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The Variable Annuity Business Education 480

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THE VARIABLE ANNUITY

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PREFACE

Great public interest has been expressed in a proposed new form of retirement income protection called a Variable Annuity Contract, under which annuity payments vary from time to time to reflect the results of common stock investments.

The purpose of this paper is to explain the Variable Annuity and how it works.

I wish to thank Carroll Baird, a Junior Business major, for proof-reading this paper.

W. C. K.

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CHAPTER 1

INTRODUCTION

Today it is not enough just for one to save in order to assure oneself an adequate income for retirement because inflation threatens to erode or destroy the purchasing power of the saved dollars. Because of past inflation, over three dollars are required today to purchase the same amount of goods and services that could have been purchased with one dollar seventy-five years ago.[1] The trend threatens to continue. Businessmen, doctors, lawyers, and other middle-class citizens are, therefore, looking for ways to invest their savings so that their value will tend to increase with the general price levels of goods and services.

Particularly for some groups, in the early stages of an inflationary development, the rise in the incomes of individuals tends to equal and at times exceed the rise in prices. But as the inflationary development continues, astute individuals begin to realize that a decline in living standards will inevitably set in as the rise in prices overtake the rise in incomes. They take whatever steps are available to protect the purchasing power of their income and savings. Under some conditions, they protect their regular income by increasing fees, salaries, and wages. To protect

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[1]Harold A. Dulan and O. Lee Bodenhamer, "The Variable Annuity," Best's Insurance News, Vol. 61:129-136, May, 1960.

their savings, however, they must place it in a media of investment (such as selected common stocks) which holds promise for increasing in dollar value in line with the decline in the purchasing power of the dollar.

A relatively new type of approach to protection is the variable annuity--a life insurance annuity policy which provides life income for retirement purposes and where the policyholder's funds under the contract tend to vary, both as to dollar income and as to market value, because they are invested partly or entirely in common stocks or other equities.

CHAPTER 2

PRIMARY DISTINCTION BETWEEN FIXED AND VARIABLE ANNUITIES

There is no statutory definition of either "fixed" or "variable" income annuities, the terms being popularly used as antonyms. A comparison, perhaps oversimplified, is that both provide for premiums to be paid, usually over a long term, and that at a future specified attained age of the annuitant the insurer will commence periodical payments either for a specified number of years or for the lifetime of the annuitant, or perhaps to an additional beneficiary, as the case may be. The essential difference is that under the fixed income annuity the periodical payments are stated as an exact or guaranteed number of dollars; under the other, a number of units of income to be paid is fixed and guaranteed but not the dollar value of the units. Hence, under the variable the number of dollars of each periodic payment varies and can either increase or decrease. The different result is achieved by a vital distinction in the investment use of the premiums received--in the first case, in so-called debt securities such as bonds and mortgages with fixed yields and values; in the other case, in so-called equities which could be stocks, convertible bonds, real estate, etc., but, most likely, in a widely diversified list of common stocks subject to fluctuation as to both yield and price.

Variable annuities, its supporters claim (premised on statistical studies of long-term trends in stock prices, living costs and dollar purchasing power), would furnish a measure of protection for annuitants against loss of purchasing power in periods of rising prices. Stressed is the importance of what the dollars will buy rather than the number of dollars. This would be accomplished through the annuitant's benefiting from the diversified periodic acquisitions of selected common stocks. Any capital gains, increase in yields, and reinvestments of gains and dividends should enhance the total dollar value of the units credited to the annuitant. As will be seen, it is proposed to use variable income not alone but in combination with fixed income in setting up the ordinary retirement plan--this being a protective measure against a drop in equity earnings at which time prices should also drop. The retired person needs his real income purchasing power, even at the risk of loss of principal, rather than safeguarding the principal but suffering a loss of real income.

It may be asked what is so controversial about the forewing concept that it could, in a few years, split the leaders and, literally, the best brains in the life insurance industry into opposite camps and cause a joinder in the dispute of the leaders in industry and finance, bankers and security dealers, state and federal regulatory agencies and the courts. The answer lies in vital and broad issues created by the adoption and any considerable use of the variable annuity. In dealing with the subject of variable annuities, some of the questions that may arise are:

(1) Is there real economic need for the variable annuity; will it reasonably solve a problem; will it create, new problems which might outweigh benefits?

(2) Will the reputation of life insurance companies, founded on guaranteed and fixed income concepts, be endangered by what opponents describe as a speculative stock purchase plan with serious dangers of loss to purchasers?

(3) Is legislation required and, if so, to what extent?

(4) Is the variable annuity an investment or insurance, and would life insurance companies become subject to supervision by the Securities and Exchange Commission, a federal agency, thus endangering benefit of long-time supervision by Superintendents of Insurance of the individual states?

(5) If life insurance companies have to engage in large purchases of securities to support variable annuities, what will happen to the stock market? Is there danger of insurance companies dominating corporations through possible purchase of large blocks of stock?

(6) Should variable annuities be issued as regular functions of the life insurance companies? Should there be separate or subsidiary companies, or should the equity assets be maintained in segregated accounts?

Consideration of the foregoing issues must portray the necessary changes in long established principles and practice of life insurance companies, some of which changes can be considered evolutionary and some even described as almost revolutionary.

CHAPTER 3

ECONOMIC FACTORS INVOLVED: IS THE FIXED ANNUITY SUFFICIENT

Upon reaching the retirement age, the desire and hope of an annuitant, who has long paid for a lifetime annuity, is for an amount of income which will be sufficient during his remaining lifetime to meet reasonable living costs--not only the minimum cost of a bare living, but enough to allow participation in any improving living standards. Furthermore, he should not be able to outlive the income. It is futile and unnecessary to try to decide in advance upon a specific number of dollars, projecting this number into the future for an indefinite time on the assumption or the hope that it will suffice. Rather, what is sought and required is purchasing power sufficient to supply the needs of the individual regardless of the precise number of dollars. A dollar being worth only what it can buy, we are cognizant of the fact that when living costs rise a larger number of dollars is needed to cover the costs. For employed persons, salaries or wages may be adjusted upward so that more dollars will be available. The retired person who is living on a fixed income, whether from an annuity, bonds or accounts and who has had his living costs increased, may still receive the same number of dollars in income, but the purchasing power of this fixed income has decreased and he will suffer.

Studies and reports by governmental and private bureaus and organizations establish what we all realize only too well--namely, that current living costs are at a recent new high and, seemingly, are headed higher. Various polls of businessmen and economists show little prospect of lower prices in the immediate or near future. On the contrary, we have daily announcements of price increases, in a broad range, in commodities, finished products and the cost of services. Since 1939, the dollar has lost nearly half its purchasing power--another way of saying that it now costs twice the number of dollars to live. Graphically, an individual who in 1939 left a new estate of $100,000 in high-grade 3 per cent bonds would have provided his widow and two children with an income of $3,000 per year, which was then probably sufficient to meet the family needs. Today, the same amount of fixed dollar income, that is, $3,000, is "worth" only half that amount and is totally insufficient in current purchasing power to buy the necessities of life.[1] The effect has been most severe on that part of our population which can least carry the burden. At the same time, it is far from reassuring to others who realize that while they can receive the same number of dollars deposited years ago in savings banks or government bonds, both of which were and still are considered among

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[1]Harry N. Schechter, Variable Annuities--Boon or Bane? (Chicago: Commerce Clearing House, Inc., 1956), p. 766.

the "safest" investments in the world, they have nonetheless suffered a severe loss in purchasing power.

The life insurance companies--even those opposed to variable annuities--are fully cognizant of the implications of inflation and its drastic effect. Indeed, they have urged the purchase of ever-increasing amounts of life insurance, family income protection, and other forms, including annuities, to cover the greater needs of survivors in the event of the death of the bread-winner or his retirement if he lives.

As stated by Ray D. Murphy, chairman of the board of The Equitable Life Assurance Society of the United States and a leading opponent of the variable annuity, in an address on September 26, 1956, at the annual meeting of the National Association of Life Underwriters:

> "Inflation works like a cruel and cynical tax that strikes hardest the patriotic and thrifty who have accumulated government bonds, savings accounts, pensions, life insurance and annuities."[1]

In addition to the ravages of inflation above referred to, there are universal predictions--some almost startling in scope--of an increasing improvement in our standard of living and of all the new comforts and benefits we will enjoy--that is, if we will have the means to obtain the increased amount of purchasing power and the correspondingly greater number of dollars needed to enjoy the fruits of the predicted better life. It will cost more money to buy

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[1]Ibid., p. 767.

more things, and more people will need more money to buy them as the luxuries of the few become the accepted standard of the many.

The last factor to be considered at this point is increased longevity. In its statistical bulletin for June, 1956, the Metropolitan Life Insurance Company, a leading opponent of the variable annuity, reports (1) that a 1954 new record high of 69.6 years was reached as the average length of life of the American people, (2) that one half of the persons reaching age 65 will survive to 78 years of age, and (3) that the life expectancy of males and females at age 65 is now 13.1 and 15.7 years respectively. Slight future increases of these figures are expected. The effect of increased longevity is that a person who is now planning on retirement in the future, whether through an annuity or some other personal plan, must be concerned about providing sufficient purchasing power for the longer anticipated period of retirement. If provision is made through fixed income, the stretched-out payment period will yield small payments, or it will take a larger fund to supply higher amounts for the longer period of time. He must have adequate income that he cannot outlive.

There is considerable doubt whether the old fixed income annuity can give the protection today which was expected when it was contracted for. There is equal doubt if such an annuity, issued currently, can be depended upon to cover future living costs.

CHAPTER 4

PRESENT STATUS OF THE VARIABLE ANNUITY

It is significant that the variable annuity, though new and controversial, is not an untried experiment. Current interest in variable annuities dates from approximately 1950. The Teachers Insurance and Annuity Association (TIAA) was organized in 1905 to provide life insurance and retirement annuity benefits--fixed income--for faculty, personnel, etc., of the colleges and universities in this country. Many of the institutions of learning which had participated in TIAA coverage for their faculties had their endowment assets invested in balanced funds with varying combinations of debt and equity securities. Natural comparisions were made of long-term yields and appreciation derived from the balanced endowment fund assets and those under the fixed income annuities of the TIAA. Extensive studies led to a report in 1950 by Dr. William C. Greenough, vice president of the TIAA, that, over the period of 70 years from 1880 to 1950, income derived from an assumed combination of both fixed and variable annuities would have satisfied the needs for real retirement income and actual purchasing power far better than income solely from the fixed annuity. Following this report, the College Retirement Equities Fund (CREF) was organized and licensed by the State of New York in 1952 as a companion organization to TIAA, permitting persons insured under the TIAA fixed annuity to make pension contributions up to an amount equal to the CREF which furnished variable annuities income benefits, thus obtaining a balanced income. Since the start of operations by CREF in July, 1952, approximately 90 per cent of those eligible have participated, there being now more than 25,000 members and funds of some $27 million.

In 1954 a bill passed both houses of the legislature in New York to allow the Variable Annuity Corporation of America to sell individual variable annuity contracts. However, this bill was vetoed by Governor Dewey after opposition, including that of the then-superintendent of insurance and the New York State Association of Life Underwriters. Since 1955 various enabling bills have been introduced in the States of New York, New Hampshire, Maryland, Texas, Massachusetts, and New Jersey. Legislation was passed in New Jersey in 1959 but it is still tied up in the courts.

As the situation now stands, life insurance companies offering the variable annuity are subject to regulation by both the Security and Exchange Commission and the insurance departments of the various states.

History was made in 1955 when the Variable Annuity Life Insurance Company of America (VALIC) was licensed in the District of Columbia. The next year the Equity Annuity Life Insurance Company was also licensed in the District of Columbia. Both are supervised by the Superintendent of Insurance of the District of Columbia, and contracts are sold only through licensed life insurance agents.

The States of Arkansas and West Virginia have also licensed certain life insurers to write variable annuities.

It should be noted here that many large employers are using self-administered or trusted pension plans--some in combination with various group insured annuities in one form or another, using the variable annuity principle with common stock assets. Included are Bristol-Myers, Wanner-Lamber, Long Island Lighting Company, Panagra, Kidder, Peabody & Company, Carnegie Institute in the District of Columbia, Boeing Aeroplane Company, Chemstrand, Smith, Barney & Company, and National Airlines.[1]

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[1]"Variable Annuities: Ready to Roll?", Business Week, p. 115-116, June 6, 1959.

CHAPTER 5

ARGUMENTS PRO AND CON

Many articles and statements have been published in opposition to the adoption of the variable annuity. Presidents, other executive officers, counsel and economists, all well qualified, have strongly objected to the variable annuity. The general substance of the objections is that buyers of variable annuities are subject to the same risks as anyone purchasing stocks, and the risks outweigh benefits which might be derived under variable annuities in the event of inflation. Thus, there might be a loss if the level of stock prices during the benefit paying period were unfavorable compared to the level during the premium paying and accumulation period. Payments into the fund might not be maintained if stock prices drop. It would interfere with the adequate and accepted performance of responsibility of insurance companies to furnish protection on the basis of guaranteed fixed dollar contracts. Sales of variable annuities amounts to "embracing" inflation by the life insurance companies, with the connotation that inflation is beneficial, instead of the companies' fighting inflation. The companies and their agents cannot conscientiously sell, on the one hand, fixed dollar life insurance contracts and, on the other, contracts based on the assumption that the value of the dollar will decrease for an indefinite period, plus a further assumption that stock prices will rise more than the cost of living. Under ordinary insurance uses, including the fixed dollar annuity, the insurance company assumes all risks as to investment losses, falling interest rates, rising expenses and improving mortality, and if the policies are "participating", the returns can be even greater than the minimums guaranteed. However, under the variable annuities the risks are shifted almost entirely to the insured.

Basically the opposition questions the view that there will be continuing inflation or that common stocks are the best hedge against inflation. If investments were limited to the purchase of blue chip common stocks with high prices and low yields, this would prevent the exercise of sound judgment by the insurance companies. Life insurance agents would have to become experts in reading statistical stock charts, and they would have to worry about market trends. Agents and the public both would have difficulty in understanding the concept of the variable annuity. It has been suggested that the speculative character of the contract should not be hidden behind the word "annuity", and that a better description would be "speculative income contract."[1]

One of the recurrent arguments is that no reputable life insurance company should place itself in a position

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[1]Op. Cit., Harry N. Schechter, p. 769.

of possibly receiving and trying to answer complaints of holders of variable annuities in periods when falling stock prices might cause their benefit payments to decrease below what had been expected, and that this task would not be relieved by any warnings or notices which might have been given to the insured of such possibilities before purchase of the variable annuities. Fear is expressed of litigation which might be brought by dissatisfied annuitants, and resentment against the companies might impair and endanger their earned reputation based on guaranteed (no risk to the insured) payments.

The PROPONENTS answer that they do not claim the variable annuity is a perfect solution without risk, nor that the fixed income annuity should be abolished. Instead, appreciation for the value of guaranteed fixed income has been repeatedly stated, and the continued need for that type of annuity has been and will continue to be stressed. A balanced program, that is, to have equal funds or assets in fixed annuities or securities or trust funds of that type, will lessen the risk of adverse investment experience if a variable annuity were used exclusively.

In the realm of economic theory, the proponents, on

studies of leading economists, point to a long-range trend toward further inflation. There are elements which should prevent any serious depressions in the foreseeable future; diversification and dollar averaging will lessen risks. Agents have a capacity and training to be able to sell and explain the functions of variable annuities, and the public can understand fair explanations. It has been said that the sale of variable annuities no more embraces or sanctions inflation than does the sale of fire insurance constitute an admission that there should be fires, or the sale of aspirin tablets suggests that a headache is desirable. The variable annuity is not dependent on predictions of more inflation alone, since the predicted general expanding economy makes common stocks attractive and will enable the public to share in the economic growth of the country whether the purchasing value of the dollar is up or down.

There is no more inconsistency in the possible offer to the public of the choice of both fixed and variable income annuities than in the offer for sale of both so-called permanent life insurance and term or temporary insurance. Fixed annuities have some variable features. If the policies are participating, possible dividends will vary. At all times the total amount which may be received by the annuitant is variable, being dependent on the date of his death. Conversely, under the variable annuity there are guarantees as to limitation of expense and mortality features, and although dollar amounts are not guaranteed, the number of units payable is fixed and determinable under definite provisions.

It is urged that (1) regular life insurance agents will not "push" the sale of variable annuities if its need is not indicated, (2) the public will not be forced to buy, (3) the life insurance companies are aware of their responsibilities and will have competent financial advisors who will use discretion as to securities purchased and held, (4) the primary purpose will be long-term yields and appreciation rather than speculative profits and, (5) defensive-type securities or even cash can be maintained when deemed advisable.[1]

To close the argument and counterargument, it is admitted that predictions as to economic future and results cannot be guaranteed. There is enough indicated merit in the variable annuity to allow the public to make the choice. Investment tastes and insurance diet need not be and are not identical. Some like income while others like growth, just as some choose term and others endowment policies.

Ibid., p. 769.

CHAPTER 6

TAXES

The individual variable annuity policyholder is not personally taxed on any increment in the value of his annuity until he actually receives it. Therefore, the policyholder may defer individual income taxes on the accumulation of his retirement funds from his working years to his retirement years. At that time, the increment is taxed as ordinary income, as the case of conventional annuities. This advantage of deferring taxes is lost if the policyholder surrenders his policy for cash. Any increment realized by the surrender of the policy is taxed at ordinary income tax rates (rather than the lower capital gains tax rate) but the policyholder may reduce the impact on his tax bracket by spreading the gain over three years.

CHAPTER 7

THE INSURANCE FEATURES OF THE VARIABLE ANNUITY

Since variable annuities may seem similar to mutual fund shares, it is necessary to distinguish between the two. Because the life annuitant, under a variable annuity, is guaranteed payment of a certain number of annuity units for life, he receives assurance that he will not outlive his income. The basic insurance aspect of the variable annuity differentiates it fundamentally from mutual funds shares, for although leading mutual funds have established systematic accumulation and withdrawal plans which create an appearance of insurance, they provide no guarantee or insurance element at all.

The variable annuity has several other insurance features. They are: (a) the policyholder may designate beneficiaries and excercise settlement options for them, (b) he may receive limited protection from his creditors, and (c) the variable annuity company may waive premium payments if the policyholder becomes disabled and unable to make these payments.[1]

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[1]Op. Cit., Harold A. Dulan and O. Lee Bodenhamer, p. 136.

CHAPTER 7

CONCLUSION

The variable annuity is a life insurance annuity policy which provides life income for retirement purposes and under which the policyholder's funds tend to vary, both as to dollar income and as to market value, because they are invested partly or entirely in common stocks or other equities. It provides at least a partial answer to the problems that arise because of continuing inflation. Many of these problems have not been met by the use of the fixed annuity.

While "fixed" and "variable" annuities have some similarities they also have their differences. The essential difference is that under the fixed income annuity the periodic payments are stated as an exact or guaranteed number of dollars; under the variable annuity, the number of units of income to be paid is fixed and guaranteed but not the dollar value of the units. Thus, under the variable annuity the number of dollars received each period will vary but the number of units received will not. The variance occurs because the premiums from the former will have been invested in common stocks and other equities while the premiums from the latter will have been invested in debt securities such as bonds and mortgages with fixed yields and values.

With the continued increase in longevity and inflation it has become almost impossible for those who have retired on a fixed income to continue to live in the manner to which they have become accustomed. The variable annuity, which tends to stablize purchasing power, can help to correct this problem.

The variable annuity, though new and controversial, is not an untried experiment. The College Retirement Equities Fund (CREF) was organized in 1952 as a companion organization to the Teachers Insurance and Annuity Association (TIAA) to provide variable annuities as a part of their retirement plan. Approximately 90 per cent of the teachers eligible have participated. Many large employers are also using the variable annuity principle in connection with their pension plans.

While the variable annuity is not yet in wide spread use, it would appear that is should be made more readily available to the American public.

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