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ANNUITIES AND SETTLEMENT OPTIONS

A. What revisions have been made recently in the interest and mortality bases for annuity contracts and retirement income policies and for settlement options embodied in life insurance policies?
B. To what extent may the use of settlement options be justified for payees other than the insured and beneficiaries who are natural persons?
C. What practical problems arise in connection with:
   (1) Requests for elaborate or complicated settlements?
   (2) Liberal settlement option guarantees in outstanding policies?

MR. H. C. UNRUH, in discussing section A, referred to the discussion of a similar topic the previous year where he described the new interest and projected mortality bases adopted by Provident Life and Accident for individual annuities, settlement options and retirement income policies.

For group annuities, he stated that his company had adopted the Progressive Annuity Table (*TSA* II, 298), modified by applying the elementary functions to the year of birth 1925 instead of 1900. The interest basis was raised from $2\frac{1}{2}\%$ to $2\frac{3}{4}\%$. With the adoption of the new basis the nature of the company's guarantees for Deposit Administration contracts was changed so that the guaranteed interest on the deposit account and the guaranteed purchase price of annuities hold for fixed periods. Previously the guarantees applied to the deposits of the first five years.

MR. GLADSTONE MARSHALL stated that the Connecticut Mutual thought it advisable to adopt more realistic interest and mortality bases for single premium immediate annuities, in view of the volume of such business done by them. In studying the application of a projected Jenkins-Lew table, his company felt that a further modification was required at the higher ages since the projection did not assume any improvement in mortality above age 90. The *a*-1949 Table projected fifteen years was assumed for ages 70 and below. The 1937 Standard Annuity Table, set back one year for males and six years for females, was used for ages 75 and above. Interpolated values were used for ages between 70 and 75. The interest rate assumed was $2\frac{7}{8}\%$, except that the present value of any payments certain was computed at $2\frac{3}{4}\%$. The loading on the new basis is $6\frac{1}{2}\%$ of gross, modified slightly at the very young ages to allow for possible reinvestment of funds at a lower rate of interest.

MR. J. E. HOSKINS stated that there is room for doubt that the *a*-1949 Table with Projection B for incomes beginning in the average year of maturity is realistically conservative. He pointed out that payee options are in the nature of original annuities, and past annuity experience points to stronger selection on the part of applicants at older ages than is shown in the *a*–1949 Table.

There is also some question as to whether Projection B allows for enough improvement at ages over, say, 75. Comparative studies of other tables (*TSA* I, 399, 406, 474) suggest the assumption that mortality will decrease at ages above 75 at the same rate as at age 75 (0.75% per year).

If the conservatism built into the *a*–1949 Table is considered to be a margin for profit and contingencies, there is no margin left to cover selection beyond what is provided in the table or to cover mortality improvement greater than that provided by Projection B. In a discussion of the Jenkins-Lew tables (*TSA* II, June, 119) it was suggested that an allowance for selection at age 85 should be made as great as would be produced by two years of select mortality at 50% of the 1937 Standard Annuity Table, grading down to a one-year select period at age 65. These suggested allowances for selection and mortality improvement at the higher ages result in increases in annuity values equal to more than 2% at age 65 and approximately 20% at age 85 above those produced by the *a*–1949 Table with Projection B.

MR. J. R. BEVERIDGE stated that it was the practice of the Manufacturers Life to tie single premium immediate annuity rates closely to significant changes in interest rates on new investments. This practice together with other considerations resulted in five different rate bases in the last eight years. Last year his company felt that a revision of the mortality basis was also advisable. The mortality basis adopted was the *a*–1949 Table set back three years at age 35, one and one-half years at age 55 and three-quarters of a year at ages 65 and over. The interest assumption was raised to approximately 3%.

No change was made in the rates for single premium deferred annuities with cash values. Since cash values are a source of potential capital loss, a generally lower interest rate is used than for immediate annuities.

No change has been made in the annual premium rates for deferred annuities or retirement income policies. The basis of settlement options has remained unchanged since 1950. Where no life contingencies are involved the guaranteed interest rate is $2\frac{1}{2}\%$, with provision for excess interest. For options involving life contingencies, the 1937 Standard Annuity Table set back two years and $2\frac{3}{4}\%$ interest is used. In the latter case it was felt advisable to offer as large a guaranteed income as possible and to omit an excess interest provision. Although a static mortality table is not very satisfactory, his company has not yet found a better method which is practical.

MR. HARRY WALKER described the new mortality table being used by the Equitable Society for life income settlements and immediate annuities. The table is known as the ELAS Life Income Table (described in detail in a paper presented in this number of the *Transactions*). The table is a practical adaptation of the a-1949 Table with Projection B. For all life income settlements this table is used with $2\frac{1}{4}\%$ interest, except that $2\frac{1}{2}\%$ is used for the deferred portion.

For immediate annuities the ELAS Life Income Table, set forward one year, is used with $2\frac{1}{2}\%$ interest and a 10% gross loading. The age is set forward because a shorter projection is required than in the case of life income settlements.

MR. E. J. MOORHEAD described the new basis being adopted by the New England Mutual for life income settlement options. The interest rate is $2\frac{1}{2}\%$. For male mortality, the q_x factors below age 50 are those in the a-1949 Table Projected 30 Years and over age 86 they are those of the 1937 Standard Annuity Table set back one year, with rates filled in at intermediate ages. Female rates are equal to male rates with a five-year setback.

The resulting table shows expectations of life at all ages lying between 106% and 109% of the expectations by the 1937 Standard Annuity Table. At the ages where options usually become effective this mortality basis amounts to a Projection B of the a-1949 Table to about 1960 for males, 1970 for females.

MR. HARRY SARASON felt that actuaries had a public relations job to do in connection with the use of projected mortality tables. With the a-1949 and the Ga-1951 tables and the projection factors, we may lull ourselves into thinking that we actually know what is going to happen next to mortality at older ages. What is worse, we may give our clients the same impression.

MR. V. E. HENNINGSEN, commenting on section B, mentioned several classes of payees other than natural persons:

a) *Trustees*. From the point of view of an estate planner, it might be argued that more flexibility can be achieved through the combined use of an insurance trust and settlement options. For example:
   1. *Insurance for Taxes*. Since taxes usually cannot be determined for some time after the death of the insured, the way could be left open for the intended ultimate beneficiary to receive the balance after taxes as income through the use of settlement options. Some companies handle this situation by naming the trustee as a direct beneficiary and the insured's widow or other relative as an additional direct beneficiary. After taxes have been paid, the trustee releases his interest and any remaining bal-

ance becomes payable to the additional direct beneficiary under the options elected. It is usually provided that at the end of a limited period (generally one or two years) under the interest option to the trustee, the proceeds may, if the trustee has not withdrawn benefits, be made payable to the additional direct beneficiary under the options elected, without release by the trustee.

2. *Minor Children.* Payment under the interest option to a trustee with the right to withdraw or change the option could solve many problems connected with complicated settlement arrangements for minor children.
3. *Remarriage.* A trustee can handle stipulations with regard to remarriage, whereas most companies will not include such provisions in their agreements.

A review of company practices shows them to be very restrictive in permitting election of settlement options by trustees, if permitted at all.

b) *Executors or Administrators.* Most companies do not appear to permit the use of settlement options for an executor or administrator. Some companies permit variations of the "additional direct beneficiary" approach discussed above. This procedure requires careful analysis of tax problems.

c) *Corporate or Partnership Employers.* A fixed period option has definite advantages for (i) enabling employers to take advantage of the $5,000 death benefit exemption under Section 22(b) (1) B of the Internal Revenue Code and (ii) carrying out salary continuance plans on the death of a key employee or partner. Similarly, a life income option is valuable for deferred compensation plans. Perhaps because of the question of the permanency of the life of a partnership, election of options is not generally extended to partnerships.

d) *Charities (Corporate and Unincorporated).* Periodic charitable gifts may be continued after death through the use of optional settlements. Also, payment of deferred compensation through a charitable corporation may remove any uncertainty with regard to tax questions. Most companies appear to apply the same rules for the use of settlement options to corporate charities as to regular corporations. For lack of permanence, treatment of unincorporated charities is more strict.

e) *Pension Trusts.* There are special problems arising in the pension trust area which, because of restricted transfers, deferred retirements, mimeograph 5717, etc., may require settlement option payments to a trustee.

MR. C. S. SCHNELLE reported on the New York Life's recent changes in their provisions and rules relative to settlement options. Previously, settlement options were generally available only to the insured and the beneficiaries if they were natural persons taking in their own right, and were not available without the company's consent if the policy was assigned. The company's new policies are written on an "ownership" basis giving effect to the concept of life insurance as property. With this in mind, options are available to any owner who is a natural person and, in the case of cash value and matured endowment proceeds, even to an owner who is not a natural person. Absolute assignees (usually close relatives of the insured) are eligible to receive payment under settlement options. If a policy is assigned as collateral security, any amount payable to the collateral assignee is paid in a single sum; any balance of the proceeds can be settled under an option.

Generally, under the new provisions, at the insured's death the payee must be a natural person taking in his own right and must also be the person who would be entitled to the policy proceeds if payable in a single sum. Only the owner can elect the settlement of death benefit proceeds under an option for the benefit of a beneficiary; an assignee cannot make such a selection. If at the death of the insured no election has been made, then the person entitled to the death benefit proceeds may make an election, if a natural person taking in his own right and not a collateral assignee.

Cash value and matured endowment proceeds can be settled under an option in favor of an owner who is a natural person taking in his own right. If the owner is not a natural person taking in his own right, he can elect to have such proceeds settled under the income-for-specified-period option or life annuity option with either the owner or the insured as payee; however, if payments under the annuity option are payable to such an owner, the amount and duration of payments will be the same as if the insured were the payee. This provision would enable an employer, for example, to set up an informal pension arrangement for key employees.

An important liberalization of the contractual provisions relating to optional methods of settlement is permitted by company practice. In order to expedite the settlement of estates the company will agree to hold policy proceeds under the interest payments option for a period not exceeding two years, during which period the executors or administrators of the insured's estate receive interest payments and may withdraw part or all of the death benefit proceeds. Upon receipt of a release from the executors or administrators before the end of the two year period, any balance of proceeds may be applied under an option elected by the insured or by the beneficiary named in the agreement. At the end of the two year period, if no such release has been received, any balance of proceeds is payable to the executors or administrators in a single sum. The company will also enter into a similar arrangement where a Buy and Sell agreement is involved, with interest payments to a trustee or escrow agent for up to two years and a single sum payment to the trustee or escrow agent at the end of the two year period, in the absence of a release of interest.

G. W. PICKERING, JR. stated in connection with section C that about 25% of the Home Life's requests for settlement options come from brokers and agents of other companies. These requests raise specific problems since many of them come outside the company's rules, and as a result require considerable time and correspondence. Requests from within the company's own field organization present very few specific problems, because their agents are well trained in the techniques involved, the company having had the "planned estate" program for over 20 years. The ratio of requests for settlements in one sum is only three to every seven requests for other types. Of the latter, 58% involve disposition of all the proceeds of a particular policy in only one fashion and could not be considered elaborate. The remaining 42% involve apportionment of the proceeds of a policy into parts, with each part applied in a certain fashion; those they would call "elaborate" requests—but not "complicated," since their frequency has made them familiar.

Over 18% of the requests for settlement agreements involve dividing the proceeds of a policy or group of policies on the same life into more than two parts. This high percentage is due partly to the company's large average size policy. General practical problems that the company faces are:

a) Since relatively few agreements are becoming effective currently, they do not yet know if they will be faced with the problem of whether the drafted agreement is what the insured thought to be the required solution.
b) As the insured's circumstances change, "elaborate" agreements may need frequent redrafting. This causes an expense problem. The company's functional cost analysis shows the average cost of drawing a settlement agreement to be $9. The cost of "elaborate" agreements is considerably higher than the average.
c) Relatively inflexible options and benefits contained in National Service Life Insurance, group insurance and Social Security cause the options in other insurance policies to be fitted with varying payments in a manner which makes claim administration more difficult.

Three possible solutions to the problem of providing for future drains on surplus by liberal settlement option guarantees are:

1. Handle the extra cost on a pay-as-you-go-basis, *i.e.*, do not fund at all.
2. Set up, out of current earnings, the extra amount required over and above the policy proceeds on a realistic basis as agreements become effective.
3. Set up, out of current earnings, annual amounts which together with interest will be sufficient to meet the extra amounts described in method 2. This can be done by (*a*) constructing a model office and determining the amounts required by making projections based on the company's own experience, or (*b*) setting up extra annual premium reserves by treating the additional amount required as additional insurance.

The Home Life has been using method 2 and in addition has been building up a fund toward establishing an extra premium reserve in accordance with method 3 (*b*). The basis used for determining the extra amounts is the 1937 Standard Annuity Table set back two years at 3% interest.

Endowment Income contracts present a special problem since a high percentage of maturities are payable as life income. An additional pure endowment reserve of substantial amount is required.

If it is decided to set up an additional annual premium reserve, the problem arises as to whether this extra reserve should be a part of the regular policy reserve or a special liability item. The former may cause a closer scrutiny by an insurance department and may raise a question about increased cash values which are obviously not justified.

It would seem more equitable in a mutual company to charge the losses due to liberal guarantees to those policies which contain those liberal options rather than to all policies. If there is reinsurance, a reduction in dividends on a particular class of policies increases the earnings of the reinsurer, which in most cases does not reinsure the settlement options, and it would appear that a special arrangement with the reinsurer is called for. Similarly, increased or extra reserves on all business are not offset by reinsurance since no additional surplus is contributed by the reinsured portion.