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A Little Annuity History

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It all began with Caesar. Although both the Babylonians and Egyptians had contracts guaranteeing periodic payments, the first true annuities were Roman. As a sign of fidelity spoils of war were given to the Roman Emperor who was then supposed to give most of it back to the soldiers that earned it. However, the Emperor changed this by only giving half of the booty back to the soldiers, and giving the other half to the army *signiferi* with the understanding that this money would be used to provide a pension for the soldier upon retirement. No interest was earned on this mandatory pension plan, but it did provide an income for life and is viewed as the first annuity.

In the 700s the Catholic Church began issuing life annuities whereby a life income would be paid for large contributions. Beginning in Germany in the 1200s landowners would solicit money and promise to pay an income for as long as the lender lived – some of these "life rents" could be passed along to heirs so the annuity was essentially forever. Also around this time merchant gilds began selling true private annuities and competing with the church. Unlike early church annuities these private annuities were often age-weighted, meaning older people got a higher annual income than younger people (and a higher income than the church paid).

The Catholic Church also offered a type of variable annuity based on *societas sacri officii*. These were church offices sold by the Pope that had the authority to do business on behalf of the church. These offices could be very profitable and thus very expensive to purchase, so office seekers would form syndicates and offer people life annuities for their contribution. Many of these paid out a portion of the income received by the church office, so that the income stream was variable.

Annuity transactions did not always run smoothly. In 1308 a French Archbishop paid the Abbey of Paris 2400 *livres* in exchange for a life annuity of 400 *livres* a year. The Abbey accepted, apparently believing the Archbishop was in poor health. Fifteen years later, with the Archbishop still alive, the Abbey sued to have the contract stopped claiming so much had been paid out that the annuity was "usurious." The court refused to hear the case and the Archbishop collected a total of 7600 *livres* before he died in 1327 earning an effective annual return of 15.6%.

Annuities were used as a way to get around the religious bans against usury – the charging of interest. This concern began to fade as governments began borrowing money and paying out amounts that looked amazingly similar to interest payments. The first government borrower was Venice in the 1100s, but by the 1500s many countries, and the Catholic Church, took money from individuals, paid interest on the money, and occasionally were set up to pay back the principal at a later date, but so that these wouldn't technically be loans and subject to accusations of usury, the interest paid was never referred to as interest but as "rents."

Even as usury became less of an issue, some governments increasingly offered life annuities to fund operations because they felt they were less expensive than issuing bonds. In the 1690s England authorized the issuance of a million pounds (roughly equal to $500 million today) of life annuities at a payout rate of 14%. France and Holland were also big issuers of annuities to fund government expenses.

One of the problems with determining how large the life annuity payment should be is there was little data on how long people lived. Emilius Macer created an early life expectancy chart, but it was vague and largely incorrect. However, in 211 A. D. the Roman scientist Domitius Ulpianus created the first mortality tables and may be rightfully considered the first modern actuary. After the empire fell the Catholic Church ignored age and simply paid the same amount regardless of age.

In 1693 Edmund Halley of comet fame published an actuarially table based on actual mortality experience. In 1725 Abraham de Moivre published a tract on annuity valuation taking another educated look at the matter. After this, better records were kept on mortality and more accurate actuarial tables were developed by the middle of the 18th century.

Friendly societies were formed in the 1700s for the purpose of collecting voluntary subscriptions (premiums) from members that paid out either a future annuity income or death benefit. As these societies grew professional managers were hired, and the collection of premiums and payouts of life annuities and death benefits became a business. The Equitable Society in England, formed in 1756, was the first modern life insurance company.

In 1759, and for a decade thereafter, New Jersey, New York and Pennsylvania chartered church corporations that provided a type of annuity benefit to “distressed ministers and their widows” but these were more charities than real insurance companies. The first true U.S. insurance company was chartered in Pennsylvania in 1794, but soon went out of business. However, in 1809 a domestic venture began called the Pennsylvania Company that did stay around. It was followed by New York Life in 1830 and New England Mutual Life in 1835 – thirty years later there were 110 life insurance and annuity companies in the U.S.

Annuity growth was slow in America. In 1910 annuity premiums totaled only $6 million, and were only $11 million by 1920. These were single premium annuities; the first flexible premium deferred annuity was marketed in 1921. However, by 1930 annuity premiums had increased almost tenfold to $108 million. By 1932 they doubled to over $200 million, and by 1939 annuity premiums were almost $400 million and represented more than 10% of all life/annuity sales.

Why the explosion of annuity sales in the 1930s? In their seminal annuity study published in 1944 Dickinson & Elliott summed it up simply by saying, “in the period of financial stress of the early 1930’s, many people turned to annuities as a safe form of investment.”

As the number of companies providing pension plans grew in number in the ‘50s and ‘60s so too did the purchase of group life annuities to fund the payout. Individual annuity sales also grew, albeit slowly. Deferred annuity sales began to take off in the mid '70s as Wall Street brokerage firms began offering high interest paying annuities and variable annuities become widely available. Annuity sales reached $22.5 billion by 1980, but were still viewed as a sideline by the insurance industry. Indeed, it was not until 1980 that *Best's Review* finally published an article dedicated exclusively to annuities

The start of the '80s had some prophesizing the death of annuities. The first blow was when the tax law changed requiring annuity withdrawals to be first taxed as interest instead of principal, thus ending the availability of early tax-free withdrawals. Then interest rates plummeted making other financial vehicles appear more attractive. Finally, the bankruptcy of Baldwin-United in 1983 cast doubt as to the safety of annuities – it should be noted that when it was all over not only did every Baldwin-United annuityowner get all of their principal back, but earned yields of 4%-7%

The 1990s were a time of innovation. Variable annuities began offering more flexibility, more investment choices and more benefits that emphasized the insurance side of this product. Fixed carriers competed more directly with banks by expanding the availability of multiple year annuities that matched interest rate guarantees with surrender period length, and in 1995 index annuities were introduced allowing consumers to realize the protection of a fixed annuity and benefit from increases in an equity index.

As the new millennium got under way annuities began offering a broad array of living benefits, once again placing the annuity focus on providing a secure income. Deferred annuity sales took off and by 2008 U.S. annuity sales were around a quarter trillion dollars a year. A long and successful run for a financial instrument created 2000 years ago.

A Little Annuity Regulatory History

Since the banking and securities industries are substantially controlled by the Feds, how did the states manage to retain control of the third leg of the triumvirate?

Massachusetts had the 1st Insurance Dept

The first state laws designed to regulate insurance were passed by Massachusetts in 1799, and in 1852 Massachusetts created the first insurance department. Due to a history of insurance company failures during the various panics of the early 19th century there was a call for federal regulation of insurance, but Congress failed to act. The issue was forced in an 1868 case, Paul v Virginia in which Paul argued that insurance was interstate commerce and fell under the commerce clause of the Constitution. However, the Supreme Court disagreed and left insurance regulation at the state level.

The states realized that coordination between the states was needed, and so on 24 May 1871 the first meeting of the National Convention of Insurance Commissioners was held. In 1936 the name was changed to the National Association of Insurance Commissioners (NAIC).

The Depression resulted in increased federal oversight of financial markets. The FDIC was formed, the Securities & Exchange Commission was created, and many other rules were imposed adding a distinct federal nature to the economy. In 1944 the Supreme Court once again heard a case, U.S. v South-Eastern Underwriters Association, asking for federal oversight of insurance, and this time the court agreed saying insurance regulation was a federal matter. However, before the decision could be implemented Congress passed the McCarran-Ferguson Act and this is where it sits today.

The voluntary nature of the NAIC changed. The first paid NAIC staff members were hired in 1947 and given an annual budget of $25,000. Offices moved from Raleigh to Chicago to Milwaukee, until finally moving to Kansas City in 1984.

New York created the first insurance guaranty fund

In 1941 New York created the first life insurance guaranty association; no one followed for 30 years. Why was there state opposition to guaranty plans? Some felt a guaranty plan rewarded incompetent management meaning well-run carriers would pay for the mistakes of the bad ones. Others felt regulators would be less thorough in examining the books of carriers if they knew policyholders would always be protected.

By 1983 only 35 states had life/health guaranty funds and then Ballwin-United failed putting 300,000 policyholders at risk. A few years later when it became apparent Executive Life was going to crash California finally created their own guaranty fund in 1990. By 1992 all states had guaranty funds.

In 1983 the state guaranty associations founded the National Organization of Life and Health Insurance Guaranty Associations. If the insolvency affects three or more states NOHLGA coordinates the development of a plan to protect policyholders. NOHLGA states "every holder of a covered life insurance, annuity, or non-cancelable health insurance policy who has made the required premium payments has been given the opportunity to have the policy assumed by another healthy carrier or had the covered portions of their policies fulfilled by their guaranty association itself."

Both state and federal advocates agree that the current regulatory model needs to change. Insurers need to be able to price based on policy economics and unhindered by price controls, but regulators need to determine that all consumers are treated fairly. The states are making progress, but only time will tell whether this progress is sufficient to avoid a federal takeover.

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