falls into the next point. The required return to shareholders is important. Some folks think they can live with their 8- to 10-percent higher arc, whereas others are a little more conservative and love their 12 to 15 percent. Who are you playing with, who are your competitors and your lapse sensitivity, which is going to be driven primarily again by your distribution? If you are a nice captive agency, your money will stay on the books longer. If you are in the bank channels, your money will fly off as soon as your rates are not competitive by 50 basis points. That will be important as well. This is a nice little checklist for you.

A couple years ago, a bit outdated now, we did a survey on fixed annuities, and we had quite a few big players in the industry participate. We asked them what their net yield was on their portfolio backing their fixed annuities, and I think the numbers are not important here. I think what is important is the difference between the numbers. You had players in the same industry with an 82-basis point difference between what the high end was earning and the low end was earning. We researched it further, and we confirmed that it was mainly because of debts on the asset side. This includes debts on duration, debts on quality, but I think we also should keep in the back of our mind if you believe in market consistent valuation, a lot of the debts you may be taking should not vary in terms of value. We did this survey a little while ago on target spreads, and I think it still holds today. Folks are trying to earn 175 to 235 basis points, but at the time they were actually earning 130 to 190 basis points, so again most folks were not earning their expected return or expected spread.

How are companies stretching profits? I mentioned this several times already. I think one thing to keep in mind in particular is obviously with the bets on duration, the shape of the yield curve is important. On quality, make sure you keep in mind that changes in quality may have an impact on your risk-based capital requirements as well. It is important today that the credit spreads are very low. In fact, I checked before I left Atlanta last week, and on the A-rated corporates, you will only get about 70 basis points. That is historically quite low. Historically I would suggest for a long-term assumption 100 basis points on an A-rated corporate, so 70 is pretty darn low. There is not a lot of extra spread out there to be had.

For a lot of this in terms of taking chances on the investment approaches, it is important to do stochastic testing, which I am sure all of you are doing, and take a look at your profit results when fluctuations are introduced. In terms of stochastic testing, a question we often get is what to use for a long-term mean reversion when generating critical interest rate scenarios, which is obviously the one key important factor in stochastic testing on fixed annuities. What folks do not want to do is first, no increase from the current rate; in other words, take the 10-year rate or the 5-year yield curve today and just keep it level. Nobody wants to do that

because the results are miserable. Another option, and a reasonable option, is to use the rate implied by the forward curve, and that will give you some more reasonable results. Another one that we often see is grading from a current rate, today's rate, to an *n*-year historical average over so many years. For instance, go back to maybe the 10- or the 20-year average and grade up today to that rate over a 2- to 3-year period.

I am sure everyone here is doing stochastic testing. I am amazed when I hear about companies who are selling fixed annuities and with bells and whistles and not doing stochastic testing. If you are not, you are not valuing or quantifying the policyholder behavior and policyholder options within these products, and that is critical to putting an appropriate value on this product, which I think is important. My next point is pretty important, and I want to make sure everyone understands it. The mean deterministic profit results may fall in the 80th percentile of stochastic results. In other words, say you run 100 stochastic scenarios and you line up the results from lowest to highest. You compare IRR, for example, and the lowest to highest 100 numbers look like this. Your deterministic result is going to be in the 80th percentile. In other words, 20 percent of your stochastic results are going to finish ahead of your deterministic or best estimates. Eighty percent are going to finish below, so when you ignore policyholder behavior and options within the product, you are missing a key piece of the equation. I cannot overemphasize the importance of stochastic testing.

What to chose for lapse assumptions? This is a question that often comes up and the reason it does is that it is very hard to quantify. It is not like the mortality, where you have eons of experience and you can chop it every which way, and you can be pretty sure using your experience values what you should use for mortality assumption. Dynamic or excess lapse is very difficult because it is very hard to go backwards and figure out which lapses would have occurred anyway and which lapses occurred because of interest rate movements or otherwise. Obviously this is a critical assumption of stochastic testing, and it should vary by sales channel. If your company has multiple distribution systems and you are using only one dynamic lapse assumption, you might want to take a second look. It is also important to not divorce from base lapse assumptions. In other words, those should be tied together. Make sure you look at your overall assumptions under various scenarios using your base plus your excess. I have an example in chart 22, which is a standard industry assumption. For those of you who are familiar with the expediential formula, it is on the bottom. It is very common, probably the most popular one used. You have a multiple of seven and a tolerance of 0.5 percent; the RR and CR are market rates, less your current credit rate, market rate or competitor rate. You have got an exponent of 1.5, and then you have your surrender charge ratio and a multiple of 10 there, and here is a projection for a couple different surrender charges. I have two problems with this slide. My first problem is that it depends on your distribution channel. I do not think we should look at this in isolation, but if you are telling me that your competitor is crediting 2 percent higher than you and you do not have a surrender charge, that red line

shows up at about 12.5 percent, maybe 13 percent excess lapses. That is low. To me this should be a little stronger. My other observation is, a reasonable linear relationship between surrender charges at six, four and two is okay, but when you get to zero, when your surrender charge ends, you better believe that there is going to be a big difference between zero and two, and that difference is going to be much bigger than the one between two and four. I think my two problems here are that is it is not strong enough, and I would like to see a bigger jolt when that surrender charge falls off.

Our third section is the impact for the annuity nonforfeiture law. It was adopted by the NAIC back in 2003, so everyone in here must have read it by now. They are still fooling around with the regulation, but we hope that will be passed soon, possibly at the June meeting. What led to the new law? Declining interest rates and solvency concerns primarily. One goes hand in hand with the other. You made the changes where your nonforfeiture rate is now lowered based on a formula. Previously it was 3 percent, then it came down to the temporary rule where you could file for 1.5 or 2 percent varying by states, and now we will base it on an index. We had the equity index considerations that Brent will talk about, and with this concept of redeterminations, because it is now based on an index, you have an opportunity to redetermine your guarantees after the contract was issued. I think I will add to the list that the definition of net considerations that previously was 90 percent for the SPDA, and then you had the 87.5 or 65 percent first year and 87.5 percent renewal year on your flexible premium products. That has now been standardized so all annuities, your net consideration, is based on 87.5 percent. We noticed that some carriers had surrender charges of as high as 16 percent, so I like to take advantage of that 65 percent piece on the flexible premium. However, I think implicitly now everyone will have to cap that surrender charge at about 12 percent. Some minor changes include that we have a fixed contract charge of $50, irrelevant of premium paid, and we have a note that premium tax is going to reduce your nonforfeiture amount as well.

In terms of determining your nonforfeiture rate, it will be as I mentioned, based upon the average of your 5-year constant maturity treasury, and I think you can go anywhere from today to average over 15 months if I am reading it correctly, minus 125, so it will be the 5-year constant maturity treasury minus 125, but subject to a floor of 1 percent and a cap of 3 percent. Redetermination is optional, and again this is where you are going to redetermine this index rate into the future. It is important to note that the date and the basis and the period of such redetermination need to be specified in the contract. I would be interested to know, but I do not know of anyone who has introduced such language for laying out their redetermination methodology into new contracts. Is anyone willing to admit that they had a brand new contract and they laid out some redetermination language and filed it, and sold it? No one or no one is willing to admit? Nothing to be ashamed of I guess, taking advantage of the new rule. That is consistent with our observation that we do not know of any carriers who have introduced any hard language either, although I think it is inevitable. The rates are so low now that why

would you want to redetermine it, right? Maybe that is the logical reason for not wanting to include the language just yet.

The model regulation, as I said, has been kicking around for a little while now. It is intended to do two things, really. It is intended to clarify or specify how insurers could change their method of determining a guarantee. For example, the method for choosing the initial rate needs to be filed, but not specified in the contract. On the other hand, the method to determine the redetermination rate has to be included in the contract, so language around that is going to get clarified and also there will be some equity-indexed annuity language that I am sure Brent will touch on.

The outstanding issues in terms of the new regulation, which we hope will be finalized soon, include the allowance for the value trigger method on redetermination. This means you do not want to be redetermining the regulation for any little movement. In other words, it is rate tolerance as to when you can redetermine the rate. I think that is actually in the regulation today and just needs to be approved by the NAIC. The second point is what rates should be used when determining compliance with a prospective test. In other words, this is the requirement that cash value has to be greater than the maturity value discounted on the rate, 1 percent higher than the guaranteed accumulation rate. If the guaranteed accumulation rate is indexed, it is a little trickier. This actually falls in line and ties hand-in-hand with AGABC, which is the annuity-reserving guideline that is also being bantered about that it will follow the rules of the new nonforfeiture law, and then what is the rate when a contract has both a fixed and equity-indexed component. I think this one is funny just because in December the NAIC had it at two rates. There was one rate for your fixed bucket and one rate for your index bucket, and then in March they changed their minds. They said, if the majority of the people are in the equity-index bucket, then you can put everyone on one policy into one rate. They voted on that in April and it was a tie, which means it loses, so they are still fooling around with this particular issue, and we hope it will get narrowed down at the June meeting.

Finally take a look to the future, a few things to think about on your way out. We feel like the crisis period with the 3 percent guarantee has passed, thanks to the new temporary rules for a couple years and then the new law. That is a good thing, but interest rates are still a concern. If interest rates fall back down, that still could be an issue, and of course, if they go soaring upward, that would most certainly be an issue. We are looking for a nice, steady rise, I think.

The advantage that fixed annuities enjoy over the short-term CD is shrinking as the yield curve flattens. This is important. Fixed annuities for a long time were crediting 3 percent or above, and CDs were hanging around 1 percent. The average rate on 1-year CDs as of this morning, I think, was about 2.68 percent, and the 5-year CD was up in the low 3 percent range, so now all of a sudden comparable CDs are crediting a very similar rate to your fixed annuity at 3.5

percent and that is something to be concerned about. That will have an impact on both your sales and your persistency. Market share of captive agents continues to decline, and in turn your bank and stockbroker sales continue to increase. I think it is safe to say that we would expect this trend to continue. Surrender rates have fallen out with the equity market and interest rates. Again, this is the perfect economic situation for fixed annuities, with the low rates, low CDs rates and the equity markets, and everyone is still a little hesitant in the equity markets, so has persistency bottomed out? Are we going to see a big rise in persistency going forward? Profitability is still below par. The $10,000 question, I guess, is what do you do to get back to 12 percent? With that, Brent will focus on the red-hot equity index side of things.

MR. BRENT A. MARDIS: Hot topics in fixed indexed annuities. What is the hottest topic? My advice would be to ask your local newspaper reporter. They seem to be very hot on this topic right now, for a lot of wrong reasons, and I will get to those later on in the presentation, but they have been certainly getting a lot of press lately.

How about a name change? Jack Marion does a lot of press on indexed annuities, and he threw out about a month ago a name change. Instead of calling them equity-indexed annuities, refer to them as fixed-indexed annuities or just plain indexed annuities. I think the big reason is, as an industry that is heavily into equity-indexed annuities, we need to make sure that we are stressing the fixed components of these products and not trying to make them look like variables with training wheels. They are fixed annuities. We hope they will continue to be fixed annuities, because a lot of the companies that are selling a fair amount of indexed annuities today would be in a world of hurt if for some reason these were no longer considered fixed annuities. As I listened to a lot of the earnings calls these last quarters on companies that sell a fair amount of indexed annuities, it was interesting to note that I do believe everybody had dropped the word *equity* in reference to the amount of premium they had coming in on these products or predictions of the future on these products. I did not hear any company this quarter refer to them as equity-indexed annuities. They were either fixed-indexed or just plain indexed annuities. It will not solve the world's problems by dropping that term *equity*, but it certainly will not hurt, and on a going-forward basis, I think that it is probably a good idea to quit referring to them and the equity components of these products and rely more heavily on the fixed components of these products.

How many people in the room do sell the indexed annuities? Here is a quick review of common policy levers. Companies typically have a budget amount available to purchase an option that will pass on a portion of the index growth to the policyholder in the form of an index credit, subject to one or more of these policy levers. Again, companies approach hedging in many different ways, and the comments I will make today are related to the experiences that I have had in the past and are not necessarily the only way that companies handle these. The most common policy levers out there today are participation rates, margin spreads or

accuracy rates and caps. Products typically only have one moving part. Some of the bigger states a few years ago kind of forced you into having no more than one moving part. There are companies out there today that claim that they have no moving parts on their product, although if you read the fine print, there certainly are pieces in those products that still move today. Participation rate is the percentage of index growth as credited to the policyholder. Typically the participation rate will correlate to the percentage of the option that can be purchased by the company. A 75 percent participation rate means 75 percent of the growth is credited to the policyholder.

Here is a common misconception. Even today, 10 years after the first products have come out into the marketplace, there are still policyholders, agents and newspaper reporters who say, what happens to the other 25 percent? At least in the companies that I have worked with in the past, there is no other 25 percent. If we have a 75 percent participation rate, that is what we as a company are probably purchasing on the option side and that is what we are passing on to the policyholders. We do not buy an option, give you 75 cents, and keep a quarter. I am amazed that that is still a misconception out there 10 years after the products were initially introduced. The percentage difference between 100 percent and the participation rate is not kept by the insurance company, but it is an option purchase that matches the amount that we pay the policyholder.

Spreads, margins and asset fee rates are different names for the same lever. Again the margin is taken off the gross index growth prior to the calculation of the actual index credit to the policyholder. A common misconception was brought up by a rating agency earlier this year. I will not tell which one, but if you sorted them out alphabetically it would be the first one. This lever was the “fee” charged by the insurer for the asset management and administrative expenses. Again I have worked with two companies that are major index writers, I served as a consultant a year before that and worked with other carriers. Margin is not collected by the insurer. Again, you are purchasing an option, and what you have available to purchase is passed on to the policyholder. For example, for a product with 1 percent margin and growth rate of 10 percent, there is an index credit of 9 percent, and again *X* percent margin is needed so the company could afford to pass through the remainder to the policyholder.

With caps, fortunately there is no misconception. Caps are maximum rates that can be credited to the policyholder, regardless of the actual index growth. The insurer does not keep the amount above this cap, to the best of my knowledge. Cap-only products have been fairly hot over the last 12 months, I will say, and even though caps today are probably only in a 6- to 10-percent range, a cap-only product still seems to be a pretty hot feature right now. Typically though, on participation rate products, you will see caps being used. They can also be used in conjunction with margin products.

I have a quick review of the crediting methods that are out there today. Monthly

point-to-point is one of the newest. I will not say it is the newest, because there are some new ones out there. Jack Marion says this is the hottest one out there. As a product actuary, it does not do a whole lot for me, but the agents love it. I think you have seen with some of the big writers of indexed policies, that their biggest seller right now is this monthly point-to-point. The index credit to the policyholders is some of the monthly change in the index, subject to a cap on the upside, but no floor on the downside. Each individual month has a cap on the upside, but no floor on the bottom. The index credit back to the policyholder has a floor of zero, but any given month, if there is a 10 percent decline in the market, negative 10 was used in the calculation here. When these products first came out, I had some market conduct concerns on how they might be advertised, especially given some of the agents I know out there. A monthly cap of 3 percent could result in an annual indexed credit of 36 percent, but that has never happened and I hope that will not be advertised. They have not seen any advertisement that advertises 36 or 48 percent, but that was a fear of mine when these products first came out. Take a quick look at the example in chart 10. Again we will go through a couple of months. In the first month, the index went up 4 percent, and we are capped at 3 percent. If you look at month 6, the index went down 5 percent. The calculation piece that goes through to the indexed credit is a negative 5. Again you can go through this example for the year. The person had a 4.5 percent index credit. This is typically how they work. One feature I think you may see somewhere down the line is a floor on each individual month. The floor probably will not be a small number like negative 1 or negative 2, but I still think somebody' will try to put a floor on that so they can have a little better story to tell.

Averaging has been around for 10 years now. Again, index credit is a portion of the change in the index, where a change is the difference in the average index over the crediting period and the beginning index value. Your averaging generally allows for a higher participation rate and/or cap, or a lower margin than a typical point-to-point method. There are companies today that use both monthly and daily averaging. I think monthly is probably the most common, but there are companies that use daily.

Point-to-point index credit is a portion of the change in the index from the beginning of the crediting period to the last day. Most of the annual point-to-point methods utilize a cap in conjunction with either a participation rate or a margin, although there are many products out there today that are cap only, and on the point-to-point pieces, you will see the lowest cap. It could be 6 or 7 percent.

With the length of the crediting period, I would say a vast majority of the products today are annual reset products where the policy levers and the index are reset at the end of each year. I have seen more 2- and 3-year periods, especially with the monthly point-to-point methods. A way for companies to offer a higher monthly cap is to lengthen out the crediting period for 2 and 3 years. There are not many original 7- to 10-year long-term point-to-point products being sold today. Those were very common early on, but have died off, I think, owing to numerous reasons,

probably the biggest one being the inability to tell the policyholder what they may or may not get for 7 to 10 years.

Let's turn to the impact of the standard nonforfeiture law in indexed annuities. In general, it is 87.5 percent at an interest rate based off the 5-year constant maturity rate. The new law allows for index products to have a minimum nonforfeiture rate that is up to 1 percent lower than a fixed interest rate product. Last time I had conversations with some people, the regulation was headed toward having one nonforfeiture rate per contract, meaning the fixed buckets of an indexed contract in the index buckets would each have the same nonforfeiture rate. Evidently that is still in limbo. In the prior version, if companies were forced to have potentially two separate nonforfeiture rates within one contract, and depending on how that person reallocated their money from one contract to the next, it could have led to a significant layer of complexity to the products and the administration of these products. That is if companies elected to go with a lower nonforfeiture feature for their index bucket. I am not aware of any index writers today who had elected to utilize the lower rate for index buckets. I think you could see that in the future, but so far nobody has been brave enough to try that. This is my own editorial comment here. Given the external scrutiny that index products are getting, should companies be differentiating their indexed annuities from their traditional fixed interest rate annuities when it comes to minimum guarantees?

Will companies utilize the redetermination feature of the standard nonforfeiture law? To the best of my knowledge, nobody out there is doing it, for a couple of reasons. Again, I think there are administrative issues. I think there are potential complexities in trying to explain to the policyholder that your minimum guaranteed rates could go up or could go down at some point in the future. I have not seen any companies out there doing that today, and quite frankly I do not know that we will.

I have another editorial here. Will we see fire sales of the older versions of indexed products as a grandfather period runs out on the old nonforfeiture law? Fortunately I really have not. I thought that with some of the products that had very hefty surrender charges, some that had very low minimum guarantees, you might see companies make one last-ditch effort to get production in and maybe take a few more profits, but I have not seen that with any other products out there today.

There are a few other impacts of the new nonforfeiture laws. I certainly think in the last 1 to 2 years, you have seen more index products that have premium bonuses on them. Premium bonuses are a way for companies to have surrender charges that are in excess of 12.5 percent, but still allow them to comply with the 87.5 percent requirement of a new nonforfeiture law. Have we seen lower surrender charges? Somewhat, but not to the extent that I anticipated, and I think that is primarily due to the use of premium bonuses. Companies today still have products out there with 15 or 16 percent initial surrender charges, but they are offset by premium bonuses that range anywhere from probably 1 to 10 percent. I

think that is the highest I have seen out there.

Moving to new product types/features, there is a product out there today that has a blended return that is 50 percent of index A, 30 percent of index B and 20 percent of index C, where A, B and C are unknown until the end of each year and A, B and C are different industries. This is a new, unique idea, but I think it adds a layer of complexity when you tell the policyholder again, not only are you not going to know what your index credit is, but you will not know the components of this blended return until the year is up. There is one company out there today, and it is rumored that they will make a few changes to that. For blended returns part 2, we have X percent of index A and Y percent of index B, where A, B, X and Y are all known at the beginning of the year. This might be a feature that you would see with a stock industry combined with a bond industry. This is not a feature that I am aware of that is out there today, but I think it is available to companies, and I think you may see a few companies hopping into this type of a feature in the not-too-distant future.

Another one that just came out with AVIA is a crediting method that pays an X percent participation rate up to a cap of 15 percent, 25 percent of the first 15 percent, and pay you 100 percent above that cap. That is a feature that was thrown out maybe 4 or 5 years ago, and I do not think anybody ever put it in their products, but it is back out there today. I think as of May 1, that feature is out there. You look similar to monthly point-to-point. You have a potential of a home run, I guess, if the market goes straight up. On a monthly point-to-point, you will get your 36 percent. I think this is a similar feature. If you had a large increase in the market, you will only get a portion up to a certain percent, but anything above 15 percent or whatever your cap is will be passed on directly to you. It will be interesting to see how that one sells. Again according to Jack Marion, there are as many as three new crediting methods that will hit the marketplace before the end of 2005. He has not shared those with me, but it will be interesting to see what they are and what they look like.

Under new product types and features, trail commissions have been a hot topic too, over the last probably 12 to 18 months. There has been a lot more activity lately. I am not sure how much utilization companies are getting. At Midland, we have had that feature out there since the beginning of the year, but we do not have a whole lot of good data as to how many of the agents are utilizing that. Most of the trails are tied back to the total accumulation value of the policy. There is one company out there today that ties the trail commission specifically back to the actual index credit of the policy.

As far as new indexes being used in the marketplace today, I really have not seen any. Again, you do not see a whole lot of the international indexes being used, and you do not see a whole lot of companies using bond indexes, but that has been pretty quiet lately. We have seen a handful of new entrants into the marketplace in 2004 and 2005. Principal American General, West Coast Life, Great American and

AVIA just got in, and again the experts believe we will see another three to four big carriers enter into the market by the end of 2005, which I think is great for the indexed annuity industry. It is nice to see the big companies coming in. Again this is my own editorial, they have a lot bigger legal staff than some of us smaller companies, and maybe that gives us a little bit of comfort. Of the companies that have entered in the last year, the theme seems to be simpler designs, which is good for the industry in general. One entrant had a single-bucket S&P 500 base. There was another one that had a three-bucket S&P 500 base. I think simpler is better in this environment today. It will be interesting to see if any of the index writers that have been out there for a while will revert back to simpler designs and fewer choices in their crediting methodologies.

In January 2005, AM Best came out with a White Paper and said they remain cautious due to thin profit margins and management challenges, code word for market conduct issues. AM Best listed the following risks associated with indexed products: certainly the product design, hedging, market conduct and earnings risk. Their biggest concern was the complexity of the hedging, a program that companies were using. They tend to prefer static hedging as opposed to dynamic, and are concerned about lack of sustained earnings, thin risk-adjusted capitalization and market conduct issues. They stated that one issue by itself is not a concern, but a combination of issues with deficiencies is. AM Best refers to indexed products as having thin profit margins. I think they are coming from the fact that we are in a low interest rate environment and spreads are being compressed, and I think they fear that profit margins are also being compressed. My rebuttal here is indexed annuities generally have very similar profit margins that are either no different or slightly higher than more traditional fixed annuities, so I do not think indexed products are any different than fixed interest rate products when it comes to the profit margin.

Market conduct issues center around the following: high commissions, long-term nature of surrender charges as well as a high level of surrender charges. AM Best believes that a long term is defined as 14 years or more. Term in and of itself is not a big concern as is the combination of the long-term nature of a surrender charge with a high maximum issue age. Having a 15-year surrender charge product being sold to an 85-year-old could happen, I guess, with some companies. AM Best believes long-term surrender charges are the key difference between fixed and indexed products. I do not completely believe this. I went through a list of indexed products. There are some out there with 15-, 16- or 17-year surrender charge periods, but there are not a lot. Most of the products are 12 years or less in surrender charge length, which is very similar to what you see with the traditional fixed annuity. AM Best believes the recent headlines confirmed the market conduct concerns for indexed annuities. I think the headlines you have seen recently that involve indexed annuities involve features or sales tactics that are not unique to indexed products, but are part of both the fixed and the indexed marketplace. It just happens that indexed annuities are the buzz word for local reporters. AM Best continues with their concern with companies that are writing too much indexed

premiums, and what companies will do if that market goes flat. I think maybe the more important issue is what companies will do if somehow these are forced to be considered registered products. I think that is probably the bigger concern for the industry, not whether the market going to dry up, but is regulation going to forfeit the change drastically? They remain cautious on the fixed and indexed annuity segment, mainly because of interest rates and conduct concerns. They have no plans for immediate rate actions. I talked with their analyst. It is AM Best's opinion that indexed products are and should be nonregistered products. They just need to come out and make that public and that might help some of us out.

For those of you who follow the indexed industry, other opinions have been pointy lately. In January, the National Association of Securities Dealers sent out a letter to their broker/dealers asking for all materials used in the sale of indexed products. I have not seen any further comments from them on that. Is anybody a member of the financial planning association? Maybe they will editorialize a little more. They sent a letter to the SEC in March of 2005 with regard to indexed products encouraging the SEC at a minimum to reopen the issue for comments and take appropriate action to protect investors. In their letter, they compare the similarities of variable annuities and indexed annuities in terms of product structure, sales practices and market risk. They state that any annuity product at a minimum should be subject to suitability and disclosure requirements generally absent in state insurance laws. I do not know anybody that sticks around in the index annuity marketplace that has not seen suitability and disclosure requirements, hot and heavy with probably each and every state and probably including Puerto Rico, Guam and American Samoa. We do not write there, but I would imagine they are on the bandwagon too. I take issue with that, that insurance companies that sell indexed annuities are not taking into consideration suitability and disclosure. Their letter also states that companies market indexed annuities to retirees as investments in the stock market. I hope not, and if you have agents that are doing that for your companies, I have a couple of attorneys in Florida who might want to contact you looking for some spending money. They also state the use of derivative options in the stock market fund annuity payment, thus exposing the policy to systematic market risk. There are no rules or regulations out there today that force any company to hedge these products. I think there were some companies that got into a little trouble back in the 1990s because they weren't fully hedging these products, so I take exception to this comment as well that we are exposing the policyholders to market risk when it is the company that is on the line to pay the returns off the indexes. I hope I am not the only one who has taken exception to their comments.

Here are some final thoughts. On your evaluation form, there is a comment about commercializing. Right now in the industry, who is licking their chops and sharpening their teeth? Is it the insurance companies, regulators, the National Association of Securities Dealers or the attorneys? Unfortunately I get the impression that everybody but the insurance companies are preparing for a fight. Attorneys specifically have taken a big swing at it. Regulators have not so much at

the state level, but I think the SEC and the National Association of Securities Dealers have taken big swings at it. If you are a newspaper reporter, it is the in thing to write about equity-indexed annuities and how horrible they are. That comes from recent articles in the *New York Times* and many articles in *The Wall Street Journal*. We got an article sent to us about a month ago that a columnist in the *San Jose Chronicle* had written. I think it is time for the industry to sharpen their teeth and to fight back, and that is a big issue right now. There is no single voice defending the indexed annuity marketplace today, and I hope that will change somewhere along the lines.

The market for indexed annuities continue to expand in premium, size and new companies entering. Plenty of variety remains in the product choices and the methodologies, but the innovation I think has slowed quite a bit over the last 10 years. You see new products, you see new entrants, but there has not been a whole lot of innovation lately. Is it time for a name change? It probably would not hurt to remove the word equity from your marketing material and product filings. It will not hurt. I do not know how much it will help. This was a comment that AM Best relayed to me. Be careful on how you illustrate your historical index credit. Should companies be comparing past index credits with past performance in the stock market, or are there more appropriate interest rates, if you will, to be comparing? Should we be comparing them to past fixed interest rates or even CD rates? Everybody wants to put these under the guns and make them registered products. I think as we stress these features of these products, we will be a lot better off. Even though it is allowed, should we utilize different nonforfeiture rates for indexed annuities than we do traditional fixed annuities? Recent headlines are more generic to all fixed annuities and not specific to features that are just in indexed annuities, although most of the lawsuits you have seen lately are related strictly to the indexed annuities. Is advertising centered more on the insurance-related items of your products like the death benefits or the liquidity features, or is your advertising centered more along the potential of market life index credits? I think that is an issue you need to look at in your advertising pieces.

Finally, for those of you who have been in this market, tighten up your seat belt. I think we are in for a bumpy ride. For those of you just getting in, fasten it. Again, enjoy it, have fun, and try to be creative. I think indexed annuities leaves you open to be creative, but there has not been as much creativity in the last year as there was early on. That is the end of my prepared remarks. I think we have a few minutes left for questions.

MR. ROBBINS: We will take questions. This is a recorded session. For anybody who wants to speak, please come up to the microphone.

MR. WILLIAM MITCHELL: I have a question on the SPIA product. First with the cap, is there a reason why you think it needs to be guaranteed over the life of the product? If I was going to invest in a SPIA, and having the money locked away especially during the life contingent portion, as a policyholder I would not accept

"Don't worry; we are going to credit a reasonable cap for the life of it. But we are not going to guarantee it." I would want that to be locked in. I would want some minimal guarantee of what I would get before I would put my money away forever. That is my thinking on what would make it sellable.

MR. MICHAEL H. CRAWFORD: I just changed jobs recently. I was affiliated with an insurance company affiliated with a credit card company. About policyholder behavior, is there any state-of-the-art research going on with that? At my prior insurance company, we had some of our credit card company affiliates come in to help us understand policyholder behavior better and come up with some really interesting formulas for fixed annuity, such as dynamic lapses that would look at unemployment and functions like returns on real estate, which we thought was a little odd for a fixed annuity. Is there any good or creative research being done out there that you are aware of?

MR. MARDIS: As I mentioned before, the troubling thing about the dynamic lapse assumption is that it is very difficult to get credible data. I would be interested as to the firm that is basing it on a multiple factor model, if you will. I think we try to vary it by sales channel, and again you have to make sure to marry it with your base lapse assumptions. I do not want to say that it is impossible to get a trend in a good SPIA. You can go back over the years, and if you have good lapse experience, you can compare that to the interest rate pattern at the time and perhaps do that as a final check, but generally I do not know of any real advanced studies out there. When we are asked to opine on that, we take the factors that I already mentioned, the sales channel, base lapse rates, and we do a final check, go back in time and compare your experience and spikes in such experience through the recommended formula and see if they compare terribly over time. I do not know of any advanced studies and I do not know how much credibility I would put in such studies. I am not too sure that past results do such a great job of predicting future results on such an assumption. Good question though.