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MARKET VALUE ADJUSTED PRODUCTS

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- o Regulatory aspects -- state and federal
- o Administrative aspects
- o Financial reporting issues
- o Canadian products

MR. DONALD R. SONDERGELD: Our topic is related to surrender values of individual life and annuity products and not to group annuity contracts, which for many years have included a market value adjustment in determining surrender values.

I'm sure some of you have read the feature article in the December, 1985 *Best's Review* on New Product Profitability. It was titled, "A Tale of Two Countries", and was written by Fred Richardson, F.S.A., President of the Hartford Life Insurance Companies. That article compares the historical development of cash value products in the United States and the United Kingdom, and indicates the lessons that can be learned from our British relatives. The major ones are the need for market adjusted cash values and the use of cash flow matching.

As actuaries, we don't want to design products that contain uncontrollable risks. A large disintermediation risk can occur when interest rates rise and the market value of assets supporting policies with book value guarantees

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become materially less than the guaranteed surrender value. One way to eliminate, or reduce, that risk is to offer individual life and annuity products which utilize a market value adjustment formula in determining cash values. However, until 1985, book value cash surrender values were required on individual life and annuity policies in the United States.

In early 1984, Hartford Life decided it wished to market a "safe single premium deferred annuity" to individuals. That is, one with a guarantee of principal at a stated maturity date, an attractive interest guaranteed during that period, but with a surrender value that is equitable to both the policyholder, and the company. That is, a surrender value that is adjusted upward or downward, based on market conditions at the time of surrender. We began offering this product in May of 1984, using an SEC registered group annuity contract.

Our product is sold to customers of four broker dealers that are affiliated with The Hartford. It is sold to individuals who are issued certificates under four group annuity contracts issued to a Rhode Island Trust. We currently offer this product in only 42 states, as these are not legal "groups" in the other states.

The certificate holder initially selects either a 3, 5, or 10 year guarantee period. We provide a simple interest guarantee over that period. Each year, the interest is either paid out or treated as a new single premium containing the original maturity rate, but with an interest guarantee appropriate to market conditions at that time. At the end of the guaranteed period, the individual can choose a new guarantee period or take the principal.

If any certificate holder chooses to surrender during a guarantee period, he, or she, is given a surrender value based on a market-value adjustment formula. The formula is designed to closely approximate the market value of assets needed to back the guarantee. This modification is why the product is called a modified guaranteed annuity. Our formula includes such factors as the period remaining in the guarantee period, the aggregate rate of interest being credited on the date of surrender, and the rate currently being guaranteed by the company on contracts with the same guarantee period remaining. This formula can obviously produce a result that is larger, or smaller, than book value. It

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is, however, fair, and removes the antiselection that the company would otherwise be subjected to when the market value of the assets was less than a book value surrender value. A rear-end load is also applied on surrender.

We would prefer to sell an individual policy, but our product does not satisfy the individual annuity non-forfeiture law (due to its market value adjustment formula), or the variable annuity regulation (which relates to separate accounts having unit values). Therefore, in 1984, Hartford Life began working with the National Association of Insurance Commissioners (NAIC) Actuarial Task Force and the American Council of Life Insurers (ACLI). Our efforts resulted in an NAIC model regulation on Modified Guaranteed Annuities, which was adopted by the NAIC in June, 1985.

In 1985, Hartford Life again worked with the NAIC Actuarial Task Force, and the ACLI, on a similar NAIC model regulation, which would permit use of a market value adjustment in determining cash values on individual life insurance policies. That draft has been exposed in anticipation of adoption by the NAIC at its June, 1986 meeting. We are interested in including this "guaranteed option" within a variable universal life insurance policy.

An important feature of both of these NAIC model regulations is that the assets must be placed in a separate account, and valued at market. I believe this discipline is essential to proper management of the assets supporting the liabilities.

Also, New York is in the process of developing regulations that will be used to implement legislation applicable to annuities, adopted in 1985, which permits utilization of a market value adjustment formula to be used in calculating cash values on individual annuity contracts. A draft of similar legislation, applicable to life insurance, is also being worked on in New York -- which could possibly be adopted either this year or next.

Our first speaker will be Bill Carroll, who is an actuary for the ACLI. Bill is responsible for providing staff support for development of industry proposals and positions on legislation and regulation affecting life insurance products and the presentation of those positions before regulatory and

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legislative bodies. Bill has been involved in discussions of modified guaranteed annuity products, both at the NAIC level, as well as in New York. He is also chairman of the individual life insurance and annuity product development section council.

Our second speaker will be Jan Pollnow, Vice President and Actuary of Hartford Life. Jan has responsibility for the valuation of statutory and tax reserves, for financial analysis and projections, as well as for product and profit review. He is also responsible for centralized business planning and corporate actuarial functions. In 1983 he was a member of the ACLI Task Force on Variable Contract Taxation, and is currently a member of the American Academy of Actuaries Life Insurance, Financial Reporting Principles and Life Insurance Committees.

Our third speaker will be Murray Taylor, who is now the director of Individual Products with Great West Life which is headquartered in Winnipeg, Canada. Murray spent two years of his career in the development of products for individual business in the U.S. and the majority of the other seven years in the Group Pension Department in product development and pension valuation work. For the last eight months, Murray has been focusing his attention on individual products and, in particular, asset and annuity products.

MR. WILLIAM CARROLL: My topic is market value adjusted products and the regulatory scene in the United States. By market value adjusted products, I mean those products, both individual life insurance and annuities, which provide guaranteed values at fixed points in time and may provide cash values at other times which are subject to a market value adjustment (MVA) formula. By the regulatory scene in the United States, I mean to include the NAIC state activities, particularly New York State, and also some Securities and Exchange Commission (SEC) matters.

First, let's look at the NAIC definition of the modified guaranteed annuity. I would submit that the definition contains most of what you need to know about the product. It is a deferred annuity with assets in a separate account which provides guaranteed values at specified periods and which may have cash surrender values subject to a market value adjustment. It's a hybrid product, not a

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variable annuity, because it has fixed amounts available at certain times and also because the MVA formula need not track the assets in the separate account. It's obviously not a traditional annuity because it may have a MVA formula. The NAIC model is quite general, any deferred annuity that would otherwise qualify as an annuity can become a modified guaranteed annuity by merely adding a MVA formula. Therefore, product design involves all of the questions associated with traditional deferred annuities plus the additional question of how to design the MVA formula. This formula is restricted in two ways. First, it must be reasonably fair. And second, it must work both upwards and downwards. The NAIC adopted the annuity model in June of 1985 and most likely will adopt the modified life insurance regulation in June of 1986.

Let's look at the situation in the states. Mr. Sondergeld mentioned that his company, The Hartford, currently sells this product in all of the states but Arkansas, Massachusetts, Nevada, New York, Oregon, Pennsylvania, South Carolina, Washington, and Wisconsin. In these states, The Hartford believes that the product cannot be sold as a group contract where the group is composed of customers of a broker. In New York, legislation was passed in 1985 permitting the individual annuity with cash values subject to a MVA formula. This year, a bill has been introduced which would permit a MVA formula for individual life insurance. It is supported by the Life Insurance Council of New York and is expected to be passed and signed into law this year. New York is currently working on regulations implementing the 1985 annuity bill. They should be published for hearing later this year. If everything goes as expected, work will begin next year on regulations implementing the life bill.

In California, Connecticut and Minnesota there have been attempts to adopt regulations based on the NAIC model; however, no state has yet adopted the model. There is an important reason for this that is evidenced by the fact that two of the panel members are from the same company, Hartford Life. That company led the effort to obtain ACLI support and NAIC approval for the model regulation. The ACLI supports the product; that is, when asked, we will give support. We will not initiate activity in a state. In California, for example, when it was initiated by others, we were helpful in providing information about the model and arguments in support of it, but our current position is to provide merely that level of support. The reason for this is that the Hartford

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Life is the only company that we are clearly hearing from. Our efforts in support of the activities of any one member company are necessarily limited. To get the ACLI off the dime, other companies must express their interest to the appropriate ACLI committees.

Several variations exist between the NAIC model regulation and the New York State law. First of all, the form is different. The NAIC adopted a model regulation similar to the variable life regulation so that states could permit the sale of this product by regulations promulgated by the Insurance Commissioner. In New York, the Insurance Department took the position that the existing individual nonforfeiture law did not permit a market value adjustment formula on an individual annuity if the resulting value could be less than the law would otherwise require as a minimum. Therefore, legislation was passed to permit the product. The legislation was general in nature requiring regulations to fully implement it. Secondly, the type of account is different. The NAIC model calls for a separate account; New York law permits the assets to be kept either in a separate account or in an insurer general account. However, the New York regulations now being developed may restrict the use of the general account to cases where assets are identifiable, such as a segmented general account. Thirdly, the New York minimum standards for the values prior to application of the market value adjustment are different. The New York annuity nonforfeiture law differs from the NAIC model, and the New York standards for life insurance products which credit excess interest differ from the NAIC Universal Life model. Finally, New York provides much more detail on the form of the market value adjustment formula.

Two types of formulas are acceptable. One type compares the interest rate currently paid on new contracts with the interest rate on the contract being surrendered. The other type is based on changes in indexes or interest rates on publicly traded assets that have occurred during the life of the contract being surrendered. The indexes or interest rates used should not reflect deterioration in the quality of the assets.

In determining if a market value adjusted product should be registered with the SEC as a security, a facts and circumstances test applies. This test currently considers the marketing of the product, the degree of investment risk borne by

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the contractholder, and the degree of mortality risk. Bear in mind that it's a facts and circumstances test. Marketing the product as a security, that is, stressing its investment values, tends to make it a security; passing some of the investment risk to the policyholders as an MVA product does, tends to make it a security; and not assuming a significant mortality risk tends to make it a security. This product is new. It's somewhere between a variable annuity which is a security, and a traditional annuity which need not be a security, although it may be a security under this test. The product's design and how it is sold will dictate the final outcome. Also, note that proposed rule 151 essentially removes the mortality test and highlights the marketing test. So, if you're calling this product a security, and you have brokers out there selling it with big signs in the window on how high the interest rates are and what a great investment this is, then the SEC will probably consider it a security. In any event, obtain competent legal advice on this question.

I want to mention a few miscellaneous points -- surrender charges, policy loans and free look periods -- which require product design decisions. Should the surrender charge be made before or after the market value adjustment? The regulations must be carefully read to determine which options are permitted.

There is more than one way to design the policy loan feature. You can avoid it, if you wish, for annuities, but not for life insurance. I'm not going to recite different designs. I merely want to touch on the point and emphasize that you need to make some design decisions. One obvious way is to treat a loan as though it were a partial surrender. A portion of the account value is market value adjusted and moved to the general account to support a fixed-dollar policy loan. Alternately, there are different kinds of other schemes in which you could create the situation where the asset supporting the loan is subject to the changing market. By making a fixed-dollar loan against a variable cash value, the policyholder is essentially buying a share of a separate account on margin. One useful characteristic of the life insurance NAIC model in this regard is that it permits the maximum loan to be set at 75% of the account value. The New York legislation may have a similar provision, except that the percentage may be 80. There is ample opportunity for design.

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The free-look period offers the same kind of a question. What amount should be refunded? I'll let you think about that.

My last point is that you should read the documents. Read them with an open mind. The designers have been careful to provide rules that permit as broad an application as was acceptable to regulators. This means the actuary must use his or her imagination in designing market value adjusted products.

MR. JAN L. POLLNOW: I'm going to discuss the financial reporting for market adjusted products such as modified guaranteed annuities and modified guaranteed life insurance.

When I speak of financial reporting, the main thing I will talk about is reserving. I'm going to talk mainly about annuities, first, because that is the one product that we already have model regulations for -- it has been approved in New York; second, it's the one I'm most familiar with; and third, because I think the life insurance product will be just a takeoff of the annuity. It will mainly be used as just another investment option in a variable life insurance contract. On the other hand, I see annuities being sold as just a single premium modified guaranteed annuity like we're selling today. By life insurance, I suppose the same thing could happen, but I'm not quite sure why we would want to do a lot of business in that area.

In the NAIC model that Bill mentioned the assets have to be put into a separate account, and they have to be valued at market. In New York you have an option. The assets can be held in the general account, at amortized cost, or they can be held in the separate account and valued at market. However, in both the regulation and the legislation, an actuarial opinion is required. This actuarial opinion must be submitted each year, and it must state that the assets are adequate to provide all future guaranteed benefits. If you can't state that the assets are adequate, you're going to have a qualified opinion or no opinion.

As Bill indicated, New York has four different task forces that are drawing up regulations that will help us understand the legislation that New York passed. Also, New York's legislation, and the regulations that are being written, apply

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to all annuities, not just modified guaranteed annuity products. In the rest of the states it's hard to tell today exactly what will happen. If they adopt the model regulation, it will apply only to market adjusted products, not other annuities. However, it looks as though company-wide opinions will probably be required in the future as part of the valuation actuary concept.

One of the things you'll find when you start trying to formalize your actuarial opinion and memorandum, as it's called in New York, is that the segmentation of assets can be very beneficial. It's very simple if you put the assets into a separate account, since the assets supporting the annuity stand by themselves. Also, in the general account it isn't very difficult to set up a separate segment for the assets that support your modified guaranteed annuity or life insurance product. Some of the advantages are that in New York, a higher valuation interest rate can be used if an actuarial opinion is submitted; resulting in a lower surplus drain. If no opinion is submitted, the valuation interest rates that apply to life insurance must be used and these are generally much lower than the annuity valuation rates. The same type of thing can happen in a separate account. With both assets and liabilities at market, you should be able to develop products that have a lower surplus drain.

Another advantage of segmentation would be that it helps in monitoring investment policy. It makes it easier for the investment department to review the matching of the assets and liabilities.

I'd like to go on to statutory reserving. I'll start with the general account, where we talked about valuing assets at amortized cost. This is pretty straightforward because I believe all you need to do is apply the normal Commissioners Annuity Reserve Valuation Method (CARVM) under the dynamic valuation law of the 1980 amendments. This means that all of the guaranteed benefits are projected forward to the various durations, and then discounted back at the valuation interest rate. Whichever one of those values comes out the highest, that's the reserve that you should set up on a statutory basis.

However, the reserve established must at least equal the net cash surrender value. Since assets are at amortized cost, the liability should be on a consistent basis, and in order to do that I believe you have to disregard the

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market value adjustment that's built into the product. In other words, when you calculate the net cash surrender value, you should calculate it without taking into consideration the market value adjustment. In the New York regulations, that are being drawn up, it is specified that the calculation of the net cash surrender value should be done without the market adjustment formula being taken into account.

In the past, assets have often been valued at market in a separate account, but this was for unitized separate accounts. In other words, the benefits are tied directly to the assets -- the net asset values determine the benefits which then determine the reserves. However, the modified guaranteed annuity is not a unitized product. Therefore, in order to have reserves on a consistent basis with the assets, liabilities must be valued at market and again, the regulations specify that you have to hold at least the market adjusted cash surrender value. Since this is different than for the general account, we now need to take into consideration the market adjustment formula. Basically the calculation is similar to the CARVM calculation, except that in this case rather than using the valuation interest rate specified in the law, we will be using a valuation interest rate that is based on market yield at the time of valuation.

I'd like to mention three different reserve methods, which I believe are going to at least be outlined in the New York Law, and what type of market rate you can use to do your discounting. First of all, you can look at the various maturities in your asset portfolio and determine the market yields on those assets at the time you want to do your valuation, and then use those market yields to discount your guaranteed benefits.

A second option would be to use some type of index. People always talk about a Moody's Index of some sort or other. I think the key here is to look for an index that will give a result that is similar to the results you are going to get in valuing your assets. There should be a consistency between the index and the kind of assets you are investing in.

A third method would be something that we call a hypothetical portfolio of Treasury Bonds. In the United Kingdom they use this type of concept. It is my

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understanding that over there the only type of bonds they really can invest in are something called GILTS, which are really government bonds. Since that's what their assets have to be invested in, they can then use a hypothetical portfolio of bonds to value the liabilities. The way this is done is to look at your cash outflows on the liability side and then take a series of bonds and try to match up the cash flow from those bonds with your cash outflows. For instance, if you had zero coupon bonds, you'd simply look at how much you are going to collect at maturity and match that up with your cash outflows. On the other hand, you might use coupon bonds. Simply, take the principal repayment and match that up against some of your cash outflow, which would probably be the maturity value of this contract. If, in the meantime, you're paying simple interest as Don indicated, you could use the coupons from the Treasury Bonds to cover the cash outflows between the issue date and the maturity date.

Once the market yield has been determined, a margin should be built in to determine the discount rate. This margin could be for future maintenance expense. It could also be for adverse deviation, such as if the bonds are callable, or to cover the default risk. Third, you might want to build in a margin for profit. This can be done by deducting a certain number of basis points from the market yield rate before it is used in discounting. Another way that you could build in margins is to simply add a margin to your cash outflows. You may just want to take your benefit or projected cash outflows and add in a profit margin to them before you do your discounting.

One of the things that happens when we do this type of reserving, and this is something we don't see in our normal separate accounts, is that if you do have a mismatch between your assets and your liabilities, or your asset cash flows and your liability cash flows, this mismatch is going to show up whenever interest rates change. There is either going to be a gain or loss in this portfolio between your assets and your liabilities, and this is something that is going to help keep your Investment Departments on their toes. Don mentioned using assets at market as a discipline. I think that's a very good discipline, and it is something that we probably all are not paying enough attention to. On this product, if you don't match fairly closely, you are going to get some wide swings in your income and also in your surplus whenever you have wide variations in interest rates.

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For example, let's say that your assets are shorter than your liabilities. If you have a positive yield curve, and if that yield curve rises when your assets are shorter than your liabilities, you come out a winner, because what you've done is guessed that interest rates were going to rise. So, as the assets mature, interest rates have risen, and you can now invest at a higher rate to cover the lower guaranteed obligation to your policyholder. Of course, the opposite happens if interest rates fall. In that case you are a loser, because now you have to invest at lower rates. The effect is that when you discount, if rates have decreased, the value of the assets will increase by less than your liabilities and a loss will result.

I'm going to talk just briefly about GAAP reporting. First of all I think that we may have a possible problem in this area. Coming from The Hartford's point of view, we'd like to see these mismatch gains and losses go through income on a GAAP basis as they do on a statutory basis. We have a company in the United Kingdom right now called Abbey Life, and it sells this type of a product. If it has mismatch gains or losses, they show up in the GAAP income statement. The audit guide doesn't address this type of product specifically, although it does talk about guaranteed interest contracts. In Financial Accounting Standards No. 60, it is indicated that guaranteed interest contracts should have assets valued at amortized cost. That's inconsistent with what we are doing on a statutory basis, but there may be a change in the future.

We do know that the Financial Accounting Standards Board is looking at other types of problems with other new contracts that are coming out. They've also addressed or are addressing single premium annuities, which is basically what we are talking about here. It looks like they will specify that profits for single premium annuities should not be taken up-front in proportion to premium. Instead, they should be spread over the life of the contract and should emerge in proportion to the assets or the reserves.

Of course, in using GAAP, you will defer your acquisition costs. You pay out some commissions, you have some other up-front sales costs, and you will want to defer these costs. On the benefit side, I think you can use the same type of techniques that I have just discussed for statutory accounting; project your benefits and discount. In this case, you may want to use different

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discount rates, because the margins that you build into these discount rates will determine the income pattern that will emerge for your GAAP accounting.

I'd like to just briefly touch on a couple of problems that we've discovered in the Federal Income Tax Code. First of all, as Bill mentioned, the benefits on this particular type of contract, a modified guaranteed annuity, or life insurance, are not tied directly to the assets in the separate account. As a result, it's my opinion, as well as that of a number of others in the industry, that this type of contract is not a variable annuity or segmented account contract for Federal Income Tax purposes. The specific words in Section 817 of the Code are that annuity benefits must reflect the investment return and the market value of the segregated assets, and we definitely know that this is not the case here. The benefits are guaranteed and even early withdrawals have a guaranteed formula rather than any type of a tie-in to the actual assets. So it appears this contract must be taxed as a general account product under what is called Section 807, which is the reserving section of the Internal Revenue Code.

This means that we will value these contracts on a book basis or CARVM basis. However, annual statement reserves are on a market basis, and some of you are probably familiar with the fact that there is a cap on the reserves that you can use in the tax return. This simply is that you can't use tax reserves that are higher than your annual statement reserves. If there is a big drop in market values, the reserves in the annual statement are going to go down. But if, on the other hand, the tax reserves are valued on a book basis, which would probably be close to your account value, this means that whenever your assets drop in your annual statement, you are not going to be able to hold a reserve higher than the annual statement reserve, and that's going to create a large increase in taxable income. The fluctuations that could occur because of this market value adjustment, or this valuing assets and liabilities at market will generally tend to change the incidence of your taxes so that they come in up-front. This will be difficult to predict, and the result is that you can't properly price for it. So I think we need to have the tax code clarified for this kind of product.

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A second problem has to do with the mutual company equity tax, or the differential earnings tax. An equity base must be calculated by a mutual company and, it also must be calculated by stock companies even though they don't really use it. The tax code indicates that the excess of statutory reserves over tax reserves should be used to increase the equity base, so that it in effect reflects the lower tax reserves. In any case, it again causes an inconsistency because assets are at market in the annual statement.

The solution to both these problems appears to be legislative, and there is an ad hoc group in New York working on a number of problems associated with contracts that have assets valued at market and have some minimum guarantees. This will be one of the contracts that falls into that spectrum of products, and hopefully, there will be some legislative clarification in the near future; although the near future might be two or three years away.

Finally, I would like to summarize the points that I have discussed. We've talked about a new type of product that is a non-unitized annuity or life product but which has assets and liabilities valued at market. We calculate reserves by discounting future benefits, not at the valuation rate, but at a market yield. Because of this technique of reserving, any mismatches in asset and liability cash flows will affect earnings and surplus whenever interest rates change. And finally, the product appears to have some adverse tax consequences that must continue to be addressed.

MR. MURRAY J. TAYLOR: In some ways the problems expressed at this meeting are almost non-issues in Canada. However, there are some market forces and technical details that I would like to touch on.

Regulatory Environment

First of all, let me review the Canadian regulatory environment with you. Various regulations exist federally and provincially which describe what an insurance company may or may not sell. Most of these rules relate to general parameters and features such as the importance of an insurance element in our products or the necessity of offering products in a way that does not conflict with human rights type issues. There is a general absence in these regulations

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of any calculation oriented rules, such as maximum or minimum interest rates used for various calculations. None of these legislative rules insist on pre-authorization of contracts or materials except for mutual funds which can only be sold by subsidiaries of insurance companies anyway.

Generally speaking, our regulatory bodies tend not to interfere with our creativity to nearly the same degree as their counterparts in this country.

The financial services sector in Canada tends to be dominated by a small number of major companies which have been driven by consumer demands to develop and maintain products which deliver fair value. Thus, our regulators have not seen fit to significantly interfere over the years.

In this context it is not surprising to find that there is no legal restriction on the use of market value cashout features for any guaranteed products, either on a group or individual basis in Canada.

If variable annuity contracts with segregated funds are utilized for individuals, there must be a guaranteed minimum of 75% of the principal payable on death or at maturity. Most products offered by insurance companies provide book value at death in any event, and the maturity date is generally at least 15 years or more after the inception of the plan. Thus, this one particular restriction imposed by government on possible market value calculations would not to be onerous.

Product Environment

In Canada, the banks, trust companies, insurance companies and other financial institutions are all fighting for a key share of an exploding market for guaranteed interest term deposits. As limits keep rising on our Registered Retirement Savings Plan (RRSP), which is our very popular tax deferred vehicle, it tends to dominate the term deposit market. Most of the comments I will make assume that the majority of vehicles exposed to market value cashouts are in fact of a RRSP nature. The definition of product for this market simply carries over into any non-registered environment or even into universal life programs.

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This RRSP vehicle is similar in concept to the IRA in the U.S. but has taken on a much larger role in Canada due to two key features.

- o First, personal income tax rates in Canada are 2, 3, or 4 times what you would pay in the U.S. for the same level of employment income. Hence, everyone from lower middle class to the upper end is looking for every opportunity to avoid or defer taxes.
- o Second, the limits and features of the RRSP are much more advantageous than the IRA. Limits for many years have been \$3500 a year. This was raised to \$7500 for 1986 to be subsequently increased based on proposed legislation to \$15,500 by 1990. In addition to these dollar limits, there is a percentage of income cap.

Based on this advantageous tax-deferred vehicle, a large portion of the average Canadian's savings is bound up in their RRSP program.

Annuity Products

In this marketplace the trust companies, which tend to be leading the market, do not permit any withdrawal (i.e. 100% back-end load) except on the death of the owner where they pay book value.

The banks typically sell the same products as trust companies, but they also have a cashable term deposit, where the value is often book value excluding any interest accrual in the first 6 months to a year, or interest calculated at a very low rate like 3% or 5%. Although this approach is understandable to the consumer, it does not effectively deal with the market value risk. The largest penalty occurs just moments prior to the expiry date when the risk is the smallest. Alternatively, the least penalty appears at the outset of the term when the market value risk is the greatest.

Most life insurance companies in Canada use market value adjustments on Non-Par interest sensitive new money products for any voluntary withdrawal. The most typical example of this would be our GIC or term deposit products. These features are present in Universal Life and deferred annuity programs, where the

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client chooses and manages his/her investment program by electing to leave money in a daily account or move it into a variety of term deposit vehicles from time to time.

Insurance companies typically provide book value cash out for involuntary actions such as death or termination of employment in group programs. For any other withdrawal, the proceeds equal the lesser of book value or market value, each of which is often adjusted slightly for administration expenses to process the withdrawal and/or some recovery of acquisition expense.

Although we actuaries might argue that true market value would be technically correct instead of the lesser of book and market, the conservatism in us comes out and suggests that we not give away appreciation. There is no competitive need to provide the excess of market value over book when rates are low, and there appears to be very little consumer understanding or demand for this feature.

Valuation & Tax Issues

If we were to use a cashout feature which could pay an amount higher than the book value (i.e. market value), then a special appropriation of surplus by the life insurance company is required, based on the sum total of all excess amounts, viewing each policy separately. A use of surplus in this manner greatly disturbs senior management or shareholders, so there is a big disincentive to moving in this direction.

Such an appropriation of surplus leads to some additional tax cost for all Canadian multi-national insurance companies due to its impact on the Canadian Investment Fund calculations.

Our interest sensitive products in Canada tend to be very determinate in nature. We do not have vehicles which pay the better of a short-and long-term rate. Instead our products tend to leave key decisions in the hands of the client and then force him/her to live with the results of his/her decision. This feature of our product and the tax-deferred nature of the vehicle, leads to less frequent withdrawals than you would probably see in U.S. products.

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Very few of our clients would take money out of their RRSP to spend on tangible goods. The primary reason for cashing out is to move their funds to another financial institution for an improved yield. If your penalty is appropriate on a market value basis, then that incentive has been taken away, and they are very likely to remain with us. Thus, the market value adjustment leads to a significant reduction in risk for the insurance company. It also deters surrender which helps to minimize our overall costs and deliver better value to the consumer.

Insurance Products

Let us talk about insurance products briefly. In Canada, the two most popular generic types of insurance are:

- o participating whole life with dividends based on portfolio interest rates or at least some aggregate interest rates for a particular class of policies;
- o and universal life which generally provides investment options for the individual much the same as our deferred annuity contracts.

The scope of our discussion does not really cover the traditional whole life par policy. The implications of market value cashouts for term deposits held under a universal life program are very similar if not identical to the comments I have already made with respect to deferred annuities.

Administration & Communication

We do not have any severe problems with respect to the administration of these rules or the communication of them to the public. However, because we operate on a different basis compared to the banks and trust companies, questions often arise concerning the onerous nature of our market value cashouts. Formulas appear in rate books to help the agent determine what the market value cashout would be under a number of circumstances, and although these would be considered elementary mathematics for the actuary, they are viewed as very

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sophisticated mathematics by the agent which often brings about some misunderstandings.

If we are ever in the situation where value is determined as the actual market value where interest rates are lower and the amount paid out is higher than the book value, then more elaborate administration will be necessary to track those excess amounts and establish the appropriated surplus from year to year. Also, in this situation the administrative people feel they are giving money away needlessly which often becomes a demotivator to expense control.

Recent Issues -- RRIFs and Cashable SPIAs

A recent issue with regard to market value cashout has arisen in Canada. In a recent federal Budget (which is a statement of intended legislation) our government announced it would be liberalizing the rules surrounding annuitization of RRSP maturing funds. This market is currently the bulk of our Single Premium Immediate Annuity (SPIA) market. The most publicized feature was the expansion of payout flexibility on a Registered Retirement Income Fund which has for some time been a quasi-increasing payout annuity without any mortality guarantees, expiring at age 90. All financial institutions were permitted to sell this vehicle, eroding by some small measure the SPIA market. The expanded rules will likely strike a significant blow to the SPIA market because an individual can maintain his/her capital for a longer period and establish yearly payout levels at any amount chosen above some low minimum amount. The government's efforts to relax these rules is in response to some negative media attention on SPIAs.

In the same Budget, the government announced that SPIAs already established could be cashed out (a feature not permitted under previous RRSP legislation). They effectively transferred the negative public relations about the finality of an annuity purchase from the government to the insurance companies.

Now, our industry must respond to this issue by deciding if we will permit SPIA cashouts and if so, on what basis. In many ways we are between a "rock and a hard place". If we were to permit cashout of a life contingent immediate annuity, we would have to seek satisfactory evidence that the individual was

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healthy, and there was only some financial reason for the cashout request. In my view, it would be suicide from a marketing perspective to seek medical underwriting evidence from an elderly lady who wants her money back and is not predisposed to like us in the first place. If we were to offer any type of cashout feature, it could only apply to the guaranteed portion and leave behind a deferred life annuity commencing at the end of the guaranteed period. This could be done without medical evidence. Under current legislation the later deferred piece would have to be non-registered, which would lead to other problems such as accrual taxation on the interest build-up under the contract. In any event, cashouts of all or part of SPIAs will become a key issue in the next year.

For term certain annuities, market value adjustments would be quite appropriate if a company chose to release the funds.

Because most of our products have market value adjustments, our valuation actuaries treat us with much greater confidence and see a reduced need for a C-3 risk margin in the reserves. The advent of asset liability management and/or matching has also led to this valuation leniency.

As I said at the beginning, market value adjusted cashouts are an accepted fact of life in Canada by the insurance industry, the government and to a large degree by the consumer. I wish my U.S. counterparts well in their fight to bring such acceptance to the regulators and consumers here.

MR. TYLER LEE: I'm assuming that The Hartford did not ask the SEC to rule on the Hartford's product, and that it was not under the SEC's jurisdiction. Therefore, what Federal regulations are you following with that product? For example, are you using only National Association of Security Dealers (NASD) licensed agents?

MR. SONDERGELD: The Hartford sells the product through three, actually four, broker dealers. We own 25% interest in three. Because we felt the product would be sold like a security, we felt we should register it. In addition, we feel that the product is a security because we believe it does pass some of the investment risk over to the purchaser. We do take the default

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risk, but if the person does not hold the product to the end of the guaranteed period, there is a market risk we believe the purchaser is taking.

We, therefore, register the product under the Securities Act of 1933. Initially, the assets were placed in the general account, but then we wanted to put the assets, valued at market, in a separate account. We went to the SEC and raised the question that, if we placed the assets in a separate account, would we be subject to the 1940 Act. We did not think we would be, and the SEC agreed with us. We then asked for, and received, a no action letter from the SEC.

