TRANSACTIONS OF SOCIETY OF ACTUARIES
1969 VOL. 21 PT. 2 NO. 59 AB

PANEL DISCUSSION

EQUITY PRODUCTS

New York Regional Meeting

I. *The Actuary's Viewpoint*
   A. Why are companies entering the equity-products field at such a rapid rate?
   B. What is the role of the actuary in determining whether the company should enter the equity field? In planning actual entry into the field? In recommending and designing the products? In securing the necessary government approvals? In preparing the training materials? In developing marketing strategies?
   C. What will be the effect—five years hence and in the long-term future—on the sale of cash-value life insurance?

II. *The Agent's Viewpoint*
   A. What will the availability of equity products mean for the agent, in terms of new knowledge required, sales approaches, sales results, and earnings?
   B. How will the financial needs of the public best be served by the various types of organizations providing equity products for sale?
   C. What will be the effect—five years hence and in the long-term future—on the sale of cash-value life insurance?

III. *The Regulatory Authority Viewpoint*
   A. What are the general principles guiding the SEC in its regulation of life insurance companies seeking to enter the equities field?
   B. What are the regulatory requirements of which actuaries should be aware when recommending and designing equity products?
   C. Are there recommended courses of action for a company wishing to market equity products?

MR. THOMAS P. BOWLES, JR.: A company's entry into the equity-products field should be derived from sound business logic, as is true of its entry into any other product field. A product that can logically and properly be offered by a life insurance company should be sold only if it can be justified by sound market reasons. The life company can remain vigorous and grow only if it responds to changing market needs and desires.

The changing economic environment has created pressures, which in turn have altered both market needs and desires. The public is seeking a product, among others, which can assist it in its struggle to provide a reasonable hedge against inflation. The public also is alert to the need for a well-planned, balanced program of savings. The life company, the tra-

RUSHMORE MUTUAL LIF
LIBRARY

ditional purveyor of fixed-dollar savings generated as a by-product of its theoretically sound program of level premium permanent protection, now recognizes the public's demand for a vehicle for a balanced program of savings which shall include equity, or "unfixed," dollar savings, as well as guaranteed fixed dollars. The affluent society not only seeks a reasonable vehicle through which it can obtain a balance but also wants equity products in order to have "a piece of the action." The public is alert to the fact that a life insurance company has more to offer than the traditional two products—protection and savings. The life insurance company may be expected to render a broad range of financial service through a broad array of products. The equity-product market appears to create an opportunity for increasing the earnings of the company and for increasing the earnings of the agent. The company's decision to enter the equity-products field will be influenced by competitive pressures arising from two sources: (1) external pressures created by competing institutions, other than life companies, which are offering a broad range of financial products, including various forms of savings that are logical life insurance company products; and (2) internal pressures created within the industry by the entry of other life companies into the equity products field.

It would appear that the internal competitive pressure is the principal cause for the rapid rate of entry into the field. In some instances this pressure is so great that companies abandon caution and respond in a frantic manner as a result of the fear of losing market position and losing agency personnel to those companies which are aggressively moving into the field.

There are many problems that have already emerged in the wake of this hasty entry into the field. A company entering hastily usually has not taken the time required to orderly, soundly, and logically structure its response to changing market needs. This can lead to the choice of the wrong product for entry into the field. It can lead to faulty construction of the product itself. It can lead to an inadequate appraisal of market potential and an ineffective market strategy. The company may find itself with a product on the shelf but with a sales organization neither psychologically nor technically prepared to do an adequate job of selling the product. It takes time to reverse the "fixed dollar thinking" generated by many years of "brainwashing," and this reversal process can be traumatic. The company which is a "follower" instead of a "leader," a posture that may have some foundation in logic, can watch the others make the errors and commit the blunders. The company which cautiously studies its market thrust and carefully develops a market strategy can profit by the costly mistakes of others.

MR. EDWARD M. LUPEAN:* I believe that Tom's statement that a company may find itself with a sales organization that is neither psychologically nor technically prepared to do an adequate job of selling an equity product is 100 per cent correct. The insurance sales organizations are not ready for this product. As a group they are willing, but psychologically and technically they are wanting. The equity field is as new to the life insurance agent as the space field is to NASA. If my agency experience is any indication as to the acceptance of the equity product by the field agent, the industry can look forward to a slow two-year start-up period.

Insurance men have always operated on the fringe of the investment world, selling safety of principal, security, and peace of mind. They have performed exceedingly well selling the concept of money and fixed-dollar capital accumulation. The agents have been "brainwashed," as Tom indicated, and the insurance industry must be congratulated on its long-term achievement of indoctrinating agents in the concept of fixed-dollar guarantees. An example of the agents' psychological problem is that of breaking the traditional twenty-year net cost concept—a "ratebook concept" of profit in an insurance contract. To a degree, we are asking the experienced agent to give up this hallowed concept and to replace it with his bitter enemy—equity products and mutual funds. It is akin to asking a man to give up righteousness for sin before he has had an opportunity to try sin.

The psychological problem will slowly solve itself as the insurance industry accepts the concept of equity products and exposes its field force to the logic of an investment program which will include fixed dollars, such as insurance, and equity dollars, in the form of mutual funds and variable annuities.

On the technical side our problems are different. Prior to eighteen months ago, the average life agent was not a stock or a mutual fund buyer. He had no contact with the market, with its nomenclature or its product. In reality, the market was a competitor—a severe competitor.

When the words "funds" and" equities" finally became acceptable to our industry, we started to impart knowledge to skeptics. In our office, we found that it was relatively simple to pass either the SECO or NASD examination, which is required to obtain the necessary license or privilege to sell an equity product. We also found that, after the agent had passed the examination, he knew nothing about the product. His knowledge was purely superficial, and it was acquired for only one purpose—to pass the

* Mr. Lupean is a General Agent in Pittsburgh for New England Mutual Life Insurance Company.

test. We therefore had a knowledge-deficiency, which, in turn, created a self-confidence problem. Without self-confidence, a salesman develops a very complex case of call-reluctance, and call-reluctance does not produce sales.

As a general agent, I was delighted when the equity barrier was breached by the industry. It was my feeling that the insurance companies, with their vast amounts of capital, extremely capable management teams, and a proved field force, would swiftly step into the investment field and make unprecedented gains in equity sales. I found, however, that the situation is not what I had expected. Where I had expected capable management teams, I found inexperienced life insurance men being appointed to investment management positions. I found this burgeoning life insurance sales force continuing its normal sales pattern and drawing upon the equity product not as a new tool or device to implement sales but as a product it would sell if the client asked for it or insisted upon it. With few exceptions major life companies have endeavored to staff an equity-oriented company with personnel from an insurance-oriented company.

This has created an exceedingly weak management group who are unfamiliar with the product and its problems. These people are directing and guiding general agents and managers, who are totally unfamiliar with the product, in their training of a field force to whom the word "equity" is an anachronism. These insurance-fund management teams have maintained an insurance company's outlook, philosophy, and procedures in the competitive investment world.

I do not believe that you can operate an insurance company today without a computer, and I do not believe that you can run a mutual fund operation without capable personnel whose background has been geared to equities rather than the fixed-dollar concept. Insurance companies should hire experienced investment personnel, from order clerks to top management. This staff must initiate sound practices, provide meaningful training for the field force, and run the organization like an investment company and not like an insurance company. I do not mean that the two are not compatible, but investment-field practices and procedures are different, and, until such time as experience has been gained operating them side by side, I do not believe that they should be merged into confusion.

As a former educator I have not forgotten the theory that knowledge is power. Knowledge is power and confidence to the salesman, and it is not always acquired by hard work and application. Few salesmen are willing or psychologically oriented to hit the books for knowledge and infor-

mation. It must be spoon-fed by the general agents or managers and their supervisory staff to these aggressive, outgoing, front-line salesmen.

When the blind lead the blind, progress is bound to be slow. When an experienced investment salesman teaches or guides a successful life insurance saleman, there will be the same chemical reaction as a mixture of saltpeter, sulphur, and charcoal—an explosion.

The mix is ready, the gun is loaded, the primer is positioned, but the firing pin is stuck. The firing pin requires oiling with equity psychology, sales presentations, and technical information. When the pin is released, and it must be soon, it will be a momentous occasion.

MR. LAWRENCE J. LATTO:* There are regulatory requirements that are likely to prove troublesome. I may say, before I drag out the chamber of horrors, that we seem to be starting with the aspect of regulation that is usually given a position of secondary importance, but I am all in favor of doing it this way, because it may turn out to be the area that will absorb the most attention and create the most painful headaches.

Ordinarily we talk first about the Investment Company Act of 1940, since most of the equity products we are talking about will be issued by a company or a separate account that will be registered under that Act as an investment company. Product design, for reasons I hope to mention later, demands an understanding of the structure and objectives of this Act.

Next, attention is usually given to the problems of living under the Securities Act of 1933—which essentially calls for full disclosure of a kind and a degree quite unfamiliar to the insurance company industry. Only after the problems of complying with those acts have been met do people usually turn to the Securities Exchange Act of 1934—which, among other things, regulates the persons who sell securities and the manner in which they are sold. But, since we started at this end, let's stay there for a while.

First, as Mr. Lupean just pointed out, passing the securities examination needed to qualify an agent to sell equity products is the smallest part of the problem. He is concerned that agents must overcome their built-in bias in favor of fixed-dollar products. I am concerned that the agent must learn that the sales techniques he has been using for years, with the approval and assistance of his supervisors, are now not permissible. The literature that may be left with a prospect must be closely controlled. It must be more restrained and replete with hedging qualifications. Invest-

* Mr. Latto is a member of the law firm of Shea & Gardner, in Washington, D.C.

ment projections are out. Analyses based on someone else's past performance or market averages are very dangerous. In general, I think it fair to say that many approved approaches and practices, if applied without appreciable change to the sale of equity products, would result in both the agent and the company being guilty of misrepresentation and fraud.

There is no doubt that the SEC thinks that this will require supervision of selling representatives. The SEC imposes very stringent requirements upon a registered broker-dealer—and these products can be sold only by duly qualified employees of a registered broker-dealer—to provide adequate supervision of his salesmen. Meeting these requirements is hard enough when the men being supervised are full-time securities salesmen and have been trained from scratch. Where the salesmen will be devoting a relatively small percentage of their time to selling securities and starting out with bad habits that have to be unlearned, where the same man must be encouraged to continue his bad habits when wearing one hat and discontinue them when wearing another, there is a danger of ending up with a patient rather than an agent.

It is not necessary that this supervisory responsibility fall only on the insurance company. As I said, sales must be made only by a registered broker. The insurance company may register as such or may use a sales subsidiary or affiliate for this purpose. Agents, including full-time and part-time employees as well as general agents and their employees, will then sell as qualified representatives of the company that has registered. If, however, the insurance company prefers, general agents, for example, can be independently registered as broker-dealers; in that case the responsibility for supervision falls upon them, at least to the extent of sales in their area by persons subject to their control.

CHAIRMAN CHARLES M. STERNHELL: What should be the role of the actuary in determining whether or not it is feasible for his company to enter the equity-products field?

MR. BOWLES: There are both market and economic considerations. Marketing is concerned with whether the products will provide an adequate response to changing market needs and desires and, most importantly, with whether those products in fact can be successfully merchandised to the public. The economics relate to a determination of whether the company's product can produce an acceptable profit to the company and at the same time produce the desired increase in agents' earnings. The market considerations are principally those of the marketing people,

whereas the economic considerations heavily involve the concern of the actuary.

There are many disciplines that must be involved to do an adequate job of entry into the equity-product field—actuarial, legal, accounting, marketing, investment, administrative. The actuary, because of time limitations, usually confines his efforts to those areas that most logically relate to his skills. These involve the actual product design, in consultation with marketing people to appraise the market response, and the creating of a price structure which will accomplish the company's profit objectives while at the same time permitting agency to receive sufficient compensation for incentive to sell the product in the desired volume. The actuary should assist legal counsel in securing regulatory approvals. He should also review sales materials before they are submitted to NASD for its approval. The actuary should be involved in structuring the administrative systems to ensure that the requirements relating to the control of the fiscal aspects of the operation are adequately established and that the information necessary for the required reports to SEC and contractholders is available. The actuary should be intimately involved in the decisions on which equity route the company should follow initially, mutual funds or variable annuities. There are some rather basic marketing and economic considerations which should be explored before this decision is made.

MR. LATTO: Getting into the right state of mind at the outset may save hours of frustration. The first thing an actuary for a company that is thinking of offering a variable contract (assuming that we are talking now about a project with life contingencies and not a straight mutual fund) should do—if it is a product that does not escape SEC regulation—is to condition himself to the view that he is not designing an insurance product but, rather, a security that will be issued not by an insurance company but by an investment company. He may permit himself to believe that the security has some incidental insurance features, but that is as far as he can safely go.

If this attitude of mind is achieved, there will be less difficulty in establishing the necessary rapport with the SEC staff and with the securities lawyers who will be representing the company. We all know, of course, that this *is not* an accurate characterization of a variable product and that the famous Valic decision of the Supreme Court (which held that a variable annuity was a security and was subject to SEC regulation) did *not* hold that it was not also an insurance contract. The fact is, however, that the SEC staff considers these contracts first, second, third, and fourth to be investment company securities and only fifth an insurance contract.

CHAIRMAN STERNHELL: Suppose that we accept that point of view; where do we go for the necessary background about this area which is still foreign to most of us?

MR. LATTO: Let me list some required reading. SEC's public policy report—the full title is *Public Policy Implications of Investment Company Growth*—can be bought from the Government Printing Office. It is rough sledding and, like so much that comes out of the SEC, is written by lawyers. But it has a wealth of useful information on both the structure of investment companies, the significant legal prohibitions and requirements, and the way in which a conventional investment company business is conducted.

Then there are edited transcripts of conferences run by the American Bar Association, the Federal Bar Association, and Practicing Law Institute that will provide insights not available elsewhere. Then, of course, while many actuaries will want to bring original ideas to the design of new products, there are now dozens of registration statements on file on both the 1933 and 1940 acts, copies of which can be obtained from the SEC at modest cost. But, beware! This whole area is in a state of flux, and what was acceptable last month may be a violation of law today.

I suppose that virtually everyone is aware of the fact that the Securities Act of 1933 is not a regulatory statute at all, in the sense that it prohibits certain conduct or requires other conduct; it imposes primarily the obligation of full disclosure. So far as this is concerned, each company must decide for itself whether to try to make its prospectus an attractive and readable selling document or to turn out a prospectus that has all the necessary information in it but is not really intended to be particularly illuminating. If the latter course is chosen, supplementary sales literature may be used for the purpose of selling the product. The SEC staff encourages persons to make the effort to draft a readable prospectus, and some persons have succeeded better than others. The most common experience, however, is that the guidelines that must be followed, and the order of presentation that the staff demands, are such that the effort to produce an easily read piece of selling literature almost always fails.

The Investment Company Act of 1940, on the other hand, is a regulatory statute. After working with it for a while, it will seem less awesome than it first appears. The main difficulty is that this statute was drafted with a very specialized industry in mind—an industry made up of companies that had taken on a unique organizational structure. When the effort is made to apply the Act to companies with a very different struc-

ture, a great many of the provisions simply do not make much sense. This is particularly true when the investment company that must register is a separate account established by an insurance company. You will have to accept the fact that this separate account will have its own board of directors that is independently elected and has authority over the activities of the separate account, which is independent of and superior to the authority of the insurance company's board of directors. You will have to accept the fact that the separate account will be entering into formal written contracts with the insurance company. As a formal matter, the separate account, through its own board of directors, has the legal right to decide that it prefers not to have the investment department of the insurance company serve as its investment adviser and to choose instead some independent, outside organization. As a practical matter, however, this is not going to happen, and, before long, you will find this strange, two-headed animal a reasonably comfortable one to live with.

MR. BOWLES: The role of the actuary in marketing strategy should not be any different from his role in the marketing strategy of any other product. The basic objective of the company, with regard to its relationship to the public, is to construct a product which meets the needs of and appeals to the desires of the public and which can, at the same time, be effectively sold. Even though it is possible that a product can be sold even if it does not satisfy a need, hopefully the insurance company will concern itself with structuring products that do in fact satisfy those needs for which a product can be designed and successfully merchandised. There are some who believe that life companies engage in too little market research and marketing testing. An entry into the equity-product area should afford excellent opportunities for appropriate research. The actuary can make a significant contribution to the company's planning of the technique and strategy of marketing a specific product to a specific market.

MR. LUPEAN: In a sense, the sales concept in life insurance and that in funds are identical, in that, in order to make the sale, you must first ask for the order. The psychology of the sale is identical, but the words are different.

In the life insurance field we sell money payable upon the contingency of death, the attainment of a certain age, or at the end of a given number of years. We sell it under the concept of peace of mind, of meeting the

needs of one's family, for tax purposes, and, in some cases, as a forced savings plan for the purpose of capital creation.

The approach for a mutual fund or variable annuity is that of capital accumulation, money management, or annuity benefits. The best approach for fund sales that I have heard is based upon a single-premium withdrawal plan of $100,000. This approach is designed around the concept of capital, management, growth, and income. It touches all bases, and the final monetary results, in retrospect, are fantastic. Let me give you a few figures from one of the funds.

Let us assume that nine years and eight months ago you deposited $100,000 with the fund. You requested a monthly payment of 6 per cent of original principal, or $6,000 per year. As actuaries and mathematicians, this is an easy question for you: "If you had deposited $100,000 nine years and eight months ago, had received $6,000 a year or a total of $58,000 in income during that period, what dollar figure would you be willing to accept today in settlement of your investment?"

How many would be willing to accept $150,000? $200,000? $300,000? Is there anyone who would like more? Would you believe $337,065? That was the final result. It was not $100,000 that grew this way—it was $96,500 after the sales charge.

Let me give you a few more figures. At 8 per cent you could have withdrawn $8,000 each year and you still would have had $284,000 of principal. At 10 per cent you could have withdrawn $10,000 each year and still have had $231,000 of principal. If you had been really greedy or really needy, you could have taken out 18 per cent annually, or $18,000 a year, and still have maintained your original $100,000 investment.

Let me ask one other question. Is your money working that well for you? My advice to all of you is not to let your training departments try to adopt a life insurance approach to a mutual fund sale. Have these departments seek help from experienced people who know what to say in the mutual fund sales process.

CHAIRMAN STERNHELL: How would you size up the potential market that life insurance agents can tap if we enter the equity-products field?

MR. LUPEAN: The market will be divided into four main areas—H.R. 10, tax-sheltered annuities, qualified plans, and the general public. Mutual funds will have a good application in all four areas, and the variable annu-

ity will probably find its major application in only three areas—the qualified areas, namely, H.R. 10, tax-sheltered annuity, and pension and profit-sharing plans.

The reason for hedging on the sale of the variable annuity to the general public is that the tax structures of the mutual fund and of the variable annuity are different. The variable annuity may not prove to be as adaptable for general public capital accumulation as is the mutual fund. The owner of a mutual fund pays capital gains taxes and/or income taxes on his growth annually, whereas in a variable annuity the insurance company pays the taxes annually. The disadvantage lies in the fact that a variable annuity is always taxed as ordinary income to the recipient, except where the general income-averaging provisions of the law may be available. You might say that in a variable annuity you are converting capital gains into ordinary income tax.

It is my feeling that the tax-sheltered annuity and H.R. 10 market is ideally suited to the mass-marketing concept using the variable annuity. We cannot discount, however, the large volume of individual H.R. 10 plans available, and I believe that variable annuities and a combination plan with mutual funds will adequately service this market.

One of the most lucrative fields will be the qualified plan market. Sizable dollar amounts are contributed to these plans each year, providing a steady flow of purchases. The field agent who is in a position to offer investment advice on a fee basis, actuarial services, and the sale of equities and variable annuities to this qualified market is broadening his product line and is becoming a full-fledged financial adviser.

Salary savings plans directed at the general public either on a group basis or an individual basis should also be an extremely marketable product. These plans would involve insurance, equities, and variable annuities in any combination or amounts. We have seen the ability of the life insurance agent to sell insurance in the form of fixed-dollar salary savings plans, and I predict that the percentage of participation in these plans using mutual funds and variable annuities will increase by 30 per cent.

It may be that a new entree for salary savings plans will be equities and variable annuities in conjunction with group life. The sale would be co-ordinated and solicited at the time that group beneficiary cards are signed.

CHAIRMAN STERNHELL: Are there any special legal problems about sales of mutual funds in combination with life insurance or with salary savings plans?

RUSHMORE MUTUAL LI
LIBRARY

MR. LATTO: These areas are good examples of the changes that are currently taking place. There has been a rapid growth in the past couple of years in the sale of what the SEC calls "equity funding." This is the sale of a mutual fund-life insurance package with the life insurance premium paid with the proceeds of a loan that is secured by the fund shares. The Federal Reserve Board now has under consideration a proposal to subject this arrangement to the margin rules. Companies in the business are fighting this, of course.

So far as the purchase of fund shares through salary savings plans is concerned, the SEC has had under consideration for some time a change in rules that would make quantity discounts for such plans more readily available. This proposal is opposed by a substantial part of the mutual fund industry.

CHAIRMAN STERNHELL: What effect will the introduction of equity products have on the individual production records of life insurance agents, and how will these changes affect their income?

MR. LUPEAN: Unquestionably, the introduction of this product will temporarily affect the life production of agents. Over all, I do not believe that we will see any change in volume or in its growth. I do believe that we will see a reduction in the average premium per $1,000. A reduction in average premium of 20 per cent is possible in the near future. This means that a $25 premium will drop to $20. There are several reasons for this: (1) the age level of the majority of our population is under 30; (2) the equity concept, which has so strongly captivated the thinking of the general public, will automatically force more of the savings dollar into the equity product. This will occur for the following reasons: (1) the buy-term-and-invest-in-equities theory, (2) inflation of 5 per cent last year, (3) more funds appearing on the market, with its inevitable promotion, (4) tremendous new volume of fund salesmen from the insurance field, and (5) public awareness of the pitfalls in fixed-dollar investments.

It does not take long for a sales force to impart to a knowledgeable public that you can lose money by earning 7 per cent. Assume a 30 per cent tax bracket, and you will net 4.9. If you spend the balance of the income, that is, 4.9, and inflation is 5 per cent, you are not only standing still but encroaching upon capital.

CHAIRMAN STERNHELL: If what you say is true, the agent is now facing a 20 per cent reduction in his over-all income, with its inherent effect upon his pension and renewal account. How will he make this up and add enough to take care of the problem of inflation and rising costs?

MR. LUPEAN: It is my opinion that the agent will be forced to sell equities or to increase life production in order to stay in the business. A loss of 20 per cent in commissions will require $600 of mutual fund sales for every $100 of present earnings in order to stay even. If the agent is currently earning $10,000 in first commissions, he will require $60,000 of fund sales at a commission level of 3.5 per cent in order to stay even with his current income.

This is not the whole story, as our business operates on a deferred-commission basis. The renewals which will be lost over a nine-year period must be made up through additional sales each and every year. This will require additional sales of $60 per $100 of annual income on a cumulative basis, so that in the tenth year the $10,000-a-year agent will require $54,000 of fund sales to cover renewals, in addition to the $60,000 first-year sales, or a total of $114,000 annually in order to stay even.

These figures would require adjustment, if the entire volume were to be placed in variable annuities at a 10 per cent commission.

MR. BOWLES: One of the problems insurance companies face is that usually the smaller life company is not staffed to do an adequate job of managing an equity portfolio. This means that the average insurance company must look outside to investment counsel. This creates problems, not the least of which is related to compensation, because, as is generally known, the successful money manager has a precious price tag. Nonetheless, companies should be realistic in their appraisal of their equity portfolio management capabilities.

Another problem is related to the misguided desire of some companies to sell a "go-go" fund. This "heat" may cause the life insurance company much woe and heartache in the years to come. A life insurance company, in our judgment, should not attempt to build a reputation as a "swinger" or as a "go-go" money manager. It should plan to outperform the averages. (Is it not generally said, perhaps too glibly, that any investment manager worth his salt can beat the Dow-Jones or the Standard & Poor's?) A good, solid record that follows a conservative course, producing over the long run a return better than the average, will provide a much

better basis upon which to build than a wild, high flying, "go-go" swinging philosophy.

Table 1 gives the performance of one-hundred twenty mutual funds during the ten-year period 1958–67 by performance rate. The performance rate equals the effective annual compound rate of return before tax achieved through appreciation and reinvestment of dividends and realized

TABLE 1

Performance Rate	No. Funds	Accum. Per Cent	Total Assets (000,000's)	Accum. Per Cent	Fund with Least Assets (000,000's)	Fund with Most Assets (000,000's)
Under 5.00%	13	10.8%	2,812	8.1%	5	1,857
5.00–7.49	20	27.5	6,911	28.0	4	2,988
7.50–9.99	39	60.0	11,502	61.2	12	2,206
10.00–12.49	24	80.0	6,396	79.6	2	1,248
12.50–14.99	14	91.7	6,115	97.2	10	2,342
15.00–17.49	5	95.8	641	99.1	4	477
17.50 and over*	5	100.0	314	100.0	33	117
Total	120	....	34,691	....	....	....

* Highest yield, 26.75 per cent.

capital gains, assuming a systematic investment program with an initial payment of $500 and a monthly payment thereafter of $100 for 119 months, providing a total payment $12,400 during the ten-year period.

MR. LATTO: The largest changes will result if the Congress adopts the mutual fund bill that has been before it for two years now. There is certainly a good chance that it will pass, and it contains significant changes in the law that will affect insurance company equity products.

First, a welcome change. There are provisions in the bill that will exempt qualified pension and profit-sharing funding from the securities laws. Variable contracts for use with H.R. 10 plans will still have to be registered under the 1933 Act, but there will be, if the bill passes, a complete exemption from the 1940 Act.

On the nonqualified front, things may get tighter. The SEC has given up its effort to impose a 5 per cent maximum sales load upon the sale of mutual fund shares and has agreed instead to a study of the subject by the National Association of Securities Dealers, to take no more than eighteen months. The SEC has also given up its effort to abolish the 50 per cent first-year front-end load in favor of a modified front-end load

that would permit no more than 20 per cent in any of the first four years nor more than an average of 16 per cent during the first four years. Some part of the mutual fund industry is still opposed to this compromise.

The other amendment proposed by the bill relates to the SEC's effort to impose greater control over the investment management fee by adding a statutory requirement that the fee be "reasonable." This may have an important bearing upon whether there will be federal control and, if so, what kind of control, over charges for the assumption of mortality risks. The SEC staff is struggling right now to formulate its own position on this subject—but this may be too complex an issue to take up in a panel discussion of this kind.

MR. BOWLES: In the emerging equity era, "cash value" life insurance becomes an inadequate descriptive term. Perhaps we need to disengage ourselves from a semantics trap. Perhaps we need to change terminology. The life insurance company is selling protection, savings, and service. (Incidentally, even marketing people sometimes forget that service is a tangible product that should be sold for a price, not provided without cash.)

An increasingly sophisticated public will seek fixed-dollar investments and equity investments as ingredients of a balanced savings program. For years the life industry, a financial institution, has provided a vehicle for guaranteed fixed-dollar savings and guaranteed fixed-dollar protection. There are guaranteed fixed-dollar savings benefits "if I quit" or "if I live," as well as guaranteed fixed-dollar protection benefits "if I die." Our traditional product could be referred to then as "guaranteed fixed-dollar savings and protection" life insurance rather than "cash value" life insurance. The equity product would have a tailored name adequately (even though coldly) to define its benefits. The term "cash value" life insurance no longer adequately describes the product.

We can remain a vigorous financial institution selling protection against the economic hazards of death, disability, and longevity, utilizing both guaranteed fixed-dollar savings and equity dollar savings without a decline in volume of guaranteed fixed-dollar savings, or cash-value life insurance, as the term is used today. It is possible that the companies offering both will obtain increased sales of guaranteed fixed-dollar cash-value insurance.

An interesting aspect of the mad dash for equity products is that the equity product is not the total solution to the real problem. A direct solu-

tion to the ogre of inflation suggests that a cost-of-living product must be given a prominent role in the total product planning, with or without cash values, fixed or equity.

MR. LUPEAN: I am sure that you have heard the old sales story about the man who wanted to buy a 1/4-inch drill. He really was not looking for a drill—he wanted 1/4-inch holes. The mass market that the insurance industry is dealing with is made up of average, inexperienced people who are trying to accumulate capital in the best way they know how. These people do not want securities, hedge funds, variable annuities, or mutual funds—they are looking for financial security. They will continue to look to the old, established insurance industry for the thing we sell best—peace of mind. They will get this peace of mind as a result of continuing guidance and advice from their insurance men. We now have an opportunity to provide financial advisory services to all levels and ages. To our life, health and accident, programming and estate-analysis services, we now add mutual funds, stocks, bonds, variable annuities, investment annuities, and variable life insurance.

Until such a time as we accept the socialistic concept of governmental support from the womb to the tomb, the accumulation of capital will be of prime interest to our clients. We can best serve the financial needs of the public by offering complete financial services. The old idea of "one stop" insurance service may apply to our new business venture—"one stop" financial service. We sell capital accumulation accounts in the form of installments or as a lump sum. We sell speculative investments for the venturesome. We have real estate trusts for the ultraconservative. We sell life insurance for peace of mind and for planners. Currently, we provide loans at 2½ per cent under the prime rate to any life contractholder—corporation or individuals. We have special put-and-take loans—take it when you want it and put it back when you are finished with it, and no demand that installments be paid back. We provide investment programs you cannot outlive.

Our industry does need, however, release from the stodgy, inflexible thinking of the old-fashioned actuary and fixed-dollar protagonist. We need your acceptance of the concept that our market is an educated, uneasy, uninhibited young world that has never lived on a $100-a-month salary. These young people have never heard of banks being closed except on Saturdays, Sundays, and holidays.

You, gentlemen, "the creative thinkers," must provide additional products and facilities for this younger generation, products which will allow the insurance industry to recoup its share of the savings dollar.

I think that there is always going to be a place for cash-value life insurance. I do think that more term will be sold. I do think that the sale of endowments, retirement income, and limited pay policies are going to drop sharply. I believe that cancellations and terminations will increase. I think that there is going to be more borrowing for a while. Financed life insurance sales may grow for a short period of time; then I believe they will taper off, because they are costing more money than the regular product. And, I think that another thing we will need is a new approach to agents' compensation. I have no suggestions, but this is one of the old-fashioned actuaries' problems.

MR. BOWLES: Do you think that we are approaching the day when the actuaries and the lawyers can enjoy a comfortable, relaxed, and pleasant relationship with the SEC?

MR. LATTO: I hope we are approaching it, but I do not think we are there yet. The SEC staff has begun to realize, during this past year, that it does not understand everything about variable products, and, until it reaches a point where it has solid understanding, I think we are going to have problems in our relationship with it. The SEC is, I think, looking for an actuary in the hope that he can be of some help, particularly in connection with the introduction of new products.

May I change the subject to ask Mr. Bowles a question?

One of the things that confuses me is why actuaries are involved at all in the design of equity products when we are talking about mutual funds. I can understand the role of the actuary when products with life contingencies are involved, but mutual funds have been sold now for at least thirty years and no one has ever needed an actuary. What skills or expertise do you bring to this area?

MR. BOWLES: Because of the skills that he presumably has, his formal academic training, and the experience to which the actuary is subjected by being thrust not only into the "actuarial" problems but also into marketing problems, financial control problems, and the like, I think that the actuary has an overview of the total problem in the life company that is certainly better than any other group in the company.

MR. LUPEAN: Mr. Latto, you mentioned earlier that investment projections are out. As you know, the life insurance man sells on a net cost basis, including dividends. Are you telling us that we are not going to be able to use interest assumptions or compound interest or anything else in relation to our products?

MR. LATTO: Yes, that is exactly what I am telling you about your equity-based products. I believe that in this area the SEC and its staff may be wrong, but, unfortunately, the fact of the matter is that this has been the subject of elaborate hearings before the Commission, in which companies already in the field made the point that it would simply be impossible to survive unless there were some relaxation of the very rigid rules that applied until now. They filed extensive briefs. Their objections were heard, and the answer was "No!"

Other techniques are going to have to be found in order to make comprehensible a somewhat more complicated product of the insurance industry as it moves forward into equity investment–insurance products.

There has always been a tremendous gap, however, between theory and practice. We must face the fact that there are going to be violations here and there.

CHAIRMAN STERNHELL: Is it feasible for a small company to enter the equity-product field by way of mutual funds or variable annuities, derive profit from that product, and not incur prohibitive development costs?

MR. BOWLES: Yes, it is feasible but probably not very—it is a difficult job. In one of their publications, Lincoln National claims to have spent $450,000 to enter the variable annuity business. This is a real problem for the small company, and there must be developed a vehicle whereby the small company can move into the equity-product area without incurring this substantial drain on its surplus.

CHAIRMAN STERNHELL: What changes in federal income tax laws would make the sale of variable annuities to individuals more attractive, and what steps are being taken to effect these changes?

MR. LATTO: There are efforts being made at the present time for changes that would make the variable products and other products more attractive to the buyer. May I add to that answer? This is also a matter that the SEC is deeply involved in, and it may prove a serious obstacle. The SEC staff is of the view that the prices being charged today are too high in relation to actual cost. The thrust of its effort at the present time is to bring pressure to reduce the charges that are now being made. Obviously, to the extent the SEC is successful, this will make the problem of recapturing development costs even greater.

CHAIRMAN STERNHELL: Is 3½ per cent about average on mutual fund commissions for the agent?

MR. LUPEAN: It depends on which company is promoting it. Some companies have started out with a commission of 2 per cent, while others are as high as 4 per cent. I think, as an average, 3½ per cent may be fairly reasonable.

CHAIRMAN STERNHELL: What may be the effect of lower commission rates on variable annuities—first, on the choice by the agent of whether he sells a fixed-benefit annuity or a variable one and, second, on commission rates on fixed-benefit products? I think the point is whether there is a conflict-of-interest problem for the agent in selling both these products at different commission rates.

MR. LUPEAN: I think we do have a conflict of interest, and we must realize that the life insurance agent lives by commission only. We have always had a conflict of interest with term and permanent insurance, and now we are faced with the fixed and the variable problem. I am seriously concerned that an agent may have trouble selling enough insurance and equity products to get along on and may resort to raiding cash values of existing contracts. The actuaries must give some thought to the problem of how to maintain an agent's income as well as a sales force to continue to sell these products.

CHAIRMAN STERNHELL: If insurance companies enter the equity field and retain the investment function within their investment departments, will insurance companies change their compensation structures and their investment departments to create new incentives for their fund managers?

MR. BOWLES: I think that the majority of companies that have gone into this have permitted their investment people to manage the accounts, and they have done a creditable job. I dare say, the life companies must come to grips with this problem, because there is a precious price tag on the "go-go" manager. I think it is going to be, perhaps, a gradual move to a happy middle ground with which the company can live. It certainly has forced many companies to sit down and reappraise the compensation of their really sharp investment people.

CHAIRMAN STERNHELL: Suppose that one estimates during the next ten years that the rate of return on fixed-income assets is equal to or great-

er than total annual return on equity; what happens to the case for the equity-oriented product?

MR. LUPEAN: I think we must give some creditability to the general knowledge of the public. If the fixed-dollar product does better than the variable product, I am sure that the dollar flow will be reversed and life insurance companies will again recoup their share of the savings dollar. If this should occur, the entry of the life insurance companies into the equity market will have been a mistake.

CHAIRMAN STERNHELL: Mr. Latto, you contend that we are not designing an insurance product but an equity product instead. Will there not be more troubles with this interpretation as we move to equity-based life insurance? Is there a chance that someday someone will recognize that they are life insurance products?

MR. LATTO: I am sure there is a chance that they will indeed be recognized. I was not saying there are not life insurance products. I am saying that in the course of design it would be helpful if one keeps in the forefront of his mind the fact that the SEC and its staff are going to look at them as if they are primarily investment securities and will deal with them in those terms. It will save a great deal of time and a great deal of negotiation, if one starts out with this approach.

Atlanta Regional Meeting

I. *The Actuary's Viewpoint*
   A. Why are companies entering the equity-products field at such a rapid pace?
   B. What are the company characteristics and goals which favor entry through combination mutual funds and life insurance? Variable annuities and companion products? Are cost-of-living products an alternative?
   C. What is the role of the actuary in recommending entry into the field? In recommending and designing products? In securing necessary approvals? In preparing the training materials? In guiding marketing strategies?
   D. What will be the effect—five years hence and in the long-term future—on the sale of cash-value life insurance?

II. *The Agent's Viewpoint*
   A. What will the availability of equity products mean for the agent in terms of new knowledge required, sales approaches, sales results, and earnings?
   B. What changes in agency procedures are necessary to cope with the SEC, NASD, and state security requirements in terms of agency recruiting and training, agency prospecting and sales approaches, and agency compensation and incentive plans?
   C. What are the general principles guiding the SEC in its regulation of life insurance companies seeking to enter the equities field?
   D. What will be the effect—five years hence and in the long-term future—on the sale of cash-value life insurance?

III. *The State Regulatory Authority Viewpoint*
   A. What are the content and status of the NAIC Model Variable Annuity Law? The NAIC Model Variable Contract Regulations?
   B. What states have now passed variable contract legislation? What problems are being encountered?
   C. What are the state licensing and other requirements for a life insurance company to engage in the sale of variable annuities? Mutual funds? Group annuities exempt from the Securities Act of 1933?
   D. Are there recommended courses of action for a company wishing to market equity products?
   E. How will the financial needs of the public best be served by the various types of organizations providing equity products for sale?

MR. WILLIAM A. FERGUSON: Before speaking directly on the program questions, let me first tell you about a survey which my firm conducted. The purpose of the survey was to gather information regarding both the current status and future plans with regard to equity products of

a cross-section of the insurance industry. The questionnaire was mailed to one Fellow of the Society in each of 196 life companies. Of the 196 questionnaires mailed, 132 responses were obtained. Some interesting statistics have been drawn from the responses, and I will refer to these statistics throughout the remainder of my comments.

Why are the companies entering the equity-products field at such a rapid pace? First, are they entering at a rapid pace? The survey shows that 60 per cent of the companies responding to the questionnaire already have a variable annuity or mutual fund affiliation or both. It also shows that another 20 per cent, or twenty-nine companies, say that their entry into the equity-product field is inevitable. Of the companies 15 per cent indicate that they will not enter the field for reasons peculiar to their companies—for example, because equity products are offered by an affiliated company or because the company is a specialty company and intends to remain so. The remaining 5 per cent of the responding companies have no plans to develop equity products. From other sources we know that over two hundred companies are now in a position, or will be shortly, to merchandise some form of equity product.

There seem to be several good reasons for the desire of life companies to have available an equity-based or equity-linked product. First, it is a logical extension of the services now offered by life insurance companies. These services include protection in the event of death or disability, savings for retirement and other purposes, and financing planning for policyholders. The equity product simply represents an alternative funding medium for the savings element of an individual's total financial program. Second, the market has changed. The public has become increasingly interested in equity investments in recent years and has perhaps lost some enchantment with insurance as an investment, as evidenced by the proportionately lower amounts of higher-premium insurance that has been sold in recent years. Third, equity products are needed for competitive reasons. Insurance companies are competing with other savings institutions and mutual funds for the savings dollar. This is competition from outside the insurance industry. At the same time, the competitive pressure from within the insurance industry is constantly building. It is generally feared that many of the better agents will seek out a company with a full line of equity products.

Why are companies entering the equity field at such a rapid pace now? Perhaps the single most important reason why companies are developing a variable annuity product now is that it has really become feasible for the first time only in recent months—unless a company was prepared to devote large sums of money and manpower to the development of the

product. Also, the market responses which are now available, although limited, seem to indicate that the variable annuity concept is salable.

Why not earlier entry into the field? This is a good question. Perhaps we should pause to pay homage, or at least a little respect, to the relatively few companies with the vision and determination to enter the equity field years ago and to those who pioneered the development of the variable annuity.

What are the company characteristics and goals which favor entry through combination mutual funds and life insurance or variable annuities and companion products? Are cost-of-living products an alternative? This question seems to shake down to, Should we start with mutual funds, variable annuities, or a cost-of-living product? First, it is important to recognize that these products are different products complementary to each other. Each does something that the others cannot. All three products are required for a company to have a complete portfolio of products, and it is our expectation that the major life companies will have products of each type in the relatively near future.

There are many considerations which would affect a company's judgment on the product that it should develop first. Let us look at a few:

1. Which of the products are permitted by the laws of the states in which the company operates?
2. What profit margins are desired? It is generally conceded that the potential profit under variable annuities is greater than that for mutual funds.
3. What are the characteristics of the agency force? The transition to the sale of cost-of-living products is much easier than it is to an equity product. The cost-of-living approach does not involve additional licensing of agents or the same degree of reorientation that is required for equity-based products.
4. What are the characteristics of the prospective purchasers in the company's primary markets? Do the prospects want "a piece of the action," as is the case in a mutual fund or variable annuity, or are they really seeking protection against the eroding effect of inflation, in which event the cost-of-living product might be more appropriate?
5. Is the company strong in the tax-sheltered markets? If a company wants a product to market to public school teachers under the special tax shelter available to them, the product must be an annuity product, and the variable annuity is ideally suited. In other tax-sheltered markets the choice of products is not nearly so clear. For the larger employer-sponsored groups, where mortality guarantees are of less appeal, the pure investment aspects of the arrangement are of greatest importance.
6. If a company is strong in retirement planning for individuals, the variable annuity or cost-of-living approaches are the only products which provide for a guaranteed lifetime income.

7. If a company specializes in the prefunding of any savings program which does not involve a lifetime payout, such as the prefunding of the cost of college education, the mutual fund product has greater appeal to the prospect because of the tax attributes typical of mutual funds and because the net investment performance will be slightly higher, assuming identical gross performance (due to the mortality and expense risk charge).

Let me say a few more words about cost-of-living products before passing to the next question. It is our belief that this product will appeal to a significant portion of the total market, provided that the contract can be structured so that the escalation is financed by superior investment performance (as is expected under a variable annuity). From the purchaser's viewpoint, a product with guaranteed protection against cost of living will have considerable appeal. Present cost-of-living products have not yet fully come to grips with the basic problem. Let us review briefly the types of cost-of-living products now available:

1. Cost-of-living payout under retirement plans. Here the risk is borne by the employer, inasmuch as the cost of escalation is borne by the employer, directly or indirectly.
2. Cost-of-living riders which provide additional amounts of insurance without evidence of insurability, the premium for which is paid directly by the policyholder, sometimes by the application of accumulated dividends.
3. Single-premium annuities with cost-of-living escalation. This type of annuity involves an additional risk for the insurance company, but, basically, the cost of the expected escalation due to the cost-of-living feature is paid for by the policyholder by an addition to the premium.
4. Level-premium term plans with escalation based on the cost of living. Here, too, the cost of the estimated escalation is reflected in the premium for the product.
5. The Life of Georgia plan. Basically, this is a life paid-up at 65 policy, which provides for escalation based on the consumer price index on a ratchet basis without limit on the increase until the face amount of insurance is doubled. Minimum cash values are computed in a special way to comply with the nonforfeiture laws. This product goes the furthest of any product of which we have knowledge toward a true cost-of-living policy. The big drawback is that the cost-of-living feature expires at age 65.

It seems entirely feasible that within a relatively short period of years true cost-of-living insurance will be written from separate accounts established by life insurance companies for this purpose. This would represent a new challenge to actuaries and investment men to develop an investment program for the separate account which will minimize the downside risk to the insurance company and yet produce a return on the invested assets adequate to pay for the cost of escalation of benefits. While

this kind of policy introduces a new risk for insurance companies, the profit potential is substantial.

The survey included some questions on cost-of-living products, and the tabulations are interesting:

1. 64 per cent of the returns indicated that a cost-of-living product was a logical product for a life company.
2. 82 per cent indicated that a cost-of-living product was a salable product.
3. 62 per cent believed that a cost-of-living product would inevitably be part of a life portfolio.
4. 38 per cent felt that a product of this kind was looming prominently on the product horizon.

Only 8 per cent of the returns indicated that the cost-of-living product was inconsistent with a reasonable philosophy of a life company.

What is the role of the actuary? The survey indicates rather conclusively that actuaries are actively participating, and often in a position of leadership, in their companies' entry into the equity-product field. More than 100 companies out of the 114 which indicated that they do have or will have an equity product reported that the actuaries played a major role in (1) determining the feasibility of entry into the field, (2) planning the actual entry into the field, and (3) developing products for sale with or as equity products. The survey also indicated that the actuaries played a lesser role in planning market strategy and securing necessary state and federal approval.

What will be the effect—five years hence and in the long-term future—on the sale of cash-value life insurance? This question was included on the questionnaire and the response was as follows: (1) 57 per cent of the returns indicated that the introduction of equity products would have no appreciable effect on the sale of cash-value life insurance or would *increase* such sales; (2) 43 per cent of the returns indicated the expectation of significant increases in the sale of term insurance; and (3) 20 per cent chose to write in a response but not all of them were negative. We believe that, properly handled, the sale of cash-value life insurance and term insurance will increase. But let us not underestimate the importance of properly reorienting and training the agents; otherwise, these projections may be very wrong.

MR. ROBERT G. OUSLEY:* When a company, an agency, or an agent enters the securities business, there appears to be at least one unanimous reaction—bewilderment! The reaction results from the maze of red tape,

* Mr. Ousley is Assistant Vice-President and Director of Equity Sales and Administration for Security Life and Trust Company and Security Diversified Shares Management Corporation.

multitude of details, restrictive regulations, and the horrendous consequences of violations, all of which comprise a new business environment.

I believe a frame of reference needs to be established for the remarks that follow. First, each of us should be aware of the fact that the world and the economy are such that people are requiring other investments than life insurance. Second, this does not mean that perhaps every company should rush pell-mell into the securities business. Each company must, by its own corporate definition, statement of objectives, and philosophy, make that decision. I would be the last person in the world to disagree with a company objective to become the best life insurance company in the world. If you are not already in the securities business, however, take a very careful look at how your company is defined. For instance, about two years ago Security Life and Trust Company was, by definition, an insurance company, and its business was insurance. This is the way we now define our business: "INTEGON is a financial services organization dedicated to serving individuals, families and businesses at a reasonable profit." Third, we have long felt that our industry has strayed far afield from a marketing philosophy responsive to the needs, desires, and wants of the customer. Having come to this realization, we are making changes so that we will become a true customer-oriented financial services organization. And, last, when management philosophy is customer-oriented, establishing a relationship for the equity products with the company's total product line is then accomplished. With this background you may find it easier to understand the remainder of my remarks.

When a company has made the decision to add equities to its product line, several requirements or decisions must have immediate attention. For instance, what objective is to be accomplished by adding equities? Do you want to be in a better position to fulfill the needs and desires of your customers? Or are you adding equities just to sell more life insurance? What role will the equities play? Are they to be complementary financial services or put on the shelf for the agent to use when and if he desires? Will you purchase or start your equities from scratch? What equity products will you need—mutual fund or funds, individual or group variable annuities, or a full range of products? Will these products be no load, level load, contractual, or front-end load? With whom will you affiliate—SECO or the NASD? On what level do you hope to limit executive liability? How will you merchandise the equities? Singly? Packaged with another product? Or as an integral part of total financial planning? How will you train your agents? Perhaps your training programs will not change and you will provide only licensing help. Or will you revise all programs to integrate equities? On what basis will you license? Will li-

censing be optional, selective, or a job requirement? What about licensing for home office and field management? How will you supervise equity sales in the field? Will your branch managers and/or general agents be responsible for the actions of their agents? You may decide to supervise regionally from the home office or to develop a customer-relations program that is regulatory by design. What areas of activity need supervision? Here are a few: field office files, correspondence, customer complaints, adherence to the suitability rule, use of sales literature, and sales procedures.

Supervision within the home office is also necessary. Many of your personnel will have to become licensed. In addition, all company-printed material must be carefully screened for possible violations. For instance, your company's annual, semiannual, or quarterly financial reports, company promotional materials, letterheads, business cards—everything printed that communicates—all of these things are possible disaster areas. Any single piece of printed material can become an incomplete prospectus and, as a result, be in violation of the SEC Statement of Policy. All correspondence and telephone calls by individuals in your home office are also subject to conformance to the Statement of Policy.

Enough about company problems. Let us next consider the meaning of the availability of equity products as far as the agent is concerned. When equities are introduced into the product line, there is obviously a broadening of the product base. This is like hooking another freight car or so to a a train, with one exception. The kind of train has been changed. Equities add new marketing dimensions that require new sales rules, a new game unfamiliar to the agent. This new horizon that opens up for the agent calls for drastic changes in his attitude toward the product, regulations, commissions, and his customers' wants and desires. He must broaden his thinking by thinking laterally and regulatively. This broadened thinking necessitates that he acquire new knowledge—the language of which is strange to him. He must pass the securities examination. His studying must go far beyond the license if he is to approach the financial-adviser and professional status that the financial community will require for the new breed of agent.

The agent's sales approach to, and in, the market becomes different. First, he will enjoy a high degree of acceptance in the market place. His sales results will be synergistic. Because of the regulations he will exercise caution in all phases of his business activity. In the past, companies have recognized the problems surrounding sales literature. As a result they have developed audio-visual and visual presentations as perhaps the only reasonably sure means of making certain that the customer is told the right story at least once.

I developed audio-visual and visual life-fund materials for my own company, and, to test their merchandising effectiveness, we carried out a six-month experimental program. The results of the program may be of interest to you. First, we made certain that the method of merchandising fit the agents' sales-activity process. We projected results, and, as you can see, our actual results came very close to the projections. During the program we observed more than one-hundred actual sales interviews to get firsthand knowledge of customer acceptance. After the test period ended, we sat down and took a very careful look at everything that had transpired. Obviously, we came to several conclusions. First, there were advantages to all concerned—the customer, the agent, and the company.

Although we were pleased with the results of the experimental program, there were several problems that inhibited outstanding success. One such problem is the matter of agent compensation, and pondering this problem brought us to another conclusion: as long as the wide variance in commissions exists on the various products, it will be difficult to hope for agent objectivity at the point of sale. For instance, my company's first-year life commission is 65 per cent, and the commission on the mutual fund is 3.375 per cent. With this difference, how can we hope to have the agent recommending what is best for the customer?

Very recently we have had some discussion on this subject. There appear to be several alternative solutions, but each is fraught with problems. First, a separate agency force could be started to handle the equities and other lines. Through education, training, and indoctrination these men would be raised on the newer concepts. Their experience would prove the synergistic result and eliminate the wide difference in commission hang-up. Second, the agent might perform a bird-dog function supported by an in-agency specialist. The agent would locate the prospect, uncover the need, and then apply the expertise of the specialist to solving the prospect's problems—all of which hopefully would lead to a sale. Third, through education, an attitude on the part of our field force might be created that would, by moral conscience, lead them to recommend what is best for the customer—the CLU pledge personified. Last, and I believe that this is the most realistic approach, the present commission method of compensation could be changed to salary plus some kind of incentive. We think that this could be a partial solution to the rather formidable problem facing us today. I referred to a partial solution, and this needs explaining.

For years our industry has attempted to solve its problem by designing new agent finance plans. If anything goes a little sour, it is felt that a new finance plan will provide the cure. In other words, we have continued to

treat the symptoms without ever getting to or solving the problem. Along with a new system of compensation we would need an entirely new education and training process, new supervisory procedures, and on and on. You could rightly ask the question, "Why don't you move to a salary plan tomorrow?" The answer is that we would, but the things involved are quite complicated. Probably the biggest deterrent is tradition, going from the known to the unknown. Tradition is a marvelous thing until it becomes involved in a rapidly changing business and economic environment. It can cause unbelievable hang-ups and throw up mile-high roadblocks in the path of progress. For instance, it has always been believed that compensation by commission will get better results than salary because commission income is based upon results. If that be the case, then why not pay all home office employees, including actuaries, a commission based upon results? I simply refuse to believe that being on salary necessarily lessens productivity. But, here again, salary alone would not suffice. The whole system of distribution would require changing.

One last comment on this question. When consideration is given to salaried compensation, thought must also be given to the traditional agent contract. Must we assume that a contract for salary would of necessity contain a detailed job description? To me this would be a giant step in the right direction. Too many agents are hired by our industry and then left to operate almost as they choose. We have failed miserably in fulfilling our responsibility to these men. This dereliction of duty continues to cost our industry millions of dollars each year and contributes heavily to the very poor image that we enjoy on the nation's college campuses. We can no longer afford the luxury of saying our industry or our business is different in order to justify bad business practices. I believe that salaried compensation will force us to come much closer to living up to our responsibility. As the man said, "Be careful about asking him a question, because in answering he is liable to write you a book."

Let us next consider the general principles guiding the SEC in its regulations of life insurance companies, either in or deciding to enter the equities field. Major legislation always guides the SEC. I have seen no evidence of its attitude being different toward our industry than toward any other. In fact, I have found the staff to be most helpful and co-operative. Each of us would eliminate much personal frustration in our dealings with the SEC, I believe, if we understood that it also has problems. Let me list just a few. It is experiencing a fantastic influx of business. Our industry is at least partially to blame for that problem. The SEC operates under an inadequate budget; it is understaffed and has a fairly high rate of turnover of staff. Again, our industry has and is continuing to

raid the SEC staff, and we are partially to blame for that problem. The SEC operates with an array of antiquated regulations brought about by post-World War II legislation. Many of these regulations are not in tune with our present economy and business climate. Only Congress can change this legislation, not the SEC. All of this may sound like a testimony for the SEC and total damnation for our industry. It certainly is not meant that way. We simply need to understand the problem before we can hope to come up with the solution.

Finally, our industry has created additional problems by approaching the SEC and the NASD on a fragmented basis. Various committees and representatives from industry associations, such as the ALC, LIAA, and ILI, plus individual company representatives have confused the regulatory bodies. Our industry needs its own organization, patterned after the NASD, before we can hope to present a singleness of purpose to Washington.

The last subject that I want to discuss will actually be an expression of personal opinions. These opinions will be in answer to the question, "What will be the effect of equities—five years hence and in the long-term future—on the sale of cash-value life?" First, I believe the effect will be synergistic, and the sale of all product lines will enjoy substantial increases. Furthermore, I believe the basic life product will undergo extensive innovations. The short-term effect will be of little consequence. However, in thinking about ten, fifteen, and twenty years hence, I doubt that we will be able to find much evidence of the present product in existence. What the product will be is anybody's guess. If we have the computer capability of going to the moon and beyond, anything is possible. Very soon agents will be carrying an attaché-case-sized gadget into a prospect's home. By simply cradling the prospect's telephone on top of his case, the agent will have instantaneous access to his company's computer center. This means instant budgets, financial plans, solutions to complicated problems, and so forth.

Consider some other facts. The insurance industry has not changed its products or system of distribution in several decades. We have modified, sophisticated, and come up with variations on the same theme, but everything is still basically the same. At the same time (during those decades) the whole world has changed many times. We were successful in adapting the old to the new. Adaptation, however, seems to be nearing an end. In today's world, a business has to run simply to stay even. If it walks, it will fall behind. If it stands still, it is doomed to early extermination. To make meaningful progress, then, a company has to sprint. It will have to be flexible to change, innovative, dynamic, vigorous, and aggressive. The

greatest potential in the world is our industry's computer capability directed in the area of innovation by our great actuarial minds and carried to the market place by the greatest group of salesmen the world has ever known.

MR. JACK B. PERDUE:* I want to make it very clear that any opinions I express here today are mine only and do not necessarily represent the views of the Georgia Insurance Department.

Activity by NAIC in the area of variable annuities goes back to mid-1965, when a special committee was appointed by the President to determine whether NAIC should resist the SEC proposed Rule 15b8-1.

The proposed rule, among other things, stated that no person could sell any security unless and until he had successfully completed a general securities examination administered by the SEC or, in lieu thereof, an examination deemed by the SEC to be a satisfactory alternative. Despite the fact that the Supreme Court of the United States had ruled that the variable annuity is a "security" within the meaning of that term under the Investment Company Act of 1940, it appeared that, if the SEC assumed jurisdiction over the examination of insurance agents selling the variable annuity, the spirit of the McCarran Act would be violated. A system of dual regulation in the licensing of salesmen was about to be established.

A task force met with officials of the SEC in September, 1965, and presented a summary of basic standards, together with suggested examination questions. It was recommended that NAIC member states, which had approved the sale of the variable annuity, consider these standards and from them prepare an appropriate examination to administer to its variable annuity agents. Under SEC Rule 15b8-1, a deadline of July 1, 1966, had been set for securities salesmen to pass an appropriate examination. The SEC agreed that any variable annuity agent who had been issued a license after passage of an examination based upon these recommended standards would be exempt from further examination.

In 1967, this committee became the Variable Annuities Subcommittee under the Life Committee. The work of this committee resulted in the adoption of a Model Variable Contract Regulation at the meeting at Portland, Oregon, in June, 1968. At the December, 1968, meeting held at Los Angeles, a few corrections were recommended and adopted.

To me, the most interesting language of this "model regulation" is on the very first page under Article II: Definition. It states:

The term "contract on a variable basis" or "variable contract," when used in this Regulation, shall mean any policy or contract which provides for insurance or

* Mr. Perdue is Deputy Commissioner of the Georgia Department of Insurance.

annuity benefits which may vary according to the investment experience of any separate account or accounts maintained by the insurer as to such policy or contract, as provided for in Section _____ of the laws of this State.

We live in a world of instant products—instant coffee, instant tea, instant breakfasts of various flavors, instant whipped potatoes, instant milk, and the like. You name it, and we have it. But, for the life of me, I cannot understand how we ended up with instant variable life insurance from a study of variable annuities.

Language designed to accomplish the same result was suggested by the Industry Advisory Committee as a change from the language they had used in their suggested model variable annuity law presented at the December, 1968, meeting of NAIC in Los Angeles. The suggested variable contract law submitted by this committee was adopted by the NAIC subcommittee, with the amendments suggested in the report presented by Mr. Gilbertson, except for his suggestion that the phrase "(and benefits incidental thereto)" be deleted and the words "other benefits" be substituted therefor. It was the belief of the subcommittee that the use of the words "other benefits" might imply that the suggested law would apply to variable insurance contracts as well as variable annuity contracts. The subcommittee did not wish to recommend a law which might be so interpreted and directed that the parenthetical expression "(and benefits incidental thereto)" would be retained in the suggested law. With this exception, the suggested variable contract law was unanimously adopted by the subcommittee.

For the first time, members of the NAIC caught the significance of the language, but the industry committee was able to confuse the issue enough to delay the adoption of the model law by the parent committee. It will be considered again at the Philadelphia meeting in June.

Why was this all-encompassing language slipped into the model regulation? Admittedly, one might argue that adoption by NAIC is not binding on any state. In spite of this, you would be surprised at how often industry representatives attempt to use the action of NAIC as a lever in their dealings with state insurance departments. I believe that is why the industry committee wrote it in, and I am sorry that the NAIC committee went to sleep at the switch on it. I am hopeful that the model regulation can be amended to eliminate this offensive language.

Someone might well ask why I consider the inclusion of variable death benefits offensive. Let me hasten to explain that I am not opposed to an insurance policy which offers a variable death benefit as long as that policy complies with our reserve statutes. By complying with these laws, a policy with a death benefit which may vary must be reserved at its maximum

upper limit. I only disapprove of variable life insurance issued in connection with separate accounts. I disapprove of death benefits which can fall below the already insufficient amount a widow expects and needs as a bare minimum. And, let us face it, that is what most men's insurance proceeds will provide—minimums.

Change is inevitable, and, when we make change on purpose, we usually make progress. We must remember, however, that all change is not progress, just as all movement is not forward. We are living in an era of revolution. Evolution seems too slow for us in this hectic age of technological progress. One of the problems of revolution, though, is that too often we revolt from something without realizing what we are revolting to.

In Georgia, until our specialty policy regulation was promulgated November 1, 1967, we were besieged with complaints from citizens whose policies had not worked out as the salesmen had said they would. Most of these unscrupulous salesmen had gone to great lengths to impress upon their victims that they were not selling insurance but an investment, with insurance included only as a minor feature of the plan. These con men, hiding behind the cloak of responsibility won by the insurance industry through years of dependable service, actually hoodwinked our people into believing that they could stop paying at any time and get at least as much back as they had put in. And they were using as their vehicle life insurance policies, not annuities. Can you imagine what a crew of these pirates could do with a made-to-order situation like a separate account with investments in equities! Some might counter with the statement that the SEC would not allow this. The SEC does not allow stock frauds, but they still exist.

The variable annuity serves a very useful purpose and fills a definite need. Inflation can erode a retirement program. A retirement program for anyone is at a definite future date; a life insurance program is now. When planning a life insurance program to provide benefits for our families, we must plan as though we will die tonight. If inflation has deflated the relative value of our death benefits, we should remember two things: (1) we are paying the premiums with inflated dollars and (2) if we are still living and in reasonably good health, we can buy more life insurance.

I contend that the insurance industry already has a product to take care of the inflationary devaluation of life insurance—the guaranteed insurability option. Through refinement and better marketing of this option, the question is settled as to the need for insurance which may vary according to the investment experience of a separate account.

Group variable annuities are now legal in all states but North Dakota. Individual variable annuities are currently permitted in all states except

Georgia, Idaho, Missouri, North Carolina, North Dakota, Oklahoma, and Washington.

In most of these states legislation has either been adopted and is not yet effective or is pending. An up-to-the-minute status report on this legislation is difficult, since these things change daily. It is my understanding, however, that the situation for each of these states is as follows:

Georgia.—House Bill 320, authorizing the sale of individual variable annuities and groups other than those presently allowed under the Separate Accounts Law, has been passed by the legislature and will become effective December 1, 1969.

Idaho.—I am unaware of any legislation pending in Idaho to authorize individual variable annuities.

Missouri.—Senate Bill 42 would authorize individual variable annuities.

North Carolina.—North Carolina is presently considering legislation which would authorize individual variable annuities. (North Carolina currently permits group separate accounts with a variable buildup but limits the payout to a fixed basis.)

North Dakota.—House Bill 285 would authorize individual and group variable annuities.

Oklahoma.—House Bill 1016 would authorize individual variable annuities and has passed the House.

Washington.—House Bill 208 has been enacted in Washington and authorizes individual variable annuities effective July 1, 1969.

For those interested in Puerto Rico, it is my understanding that neither individual nor group is allowed there presently; however, legislation for both is being prepared and will be filed there in the future.

At this time I know of no problems being encountered from a regulatory standpoint in the sale of variable annuities.

It is quite apparent that all life insurance companies should not be permitted to engage in this new operation. Some of them simply do not have enough money to take on this additional drain on surplus. Other companies' concentration on sales to lower-income groups makes this new product, designed for more affluent prospects, unfeasible. Still other insurers have not had a history long enough to indicate the ability of management in regular insurance operations, much less in this strange new concept. Only those companies whose histories of success, whose stability of management, and whose financial strength indicate a definite probability of the desired achievement and performance should be licensed to sell variable annuities.

A company wishing to sell these products in Georgia must complete our Form GID-20. No additional fee is required by the insurance department.

It is also necessary for the company and its agents to secure a license from the secretary of state, who is ex-officio securities commissioner. This dual licensing in Georgia will cease on December 1, 1969, when the newly adopted Variable Annuity Law becomes effective. After that date, variable annuities will be exempt from the definition of "securities" and all licensing will be handled by the insurance department.

A life insurance company or an agent wishing to engage in the sale of mutual funds in our state must secure that license from the secretary of state. Our new Variable Annuity Law does not affect this.

Under Georgia's present Separate Accounts Law, which permits the sale of group variable annuities only, the secretary of state allows no licensing exemptions for any group annuities, even those exempt from the Securities Act of 1933.

When the insurance department takes over this licensing function as of December 1, 1969, I anticipate a continuation of those requirements, with no exemptions being allowed.

As you know, it is always easier to rear your neighbors' children than your own. So you see, being a "neighbor" of industry makes me an expert at solving their problems. My first recommendation is that any company wishing to market equity products enter into this new experience like two porcupines about to make love. This thing must be planned very carefully and executed with extreme caution, or somebody is going to get hurt!

Many decisions must be made by the full management team. Much advice must be sought and studied. A company must decide whether to offer both tax-qualified and nonqualified contracts, whether the products should be offered by the parent company or by a subsidiary company, and so on.

The makeup of a company's agency force should be considered in deciding the types of equity products to be offered. Companies with a closely controlled full-time agency organization may lean toward individual variable annuties or, possibly, mutual funds. These agents have made their living on individual life sales and will probably prefer individual rather than group annuities. Other companies may have specialized in group insurance, and these companies should naturally concentrate on developing group products for their sales forces, which are already group-oriented.

Another decision must be whether to set up a separate account or accounts and sell the variable annuity or to organize, or associate with, a mutual fund company.

A company must decide why it wants to enter the equity-sales field.

This should not be done merely because it is now faddish. The philosophy of a company's entire operation must undergo some serious alteration. This new vista probably will represent a demarcation from a long, traditional set of operational guidelines.

Sales management must be properly indoctrinated. They must be qualified and ready for the job before concentrating on agents' training and actual sales. Most companies should be very selective of the agents who will be allowed to offer this new service.

My final recommendation to a company thinking of entering this field is to prepare to be criticized by an indignant public and investigated by federal politicians if a recession or depression causes a substantial decline in stock prices and in annuities. I believe that one of the greatest potential dangers for companies entering the variable annuity field is the fact that people have come to believe that "variable" means "increasing." They have confidence in the insurance industry to pay contractual guarantees or more, and the accelerating economic prosperity of the last twenty years has lulled them into a feeling that equities will never come down.

I may be prejudiced, but I sincerely believe the financial needs of the public will be better served by life insurance men selling equity products as an adjunct to an adequate life insurance program than by mutual fund salesmen selling insurance as a supplement to an adequate investment program.

Equity products cannot serve as a substitute for a life insurance program, and by a program I mean an adequate amount of permanent insurance to serve as a guaranteed platform of security. Every insurance program needs such a base, onto which should be added the proper additional kinds of insurance, which can be determined only after a personal analysis has been made.

A payout at retirement which will vary with the economic climate at that time is an important tool for sound financial planning. It is not intended to take the place of life insurance. Nothing can do that. When properly applied as a supplement to life insurance, a balanced program of family security results.

In my opinion, any wild plunge into equities which necessitates the borrowing against cash values is foolhardy, and anyone who recommends such a dangerous scuttling of this basic platform of guaranteed values is suspect, to say the least.

Simply stated, I am happy to see the responsibility and integrity of the life insurance industry being projected into the equity arena. This industry learned long ago that it does best and profits most when the interest of its customer is put first.

CHAIRMAN JOHN M. BRAGG: The panel in New York made a great point of claiming that a company has to "de-brainwash" its agents. Mr. Ousley, I wonder if you would comment on that from your experience.

MR. OUSLEY: Actually, we have found that the majority of our sales force is more ready for the equity products than is our home office. I think we all need to remember that agents are on the firing line all the time. They know the objections they get to the fixed-dollar product time and time again. They understand that people are requesting more variable-dollar products in financial planning, and as a consequence I think that agents are more ready than the home office.

CHAIRMAN BRAGG: Mr. Perdue, do you oppose NAIC legislation that would permit the sale of life insurance policies with variable cash values?

MR. PERDUE: I do not oppose NAIC legislation that would authorize the sale of life insurance with varying cash values. I would oppose at the moment any policy presented to the Georgia Insurance Department with that feature, because it would run into the same problems that Life of Georgia ran into when it first tried to get its approved. To comply with our reserve statutes, you must reserve at upper limits, and, when we start dealing with varying benefits, you might very well get into some problems with our present statutes.

The life insurance industry has been forced into the equity products primarily because of the inflationary erosion of retirement programs. I think that these other things may come, but we ought to let them come through evolution and, as I said, not through revolution.

CHAIRMAN BRAGG: I personally believe that cost-of-living products have to fall within the framework of the Standard Nonforfeiture Law and the Standard Valuation Law, which are the bedrocks of the business in the country, or the laws ought to be changed in some way that we will consider satisfactory.

Mr. Ferguson, are any companies selling variable insurance? Could you name them and briefly describe their products?

MR. FERGUSON: I do not believe that any companies are selling pure variable insurance products. One policy has been filed in Arkansas by Participating Annuity Life Insurance Company, but I do not believe that they have actually started to market the policy at the present time. It is a

true unit policy, just like the variable annuity contracts—everything varies in terms of the value of the unit in separate account. In other words, as the unit escalates, the premium escalates, the cash values escalate, the face amount escalates, and vice versa.

CHAIRMAN BRAGG: Someone has asked how many states have approved my company's (Life of Georgia) cost-of-living policy. It is approved at the moment in six out of the eleven states in which we are admitted. In three states we have heard nothing, and in two states we have run into some objection because of minor technicalities in the state laws. In both cases there is something in the laws that states that the benefit has to be "specifically stated," which they interpret as meaning a dollar amount. There is no objection from any place on the subject of the method of calculating the cash values and reserves.