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EQUITY-ORIENTED PRODUCTS

I. What are the arguments for and against a company's entering the variable annuities or mutual funds field?
   A. What are the relative merits of mutual funds vs. variable annuities from the insurance company's viewpoint? from the contractholder's viewpoint?
   B. What are the relative merits of mutual funds vs. variable annuities from the viewpoint of federal and state taxation? Under nonqualified variable annuities, should a reserve for tax liability on unrealized capital gains be set up and, if so, at what rate?
   C. What are the advantages and disadvantages of the use of subsidiary organizations for the management and marketing of variable annuities?

MR. RAYMOND L. CRAPO: There are several arguments against such entry.

1. *Decisions.*—While any new product line requires a number of decisions, the equity field seems to offer an abundance of alternatives. As a result there will be a number of major decisions, each of which may have a substantial impact on the resulting operation, its effectiveness, and its profitability.

Perhaps it is the challenge of making these decisions and working with the result that makes equity products so exciting to those who have become involved.

2. *Federal regulations.*—The next and most obvious disadvantage of equity products is the involvement with the federal government.

a) An investment company must be registered under the Investment Company Act of 1940. This means filing for public reference certain details of the investment company and its activities. The 1940 Act places restrictions on the management of the investment company and its dealings with associated or affiliated persons. The administration of an investment company and the marketing of the securities it issues must be covered by a written contract meeting the requirements of the Act, and these contracts also must be filed. The Act places restrictions on the investment practices of the investment company, and the assets of the investment company must be held in custody by a national bank. The 1940 Act also places limitations on the pricing of the security—as to level, format, and flexibility.

b) The security offered must be registered under the Securities Act of 1933. This means the publication through a prospectus of much of the information filed under the 1940 Act and to a certain extent places more responsibility on management for disclosure of its activities.

c) The salesmen must be licensed under the Securities Act of 1934. While life insurance companies have long been considered responsible for the actions of their agents, there appears to be a stronger legal basis for that responsibility in the case of securities salesmen. The 1934 Act requires record-keeping and -reporting of a quite different nature than life companies are accustomed to.

3. *NASD.*—The possibility of dealing with an industry-wide organization for policing the activities of salesmen may be considered by some a disadvantage. If that organization is controlled by members of a competing industry, it must be considered a disadvantage.

4. *Start-up expenses.*—While they are less for a mutual fund than for a variable annuity separate account, start-up expenses are substantial.

There are also several arguments for such entry.

1. *Demand.*—Having become aware that guaranteed fixed dollars do not necessarily mean guaranteed purchasing power, the public has turned increasingly to equity-type investments.

There seems to be a distinct trend away from life insurance as a savings vehicle toward anything that represents a direct share in the American economy—but more than that, a piece of the action, a chance to swing a little.

2. *Increased earnings for sales personnel.*—The salesman will have a broader portfolio and will as a result make more sales. While the additional complexities may work a hardship on the marginal salesman, the additional product should help retain better agents and can be used as a tool for upgrading the entire agency force.

3. *General upgrading of entire operation.*—A brief check of life companies which have been offering tie-in sales for five years or more produced an amazingly similar comment. While the financial return in terms of additional sales was disappointing, there was an obvious upgrading of the agency force, the clientele, and the average amount of cash value insurance being sold. In addition, there was an increasing enthusiasm among home-office personnel for new ideas and new products.

4. *Defensive measure.*—While it is nice to be on the band wagon with the winner, more important to the individual life insurance company is the consequence of remaining a pure life insurance company. Can such a company continue to meet its goals in the face of increased competition from companies which have broader financial services available?

With regard to mutual funds vs. variable annuities, first let us discuss the relative merits as they affect the life companies.

1. *State regulation.*—Mutual funds are not insurance, and therefore there are no insurance department problems. While blue-sky laws are

involved, the more standardized products and procedures of the mutual fund make these laws easier to adapt to. On the other hand, variable annuities are new to many insurance departments. The laws themselves are relatively new, and we do not yet have a model. Regulations are even newer, and many states are currently in the throes of establishing regulations. Variable annuities may also involve blue-sky registration in a handful of states. The blue-sky registration is a copy of federal filing. Agents' licensing is another problem involving additional examinations.

2. *Federal regulation.*—Regulation and administrative procedures have been clearly established for mutual funds. For variable annuities they are still in the experimental stage.

3. *Where sold.*—Mutual funds may be sold in all states, at least as far as voluntary plans are concerned. Contractual plans may be sold in almost every state, the most notable exception being California.

Variable annuities may now be sold in a substantial number of states, and the number of states permitting group but not individual variable contracts is diminishing. However, variable annuity laws are notable for their lack of uniformity. Ian Rolland indicated to me that the Lincoln tax-sheltered, group variable annuity contract is approved in forty-three states, the qualified plan individual contract in thirty-five states, and other individual contracts in thirty states.

4. *Public acceptance.*—Mutual funds are much better known to the investing public, especially in the Northeast and on the West Coast. However, acceptance in other parts of the country might be more easily developed by the life industry with an equity-based life product.

5. *Track record.*—An investment history (track record) is quite important when it is noted that projections are not permitted. This has been made more painful by the recent ban on hypothetical projections for variable annuities.

To get a track record, a life company will have to acquire, or at least become associated with, an existing fund. The shortage of available funds has made acquisition expensive. There are few real advantages in the selling of someone else's fund.

On the other hand, very few variable annuity companies have a track record; therefore, life companies selling variable annuities are going to be competing on the basis of reputation rather than of investment history, and a new separate account is not so much of a burden. Also, a separate account registered as a unit investment trust offers the possibility of starting with a track record and still sharing in the profitability of variable annuities.

6. *Product design.*—Mutual funds are relatively standardized. The

major differences are between voluntary and contractual plans, although some identity may be achieved with specialized withdrawal plans.

Variable annuities are usually personalized. Life company managements have different opinions as to the principal purposes of having variable annuities in their portfolios and how they should fit in. Simply copying what someone else has done does not work too well.

7. *Investment objectives.*—Different separate accounts for qualified and nonqualified contracts may be considered desirable or even necessary, and such separate accounts may have different investment objectives. However, it appears neither easy nor practical to offer a choice of investment policies with variable annuities while multiple mutual funds with different investment objectives seem to be common in the industry.

8. *Taxability.*—Since mutual funds pass on income and realized gains to shareholders, either in cash or additional shares, any tax due is paid by the shareholder. However, realized gains on separate account assets which do not represent reserves for qualified plans are currently taxable to life insurance companies, and the net after tax result is taxed once again when received as income by the variable annuitant.

9. *Availability of personnel.*—Up to the present mutual funds had an advantage because of the existence of trained sales and management people. The demand has cut into this availability. At one time there were no available variable annuity personnel, but several major companies are now correcting this situation.

An important consideration, however, is the fact that the separate organizations necessary for the sale of mutual funds make it easier to obtain the type of personnel required to make such an operation go. Compensation need not be directly comparable in amount or type with that available in the life company home office.

10. *Profitability to life insurance company.*—Sales charges are not a likely source of profit in either case. Administrative loadings are usually for specific functions, such as custodian fees and premium accounting, and are not a direct source of profit. (An exception to this rule is the level load variable annuity commonly offered for tax-sheltered annuities and qualified plans. Loadings will exceed costs once acquisition costs are amortized, and, of course, good persistency will improve this source.)

The management and risk charges are the primary source of profit. Life insurance companies will likely be disappointed in the profit level of $\frac{1}{4}$ per cent on assets available from a mutual fund compared to 1 per cent or more on life insurance reserves. The risk charge on variable annuities, however, is a source of profit and, in the final analysis, probably the major direct source of profit in equity products.

Indications are that individual variable annuities offer to the issuing company a profit potential at least as attractive as high-quality ordinary life business, while mutual funds offer mainly subsidiary values to the life company. Actually, because the ratio of reserves to premium is higher for variable annuities than it is for ordinary life and the average premium per sale is substantially higher, the potential profitability per sale is substantially greater for variable annuities than it is for ordinary life.

Now let us consider the relative merits as viewed by the buyer.

1. *Investment objectives.*—The previously mentioned choice of investment objectives of the fund itself is a consideration to the buyer. The buyer can take a choice between income, growth, and go-go funds.

With mutual funds the buyer has in and out privileges and can speculate with the fund itself. He is taxed on income now, and realized appreciation is treated as capital gain for tax purposes.

Variable annuities provide a retirement vehicle with tax-free (almost) buildup and the annuity rule on the payout.

2. *Relative costs.*—

a) Premium taxes. There are no premium taxes applicable to mutual funds, but variable annuities will be subject to tax in some or all states, depending on the state of domicile of the issuing company. However, in at least one state the intangible tax on mutual funds is a partial offset to this difference.

b) Administrative costs. For mutual fund voluntary plans there is usually no direct administrative charge, although the fund is usually charged directly for certain organization, legal, and administrative expenses which the life insurance companies normally pay out of their general accounts.

Mutual fund contractual plans usually charge as much as 3 per cent for administrative expenses, primarily for the custodian of the securities of the trust, and in addition the underlying fund will be charged with its own custodial expenses.

Variable annuities commonly include an administrative charge of 1.5–3.0 per cent of purchase payments for the death benefit, premium accounting, and certain other expenses. It seems to be common practice to charge any premium taxes separately, and at least one state will likely require this if they ever adopt workable regulations.

c) Management fee and risk charge. The most common management fee for mutual funds is 0.5 per cent, and, as mentioned previously, certain expenses are paid by the fund over and above this 0.5 per cent. Total expenses may run as high as the legal maximum of 1 per cent of the fund each year. Typically, life companies are charging $\frac{1}{3}$ to $\frac{1}{2}$ per cent for investment management and $\frac{3}{4}$ to 1 per cent as a risk charge. Since the sponsor of a separate account will pay certain expenses out of its general account that a mutual fund pays directly, the advantage to the buyer will depend upon his objective and the reasonableness of the risk charge.

MR. IAN M. ROLLAND: Under nonqualified variable annuities, the insurance company must pay a tax on realized capital gains. This tax will be paid at the corporate rate, which currently is 25 per cent plus the 10 per cent surcharge. Whether or not a company establishes a liability for this tax in connection with unrealized capital gains depends upon the assessment made against variable annuity contractholders for this tax. Most companies deduct the amount of the tax paid on realized gains from the assets of the variable annuity fund; thus the tax is passed along to variable annuity contractholders. Several companies, however, make a charge periodically to contractholders for taxes and in turn guarantee to pay all taxes resulting from the investment experience of the variable annuity fund. In this latter situation, there is probably no need for a company to establish a tax liability in connection with unrealized capital gains. Where taxes are assessed against contractholders, however, equity between the contractholders can best be achieved only by establishing a reserve for taxes on the unrealized gains. In fact, at least one public accounting firm has taken the position that this reserve must be set up in order for the financial statements of the variable annuity fund to conform with accepted accounting practice. Thus, each contractholder will be assessed for taxes on capital gains while he is a participant in the variable annuity fund. New entrants into the fund will not be buying into substantial tax liabilities on the accumulated unrealized capital gains.

The establishment of this tax reserve is consistent with the idea that the variable annuity is a long-term investment contract. In the absence of the reserve, contractholders could participate in a variable annuity contract for a short period of time and then withdraw without paying the tax which would pertain to the unrealized gains experienced during their participation. Because of this, contractholders remaining over a long period of time would be penalized. The establishment of the reserve will avoid this problem and assure that each participant will pay his fair share of the tax. In addition, the establishment of a tax reserve will make future investment decisions easier. If a reserve exists, the tax situation will not be important in deciding whether to sell securities at some point of time in the future. If the reserve does not exist, variable annuity fund managers might be reluctant to realize substantial amounts of capital gains.

It is entirely logical that the liability for taxes should be maintained in the variable annuity fund; participants in the fund will then receive investment income on the amount of the tax liability. This creates a somewhat leveraged fund and gives some advantage to participants entering the fund after a substantial liability has been established. New participants will be earning investment income on tax assessments made against participants previously in the fund.

There is a reasonable argument for the fact that the liability should be established without regard to the 10 per cent surcharge now in effect. Hopefully, the surcharge is a temporary tax, and it will probably not be in effect when many of the unrealized gains now accumulating will be realized and taxed. For this reason, the reserve should be established on the basis of a 25 per cent tax rate.

Whether or not to use a subsidiary organization for the offering of variable annuities is a very basic question which must be answered by any company contemplating entrance into the variable annuity market. This question takes on extreme importance if a company contemplates the issue of variable annuities, which requires registration under the various federal securities laws. The use of a subsidiary either as the company containing the separate account or as the selling organization offers several advantages in the event that securities law registration is involved. The main advantage of using a subsidiary is that the area of SEC jurisdiction is more clearly defined. The parent of the subsidiary would not be directly involved in registration under the federal securities laws. Another advantage of a subsidiary is that expenses of auditing would be less for a subsidiary than they would be for a larger parent. The SEC has ruled that audited financial statements will be required from the insurance company offering the variable annuity contracts.

In spite of the obvious advantages of operating through a subsidiary company, many companies now entering the variable annuity business are doing so without the use of subsidiary organizations. State-level problems created by the use of subsidiary companies are primarily responsible for these decisions. Several states require a foreign company to operate in its state of domicile for a period of two or three years before they will issue a company license. These seasoning requirements could prevent a company from having access to very important markets for variable annuity contracts. Other states have established surplus and/or asset requirements which might be difficult or impossible for a small subsidiary to satisfy. (Until recently, California required $16 million of surplus or $250 million in assets.) Difficulties arising from these state-level requirements can be entirely avoided by doing business through a company which is already admitted.

Another disadvantage of the subsidiary company lies in the area of expenses. Legal fees and other expenses involved with establishing a new company, as well as the added operating expenses, may be avoided by doing the business through an established company. Operation through an affiliate organization will also create problems in the agency area. It will be necessary to license the parent company's sales force as agents of the affiliate in order to sell variable annuities. Administrative difficulties would arise in the entering of convention credits, agents' club credits, and pension plan credits. It would be very difficult for an agent to understand why variable annuity sales in the subsidiary company could not be used in qualifying for convention and pension credits in the parent company. Finally, there might be sales advantages in offering the variable annuity through a company with an established identity or competition in the minds of the public. These sales advantages, however, could be minimized by closely identifying the affiliate with the parent by means of its corporate name.

MR. J. REUBEN RIGEL: Some tax calculations done at our company indicate that a tax savings would result from the formation of a subsidiary for all annuity business. It would be effected by placing the highest-yielding investments in the subsidiary company.

II. What changes in sales methods may result in the light of the peculiar nature of equity products, SEC regulation, licensing requirements, and mutual fund competition?

A. How are the conflicts among the salesmen-compensation pattern of the mutual funds, the SEC-proposed limitations on sales loading, and traditional compensation patterns on fixed-dollar annuities likely to be resolved?

B. How persistent will equity-type contract business be, especially in periods of poor market performance? Will sales be highly volatile?

C. Will there be problems in the replacement of existing life insurance contracts where there are tie-in sales of life insurance and mutual funds? Will term insurance gain to the detriment of permanent insurance? What lapse rates may be expected on the life insurance involved in such tie-in sales?

MR. IAN M. ROLLAND: Changes in sales methods for the variable annuity in contrast with other life insurance products will result primarily because of SEC regulation. The idea of delivering a prospectus, which describes on its cover the charges under the annuity contract, will be very difficult for many life insurance agents to accept. Life insurance agents have not been accustomed to discussing the charges for expense and mortality guarantees under their conventional fixed-dollar annuities. The fact that these charges are now shown in great detail to the prospective purchaser will change greatly the agent's approach to the sale.

SEC regulations with respect to direct-mail solicitations will affect sales methods greatly. In the past, life insurance agents have felt very free to draft direct-mail letters on their own and to distribute them to a large number of clients. In these letters the agent could expound upon the merits of his life insurance product. He will not find it easy in the sale of variable annuities to leave the drafting of direct-mail letters to the company's home-office staff. In many cases he will find that direct-mail letters covering variable annuities, in contrast to those he is accustomed to using for life insurance, will have very little sales appeal. Another problem that arises in connection with direct mailing is the need to enclose a prospectus. This increases greatly the mailing costs and casts some doubt upon the desirability of extensive direct-mail campaigns.

Another significant change in sales methods will result from the recent SEC ruling prohibiting the use of projections in connection with variable annuity sales. It will be very difficult for agents to offer the variable annuity, since they will have no means of informing their clients of the amount of income they might expect when the annuity payments commence. Agents have included such projections as an integral part of the sale of fixed-dollar annuities and life insurance. The avoidance of the use of these projections with variable annuities will be very difficult and will hinder greatly the agent's ability to sell the product.

Mutual fund competition affects sales methods under the variable annuity because it tends to make our agents view the variable annuity as an investment contract rather than an insurance contract. They may attempt to compete with mutual funds on the basis of the loadings in the contract without pointing out that the variable annuity contains several features not available under mutual funds. In selling fixed-dollar annuities, agents did not discuss the loadings in the fixed annuity contract but dwelt instead upon the benefits to be received. Mutual fund competition has resulted in more discussion of the expense charges.

The current limitations in the Investment Company Act of 1940 on the charges for sales expenses in a variable annuity contract and the proposed amendments to the Act prohibiting front-end load contracts have resulted in compensation patterns on variable annuities being quite different from fixed annuities. The compensation patterns on variable annuities may require companies to provide lower first-year commissions but higher renewal commissions than are currently offered under fixed annuities. In the absence of a front-end load contract, a company cannot offer first-year commissions of the magnitude available under fixed annuities. The 20–25 per cent first-year commission under an individual fixed annuity probably cannot be tolerated by a company offering a level load variable annuity. First-year commissions of a little over 10 per cent can be allowed. To compensate for these lower first-year commissions, it is likely that companies will pay higher renewal commissions and service fees than are available currently under fixed annuities.

Under group variable annuities, there is no uniform pattern of commission payments. One company has adopted a commission scale under which only first-year commissions are paid. Other companies have chosen a level commission scale, while still others have attempted to conform more closely to the traditional group annuity patterns of a higher first-year commission. At least one company offers a choice between a level commission scale and a scale with an increased first-year but lower renewal commissions.

MR. RAYMOND L. CRAPO: Traditionally, sales of mutual fund voluntary plans have tended to drop off when the market drops, and redemptions tend to increase at the same time. The small investor tends to panic and sell when the market slides and re-enter the market when it recovers.

At VALIC, market fluctuations appeared to have no effect on persistency or sales for either individual or tax-sheltered annuities.

As for tie-in sales, the sampling of results of companies offering tie-in sales indicates that persistency seems to be approximately the same as it is for regular business. Surrenders tend to occur at high points rather than low points in the market, and sales do not seem to vary with the market level.

It should be remembered that tie-in sales are not the same as package sales. A tie-in sale is typically a combined sale of mutual funds and ordinary life, with a single payment check, but each element can be independent. That is, either element may be canceled while the other is continued. Thus an agent may use the combination as a door-opener but is not faced with the necessity of twisting if the prospect insists he has all he can afford of one element or the other. In contrast, the package sale is a fully registered combination of life insurance and mutual funds, which are inseparable, and the agent may well be tempted to twist in the face of such an argument.

It occurs to me that seeing tie-in sales go contrary to the mutual fund trend indicates that a different sales technique has been used. Perhaps more emphasis on the long-term values of cash-value life insurance plus the flexibility the agent has with tie-in sales, as opposed to package sales, results in better persistency.

MR. HAROLD G. INGRAHAM, JR.: For some years, certain entities have been marketing mutual fund shares to customers on a basis whereby a portion thereof are hypothecated and the proceeds provided from such loans are used to pay premiums on a life insurance policy. The SEC requires that the entire package must be registered with them.

In Release 6851, dated July 17, 1962, the SEC announced the adoption of Rule 15c2-5 under the Securities Exchange Act of 1934. To quote from the release:

> Rule 15c2-5 makes it unlawful for any broker or dealer to offer, sell or attempt to induce the purchase of any security by any person if the broker or dealer, in connection therewith, offers to extend any credit to or to arrange any loan for such person, or participates in arranging any such loan or credit, *unless* before any part of the transaction is entered into, the broker or dealer delivers to him a written statement setting forth certain information about the specific arrangement being offered to him.

The release goes on to state that this would require particularized information which goes beyond the general information contained in the prospectus delivered to the customer. The customer would have to be informed of the following:

1. The specific charges he will incur in each period during which the loan may continue or be extended.
2. The risks and disadvantages which he will incur.
3. The commissions, and so forth, to be received by the broker or dealer and others participating in the transaction.

The broker or dealer must also comply with the usual suitability requirements. Then follows the requirement that appears to have been clearly violated in a number of recent situations that have come to our attention:

> If, in connection with the transaction, it is contemplated that the prospect will *cancel* existing life insurance, the written statement delivered to the prospect before the transaction is entered into would have to disclose the disadvantages, if any, which the prospect will incur because of this.

Among other things, this may require disclosure that (1) the premium on the new policy is higher than the premium on the old policy; (2) the purchaser may be incurring additional expense because he is reincurring acquisition costs; (3) it may take a specified additional period of time for the dividends or the cash value of the new policy to equal those under the old policy; and (4) suicide and incontestable provisions run anew on the new policy.

It is important to keep in mind that Rule 15c2-5 applies strictly to leverage schemes, where mutual fund shares are pledged as collateral to buy life insurance. Remember that Section 11(d)(1) of the 1934 Act and Regulation T essentially preclude "participations" by agent/registered representatives in arrangements to *borrow* money on insurance policies to buy mutual fund shares. However, in addition to possible violations of a state insurance department's replacement statutes, it appears that outright surrender of policies to buy mutual funds in conjunction with such leverage schemes can be policed—as far as the SEC is concerned—through Rule 15c2-5.

III. How might SEC regulation affect company operations?
   A. What is the status of the various task-force discussions concerning exemptions for insurance products from SEC regulations and the 1933, 1934, and 1940 acts?
   B. What is the status of state laws and regulations concerning variable annuities? What problems have been encountered? What is the status of the Joint ALC-LIAA Committee discussing these problems?

MR. RAYMOND L. CRAPO: Time will not permit a full discussion of this question. Before going on to the next item, however, there are two topics of current interest that should be included for the record.

Federal Reserve problem.—Two recent releases by the Federal Reserve System present a new problem to insurance companies entering the equity field. SEC staff is understandably concerned about these releases and their effect on insurance company equity filings.

Basically, these rulings make it clear that the officers, directors, and employees of banks which are members of the Federal Reserve System may not serve as officers, directors, or employees of insurance companies closely related to investment companies and their investment advisers or principal underwriters.

An important point in one ruling is the definition of "primarily engaged in securities transactions." While a variable annuity subsidiary (the subject of one ruling) is obviously primarily engaged in issuing securities, the 10 per cent limit implied in the other ruling is much more far-reaching. This latter ruling seems to indicate that if income from the issuance of securities can reasonably be expected to become 10 per cent of the life company's total income, the life company may be considered as "primarily engaged in securities transactions" and subject to the above prohibition.

Variable annuity dealers association.—Those of you who are interested in an alternate approach to SECO or NASD should read Mr. Robert Crichton's panel presentation at the recent ALC meeting in Chicago. The following is a summary of his remarks:

> By forming a separate securities association for self regulation and registering such association under Section 15A of the Securities Exchange Act of 1934, life insurance companies could market variable annuities and mutual funds through their own sales forces and NASD members, without being subjected to the many natural disadvantages of regulation through the National Association of Securities Dealers.
>
> There would seem to be no question but that a securities association composed of marketing organizations sponsored by life insurance companies could

meet the basic qualifications of registration under Section 15A(b) of the 1934 Act, namely, that it would involve a significant number of members, a significant volume of transactions and that the distribution of its equity products would be on an encompassing geographical basis. With most of the major life insurance companies entering into the equity field or having announced plans to do so, there is no question but that the life insurance industry will be one of the three major factors in the marketing of equity securities. Certainly a significant number of the present life insurance sales force of 415,000 will ultimately become involved in the marketing of equity products. So whether it be today or within a year or two, a separate securities association sponsored by the life insurance companies would most certainly be recognized by the SEC and qualify for registration under Section 15A of the 1934 Act.

There is no challenge to the worthiness or value of the Rules of Fair Practice of the NASD, many of which would be included within any rules that would be adopted by a separate securities association. The important consideration must be that the life insurance business, as significant as it is, should develop its own pattern of self regulation and place the control and management of such a securities association in the hands of individuals whose background and experience permit them to exercise judgment based upon knowledge of life insurance operations, and within the requirements of law.

From time to time there will be need for responses to change in regulation of the equity area suggested either by SEC or the Congress. The position of the life insurance business, from the standpoint of self regulation, can be far more responsive as a separate securities association than as a part of a self regulatory organization of the general securities business.

IV. What new products based on equity investments are being offered or considered?
   A. What is the reaction of state regulatory authorities to such new products?
   B. What special actuarial or administrative problems are involved in these new products?

MR. CHARLES T. P. GALLOWAY: I propose to discuss the development of life insurance policies involving an equity element that has taken place in Canada in recent years.

There are several factors which have made the development of experimental products with an equity element easier in Canada than it would have been in the United States. These are (1) the Canadian insurance statutes do not impose minimum nonforfeiture values, (2) there has in the past been no requirement that policy forms be filed and approved before new contracts can be issued, and (3) there is no problem of SEC regulation.

The types of policies being issued have been described in some detail at the spring meetings, particularly by Mr. Ellis at Philadelphia and by Mr. Thompson at Los Angeles, and they were also discussed at the equity products and individual insurance sessions at Milwaukee. I will summarize the general types of policies that exist.

The first is simply a regular participating policy with the dividends left with the company and invested in units of the company's equity fund. The idea is evidently to retain all the customary benefits of a regular fixed-dollar insurance policy and to introduce the excitement of equity investment into the policy for the part with which the policyholder can speculate without endangering the regular benefits.

The second type is a package "buy term and invest the difference" arrangement under which a stipulated part of the premium is used to purchase a level or reducing term policy and the balance is invested in equities. It would appear that these policies have been designed to compete directly with the mutual funds and their "plan completion insurance." The arrangement provides an equity hedge against inflation for the insured's retirement savings, but any alteration in the death benefit is incidental and due only to change in the savings fund being added to the fixed death benefit of the term policy.

The third type of policy—in this case the diversity is such that perhaps "types" would be a better term—is one that is very much like a regular insurance policy in external details but involves investment by the insurance company of part of the assets held to cover the reserve in its separate account. One of these policies that resembles the second type most closely includes a minimum guarantee of death benefit and maturity value expressed as multiples of the stipulated premium but the insured receives excess amounts accumulated by the equity investment of the funds. A second policy takes the form of a regular participating straight life or endowment policy with paid-up additions, but with an amount equal to half the medial reserve invested in the equity fund and the performance of the equity investments taken account of by adding a special "dividend" (which may be positive or negative) to the regular dividend before determining the paid-up addition (which may also be positive or negative). Another plan that is similar provides for various percentages of equity investment; it is basically nonparticipating but has "performance adjustments" which are handled in a similar fashion in that they are applied to purchase positive or negative paid-up additions. This policy also provides for a minimum guarantee of death benefit. Policies in this class are designed to relate all the benefits of the policy directly to equity investment, presumably as a hedge against inflation, although the effect is "damped" by the conversion into paid-up additions and the various guarantees involved.

There is one common feature in all the plans mentioned above: they provide for a stipulated premium that does not vary with performance and for which, therefore, the policyholder can budget, as he can for a regular life insurance policy. Apparently no one has seen fit to introduce a policy expressed entirely in units of its equity fund and to try to deal with the problem of billing varying amounts from year to year.

This problem would, of course, be less important with a deferred annuity policy, where varying contributions actually at the policyholder's option could be handled, and in fact would be useful for dealing with various types of annuities where tax relief is an important factor. Such a deferred annuity policy is being offered by one company.

It is quite evident that the provincial superintendents of insurance are going to take a considerably more active role in supervising equity-type products than they have previously taken with the regular guaranteed value policies issued heretofore. Reference was made by Mr. Ellis at Philadelphia to the amendment to the Alberta insurance act requiring filing of equity policies at least thirty days before issue and to the meeting of the superintendents in September of this year to draw up uniform regulations.

In September the superintendents met in Toronto, and their proposed regulations were presented at a public hearing and comments from the Canadian Life Insurance Association and the Life Underwriters Association were received. As a result of this meeting certain "interim" rules were prepared, which cover some of the areas which concern the SEC in the United States. It seems to me that they were concerned with three general principles and that the details of the rules are related to them:

1. The first is the danger that the policyholder would not appreciate the difference between an equity contract and a traditional guaranteed contract, with the result that he would be dissatisfied and the image of the insurance industry would be damaged. They also seemed to be concerned over the ability of the salesman to comprehend and explain the distinctions.
2. The second is the possibility that the policyholder might have a grossly exaggerated idea of the possible benefits under the contract.
3. The third is that they seemed to be concerned that the companies might levy excessive expense charges and/or obscure the magnitude of these expenses in the complications of the contract.

The first section of the rules defines a few terms which are used thereafter.

The second section of the rules requires, at least thirty days before issuing such contracts, the filing of (1) the policy form and (2) a copy of an information folder to be used in connection with the sale of the contract. It further requires a refiling of the information folder annually or at any time when a material change in any of the facts occurs.

The third section sets out certain required information to be included in the policy:

1. A statement in bold print warning that the contract includes benefits which are not guaranteed.
2. The contract must clearly distinguish between guaranteed and nonguaranteed benefits in describing them.
3. The percentage of premium or dollar amounts to be allocated to the separate fund must be quoted, or else the basis of these amounts.
4. The contract must state the times, at least monthly, when the fund is valued.
5. The contract must state the method of calculating the policyholder's interest in the fund, or the related benefits.
6. The contract must state the charges or methods of determining charges against the separate fund for taxes, management, and other expenses.

The fourth section requires that each prospective purchaser of an equity policy be supplied with a descriptive booklet and that the company receive from each applicant a written statement that he has received such a folder; it also sets out certain required information to be included in the folder. This information covers a description of the contract, including the information in rule 3; a description of the investment policy of the fund; a statement of the assets and securities in the fund at a date not more than forty-five days before filing of the folder; and a statement that the folder is *not* a document evidencing the contract.

The fifth rule deals with projections of future performance of the policy. It forbids the insurer or agent to make any "representation" as to the future values of the fund or related benefits and requires that any illustration of growth rates be reasonable, clearly stated, and accompanied by an explanation that the investment risk is related to the fluctuations in market value and at the risk of the assured. Study of just what is to be considered reasonable is now being undertaken by the Canadian Life Insurance Association.

The sixth rule requires an annual or more frequent statement to the insured showing (*a*) the amount allocated to the fund during the statement period, (*b*) the value of his interest or benefits at the statement date, and (*c*) a complete statement of the assets and securities of the fund.

The seventh rule exempts group variable life contracts from the filing requirements of rule 2 and the information-folder requirement of rule 4.

As well as establishing these rules, the superintendents apparently looked with favor upon the suggestion of the Life Underwriters Association that, in addition to the information folder prescribed by rule 4, the policyholder should be supplied with a standard proposal form showing the essential figures and provisions and that acknowledgement of such form be included in the policyholder's written statement. They also recommended that the agent be required to file a copy of the proposal with the application. I presume that this requirement is to inhibit the salesman from making a deliberately misleading presentation and to give the company an opportunity to prevent this from happening innocently by reviewing the forms. It would be interesting to see what effect this filed information might have on a dispute between a company and a disgruntled policyholder.

It is interesting to note that, whereas the policyholder is considered to be sufficiently unsophisticated that he must be protected by many precautionary measures, he is nevertheless considered to be able to absorb a large amount of technical information about the policy and to be a sophisticated investor who can analyze the investment policy and portfolio of the fund. I would have no objection to the requirement that the company have available information on its investment policy and portfolio of assets for use by sophisticated salesmen and prospects; in fact, that seems to be something it would want to do anyway. I doubt the wisdom, however, of forcing this information on every policyholder annually. There is good reason for having the terms of the contract carefully spelled out in it for expert interpretation in the event of a dispute, but I doubt if each policyholder can reasonably be expected to understand all the details.

Subsequent to this issuance of the above rules, we received an inquiry from one insurance superintendent about the training programs we had set up for our sales force. It will be interesting to see if this eventually results in some rules on equity-policy training in the licensing requirements.

Evidently the procedures required by the rules will create administrative problems for the companies. There are, however, some other problems which we have experienced with our own policy. One of the fundamental administrative problems with equity products is that the value of the equity portion of the policy cannot be determined until after the anniversary, since unit values cannot be predicted in advance, so that the customary lead-time procedures cannot be followed. We have planned to put a statement on the annual billing notice to the effect that such information will follow, and to send it out later.

There are problems connected with the annual-statement reporting for equity policies. The most convenient way to handle the more complicated policies probably is to treat the separate fund as a subfund of the general fund and to receive all premiums into the general fund, paying all expenses and benefits out of it. The accounting for the equity portion can then be dealt with by transfer items, which would be included in the summary of operations in a similar fashion to reserve increases but would in fact be actual cash payments made into the separate fund during the year. There is, of course, considerable extra work involved in calculating these transfers.

A number of problems came up in the design of the policy itself. We did not wish to administer policy loans with a fluctuating cash value, so we deleted the loan clause. In order to compensate for this in part, we put in a "conversion" clause permitting the policyholder to change at any time to a regular participating policy with a loan clause. Since our regular nonforfeiture provision provides for automatic premium loan, we had to change this; we included automatic reduced paid-up instead.

The policy provides for "interim" special dividends to be calculated for termination between policy anniversaries to reflect changes in market value since the last year end, so that there will be special calculations required in our surrender and claim procedures as well as when there is a default in premium.