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Group Annuity Rate Changes

A. What are the causes for and probable short-term and long-term results of the current reductions in group annuity rates?
B. What are the actuarial implications, if any, of such causes with respect to group annuity business already in force?

MR. RAY M. PETERSON of the Equitable of New York ascribed the current reductions in group annuity rates to the improved investment outlook and the provision in the Life Insurance Income Tax Act of 1959 for the tax exemption of income on pension plan reserves, the first being probably more significant than the second. He noted that most companies strengthened mortality assumptions while liberalizing interest assumptions. A short-term result of rate reductions would be a significant decrease in gross purchase payments, which might be offset to some extent by plan improvements. He had observed a considerable interest in such improvements. They result in giving employees the benefit of the rate reduction and in keeping up the level of group annuity purchase payment income. He pointed out that plan improvements will increase ultimate costs and that any plan change based on a reduction in rates represents a reappraisal of the benefit of future interest earnings. He also expressed the hope that deferred annuity contracts would become more popular as a result of the narrowing gap between deferred annuity costs and cost estimates for deposit administration contracts and trusteed plans, attributable to tax abatement and a firming up of mortality assumptions used by consulting actuaries.

A long-term result of lower group annuity rates could be an improved opportunity for small and medium sized employers to install sound pension plans. Increased public interest in vesting and the security of pension promises might lead to a considerable growth of insured retirement plans.

Mr. Peterson considered the implications of the improved investment outlook with respect to surplus distribution practices on existing business. In simple terms, might group annuity clients not feel that they had been "overcharged" for benefits purchased in the past? If so, would there be pressure for the insurance company to reduce reserves held for dividend purposes and to distribute the amount of the reduction in the form of dividends? From the insurance company's point of view, current conditions are not necessarily permanent. Political and economic factors could well operate to reduce the interest rate or alter the present tax treatment of pension funds for both insured and trusteed plans. These circumstances suggest that judgments applying to the current assumption of new liabilities should not be applied automatically to immense existing liabilities.

Prudent consideration of the possibilities of the future, including mortality improvement, is reflected in the limited guarantee applicable to group annuity rate scales.

An insurance company that is using or considering the "select" method of allocating investment income for dividend purposes should be particularly careful about any downward adjustment of any existing reserves.

Under current law, the tax related to the pension business can be minimized by strengthening reserves and increasing dividends. Strengthening reserves benefits the contract holder by decreasing tax charges. Increasing dividends is an irrevocable action which decreases the insurance company's capacity to meet its obligations.

From the employer's point of view, any sudden extra distribution of reserves due to a downward appraisal of existing liabilities could be quite undesirable, because it would come on top of a reduction of current gross purchase payments and an increase in the excess interest element of dividends. Such a reduction in deductible limits might be considered undesirable, particularly if it is believed that there may be a future decrease in the rate of corporate income tax.

Mr. Peterson also considered the implications of rate liberalizations with respect to existing deposit administration funds, in the light of possible requests that the new guarantees be extended to these existing funds. He felt that such a liberalization is no more appropriate than an increase in the annuity purchased by purchase payments made for particular lives. The conventional type of deposit administration contract is a collective deferred annuity with essentially the same mortality and interest commitments as a deferred annuity for an individual. He noted that the problem might be different with respect to deposit administration contracts employing limited guarantees, a type not issued by his company.

MR. JOHN K. DYER, JR. of Towers, Perrin, Forster and Crosby, Inc. referred to a letter which was widely distributed by his company, commenting on group annuity rate changes and observing, among other things, that the insurance companies would be well advised to take a more realistic and enlightened approach to the determination of dividends under existing group annuity contracts. Mr. Peterson's remarks prompted Mr. Dyer to elaborate on this topic.

Entirely apart from all other considerations, the passage of the Life Insurance Income Tax Act of 1959 resulted in a definite and measurable reduction in insurance company liabilities under group annuity contracts. For purposes of discussion, Mr. Dyer suggested that the reduction might be five percent. This reduction is something that can be well understood by group contract holders. Those who have been receiving dividends might be expected to inquire why the insurance company can't immediately hand back the surplus represented by this 5% reduction. This would be analogous to the situation under a trusteed plan when there is an increase in the interest assumption, resulting in a decrease in the unfunded liability. In this period of rather tight money, a good many employers feel that, having met their retirement plan obligations with reasonable conservatism, they would rather keep any other funds invested in their own business.

Such employers wonder why this surplus shouldn't be returned. Mr. Dyer stated that he did not expect there would be many cases where the return would be desired in a lump sum; he felt that an arrangement spreading it over several years, during which the employer might be funding some new pension obligation, would be reasonable. If the insurance companies insist on maintaining whatever level of funding has been achieved, giving no recognition to the clear and obvious decrease in liabilities, they will be in a less favorable position than would result from taking the realistic and enlightened attitude described by Mr. Dyer.

MR. ALDEN W. BROSSEAU discussed the revised basis of group annuity rates recently adopted by the New York Life. A criterion for a mortality table is that it adequately and faithfully reflect future mortality for annuities purchased over a period of five or ten years and thus permit the accumulation of proper funds with minimum distortion. This criterion should lead to the use of a mortality basis with full projection. In 1955, mechanical and administrative difficulties led to the adoption of the Ga-1951 Table projected to 1954 by Scale C, with a one year setback for males and a six year setback for females. The rates recently adopted by the New York Life are based on the Ga-1951 Table, with full projection on Scale C, a five year setback for females, with age at purchase assumed to be attained in 1960. The IBM 705 facilitated the calculations. The basis chosen is intended to recognize mortality improvement since 1955 and to adhere to the criterion stated above. Computing rates as if the purchase occurred in 1960 results in no more rate tables than would have resulted from a static mortality basis. Such rates lose some mortality margin with the passage of time; however, the New York Life has experienced retired life mortality somewhat more favorable than the intercompany experience, and has also observed that deposit administration funds are applied rapidly.

The interest rates of the new basis reflect the continued favorable trend in investment yields and the benefits of the new tax law. The interest rate for deferred annuities is $3\frac{3}{8}\%$; the interest rate for deposit administration funds during the first five years is $3\frac{1}{2}\%$, both for interest credits and for the basis of immediate annuity rates; thereafter it drops to $3\frac{1}{4}\%$ for both purposes, with respect to unallocated contributions received during the first five contract years.

Basic loading remains at 5% of gross. Administrative extras have been increased to \$650 for noncontributory contracts and \$900 for contributory contracts, reduced by 1% of contributions in excess of \$20,000.

No change has been made in the traditional type of rate guarantee, which applies to contributions received in the first five contract years. The customary first-in first-out basis applies to deposit administration funds. Returns of contributions under deferred annuity contracts are at 3% interest, with a charge against the employer cancellation credit equal to 5% of the amount returnable to the employee.