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EIPs explained

As insurers continue to seek new products, actuaries will take an active role in developing them. Here, two actuaries discuss an innovative product group — equity-indexed products — that is selling well but has raised some questions among regulators. In addition to describing equity-indexed products, the authors talk about actuaries' involvement in efforts to address some of the issues. The authors welcome comments and questions from readers of The Actuary.

The cure for our savings problem?

by Richard D. Farrell

"Save for a rainy day." Although many have received this advice, it seems most individuals do poorly when it comes to saving money.

A recent study by Fidelity Investments revealed half of all working Americans ages 22-61 have less than $10,000 saved toward retirement. An April 1997 survey by Scudder, Stevens & Clark, Inc., showed that among the 1,140 Baby Boomers surveyed, one-fifth had less than $10,000 and two-thirds less than $50,000 in their 401(k) plans. It seems that most Americans are not taking the steps needed to provide for a comfortable retirement. By saving too little and waiting too long to become serious about investing, many baby boomers will need investments with relatively high rates of return to achieve their retirement goals. Historically, such returns have come only from equity-based vehicles.

According to the Variable Annuity Research and Data Service, Atlanta, one-third of variable annuity assets were allocated to general account and money market accounts as of March 31, 1997. This is an indication that large numbers of individuals allocate a high proportion of their assets to low-yielding vehicles. Often, this stems from the fear of possible loss of principal, investment advisors say. Those using an overly conservative strategy risk inadequate rates of return.

There are also potential problems for current equity investors. Many have

little experience with equities and have not experienced a bear market (a drop in stock prices of 20% or more) because of the favorable run enjoyed by the stock market since the early 1980s. If such investors "run for cover" after a bear market, adopting an overly conservative attitude and strategy, they also risk too-low rates of return on their investments.

Are EIPs the answer?

Equity-indexed products (EIPs) are well positioned to help address the savings problem. Although there are many variations in EIP design, the basic premise is for the cash surrender value to vary according to a formula which is driven by a predefined equity index (e.g., the S&P 500). Unlike variable products, EIPs provide minimum guarantees of the cash surrender value that typically meet or slightly exceed those required by nonforfeiture laws. EIPs are usually supported by general account assets and

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Still evolving, hot product group gets actuaries' scrutiny

by Donna R. Claire

Equity-indexed products are hot in the marketplace today. More than $1 billion in equity-indexed products (EIPs) were sold in 1996, and estimates for 1997 range from $2 billion to $10 billion, according to many investment bankers involved with EIPs.

As EIPs have taken off in the U.S. insurance market, so have regulatory concerns about appropriate disclosure and reserving. These concerns were expressed at NAIC meetings, with some states either shutting down the approval of the products (including revoking earlier approvals) or suggesting they might do so unless reasonable methods of regulating EIPs could be developed. Several initiatives by actuaries aim to resolve issues and concerns that have led to a "go slow" attitude among many regulators.

Actuaries taking active roles

At the request of the NAIC, the American Academy of Actuaries formed the Equity-Indexed Products Task Force in January 1997. The task force has issued three preliminary reports, the most recent in August. The group is charged with producing a final report, expected by the end of the year, that will:

- Address the many issues surrounding equity-indexed products

- Provide information to the NAIC and state regulators on EIPs, both to familiarize them with equity-indexed products and to suggest sound actuarial methods for valuing and evaluating them
- Suggest a framework for market conduct and disclosure for these innovative products that would not mislead consumers
- Develop guidance for managing and reserving EIPs in such a way as to not endanger company solvency

To ensure the value of its work, the task force has established liaisons with other interested groups: the SOA; the technical resource advisory to the NAIC life disclosure work group; the National Association for Variable Annuities; the National Alliance of Life Companies; the ACLI; the National Conference of Insurance Legislators; and various Academy committees and task forces. The EIP task force reports to the Academy's Committee on Life Insurance, chaired by Craig Raymond.

A wide range of EIP topics has been featured in sessions at SOA meetings. At the 1997 annual meeting, EIPs will be discussed in the following sessions:

- "Equity-Indexed Insurance Products — Pricing, Investment, Accounting, and Reserving," 2:30 to 4 p.m. Tues., Oct. 28
- "Reinsurance of Equity-Indexed Annuities," 10:30 a.m. to noon Wed., Oct. 28
- "How Annuities are Really Sold," 2-3:30 p.m. Wed., Oct. 29

Also, the SOA is hosting a seminar, "Equity-Indexed Products," on Oct. 16 in Chicago. Information is available from Sue Berg at the Society (phone: 847/706-3545; fax: 847/706-3599; e-mail: *sberg@soa.org*), and the brochure can be downloaded from the SOA Web site (*www.soa.org*).

What will insurers do?

EIPs come in a number of different flavors — deferred-annuity designs as well as universal-life and immediate-annuity products. However, the basic design is a guarantee of 80% of principal plus a guaranteed-minimum interest rate, with the customer receiving additional interest based on a percentage of the increase in a particular stock index. The investments for this product typically are a combination of bonds and stock index hedges. Typically, the products are monitored on a daily or weekly basis.

What will insurance companies do with this new product and its evolving market?

One possibility is to ignore EIPs, at least for now. Not all shooting-star products become dominant in the marketplace. Equity-indexed certificates of deposit did not exactly take over the marketplace when they were introduced in the United States in the 1970s. (The stock market's downturn at that time did not help.) It was more than 15 years before variable products became a force to be reckoned with.

A wait-and-see attitude has other advantages as well. It's still somewhat unclear how these products will be regulated. Companies with in-force business are risking that they'll need to increase reserves and meet other requirements.

The downside of waiting is missing the market. If a company determines that it does not want to lose out on this market opportunity, there are some noteworthy avenues for information, advice, and alliances:

- Seminars on EIPs are available, such as those offered by the SOA. At seminars, individuals who have worked on issuing EIPs might be available to discuss potential pitfalls as well as what worked best.
- A draft of a practice note on EIPs is available from Steve Rentner at the Academy (fax: 202/872-1948).
- Several investment banks are supplying the hedges needed to back this product, and they can assist in determining the cost of various product options. They also can advise on ways to best handle the product; for example, it may be most cost-efficient for a smaller insurance company to only have issue dates of the second and fourth Tuesday of each month.
- Several reinsurers have expressed interest in this market. Consulting with a reinsurer is another a way to learn about the cost of certain product designs. The reinsurers also will potentially share some of the risk involved in the product for a fee.
- There are a number of consultants who have some experience with EIPs. Tapping this resource might be useful.

Keeping up with EIP issues

Those interested in staying up-to-date on the Academy task force's activities can get on the Academy's "interested parties" list for equity-indexed products. Also, the task force still is open to new participants. Contact Steve Rentner on the Academy staff for information on the interested parties list or joining the task force.

Copies of the EIP task force's reports are available through Actuaries Online, from the Academy's library, and from Steve Rentner at the Academy.

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