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UNIVERSAL LIFE UPDATE

Moderator: J. LYNN PEABODY. Panelists: CHRISTIAN J. DESROCHERS, ROBERT D. HOGUE, STEVE RADCLIFFE

Current questions, derived from survey responses from fifty Universal Life experts will be discussed. Discussion will assume a high level of product knowledge by the audience.

Marketing considerations from the actuary's perspective will be emphasized. The impact of indexed products, termination charges on surrender, and reinsurance are a few of the questions to be considered.

Formal presentations are not expected. Overlap with the panel discussion on tax parity for individual life insurance products will be avoided.

MR. J. LYNN PEABODY: When we were putting together this session, we tried to take an approach that was a little different. Many of you have been to Universal Life seminars. It has been a subject discussed at other Society meetings. We certainly did not want to come up with an approach where we were going to try to teach people who were already very much familiar with the product and the concept. We did not want to go back to basics. We did not want to cross paths that have already been crossed many times.

We decided to approach the session utilizing the results of a survey. Tom Eason, who is the moderator of this same session at the upcoming Colorado Springs meeting, and I developed a questionnaire which dealt with the subject of Universal Life. This questionnaire was sent out to about sixty Society members. The members were basically chosen from lists that were provided by the Program Committee and, for the most part, were people who had been suggested as panelists, moderators, workshop chairmen or co-chairmen for sessions very similar to this at other Society meetings. We had a response rate that was very good, over 80%.

The original questionnaire included a number of questions dealing with many topics in the Universal Life area. It was a multiple choice type survey, and we asked the people not only to respond specifically to the questions but also to respond as to whether or not this question was important to them and whether or not they thought the question would be an interesting topic to be discussed at a meeting. We were trying to get their input, not only as to how to structure the meeting, but also their input as to the specific questions.

Based on these responses, we went through and picked about ten of the questions determined to be most interesting to the people who had been surveyed. These are the questions that will form the primary discussion of our panelists today. The questions in the survey and the multiple choice answers were not intended to be all inclusive. We did try to find some areas that would be somewhat controversial. We also tried to find some areas which did not have any specific answers as such. The wide ranges of responses that we got to the questionnaire indicated that we were very successful at being somewhat vague in some questions.

For the questions deemed of most interest, the responses were summarized and sent to all meeting attendees who were advance registrants. I hope that most of you had a chance to get those and look through them. They will also be sent to the people who had pre-registered for the Colorado Springs meeting.

I would like to introduce to you the people that will be making up our panel today. Our recorder is John Schreiner. He is with Milliman & Robertson in their Milwaukee office. Our first speaker will be Bob Hogue. Bob is the Senior Vice President and Chief Individual Actuary at Maccabees Mutual. His main responsibilities are the individual insurance operations of the company. In addition, Bob is President of Maccabees Life and Annuity Company, which is a stock subsidiary formed primarily for the purposes of marketing Universal Life. Bob has been very intensely involved in that project for at least the last year. Our second speaker will be Chris DesRochers. Chris is new with Milliman & Robertson in Hartford. Prior to that time, and for the last nine years, he has been with the Hartford Insurance Company. He was involved primarily with life product development. For the last year and a half Chris has been one of the main persons involved with the development of the Hartford's Universal Life product. In addition, he has served as a member on the LICONY Task Force, which is responsible for drafting legislation proposed in New York for Universal Life. Our final speaker will be Steve Radcliffe. Steve is the Reinsurance Actuary at American United Life. Steve has been involved in the development of reinsurance systems for Universal Life as well as various facets of the pricing and administrative area as it relates to reinsurance.

MR. ROBERT D. HOGUE: Lynn divided up the questions from the questionnaire and asked each of us to comment on specific ones. He asked that I comment on three of them, those questions involving business mix, index products and the investment considerations. The first question is related to business mix. The question stated, "Universal Life has been described by some as a whole portfolio wrapped up in one product. Will Universal Life basically replace most of the other products formerly sold by the companies?" There were four options given for the answer. Option A was yes, it is indeed universal and essentially can be structured like most standard products. Option B was no, it will only be sold by a few agents, and the remaining agents will sell traditional products. Option C was no, it will be used almost entirely for replacements. Option D was "other". The answers were split about 50-50 between Option A yes and Option D "other". I would say that that response is probably accurate because the feeling of many people is that it will replace most whole life sales in the long run, but so far, I do not think we know enough to tell if that is true or not. I think that the business mix strategy is the key element to your marketing strategy when you decide to sell Universal Life. Note that I said when, not if, because I think that essentially everybody will be forced to go into it. So probably the first thing that companies will look at, the first thing we looked at, is choice of business mix strategy. It is going to vary from company to company. A company with a lot of term is essentially going to want to issue a lot of Universal Life. A company with a lot of whole life will not want to do so. And I think that that is basically what you are all going to face. What we went through as part of our market planning for Universal Life was to identify the target mix that we wanted. We had many things that concerned us, but three things in particular. I would suggest you put these three at the top of your list when you make one out.

The first one was whether or not we wanted an offensive versus a defensive strategy which seemed to relate to the amount of whole life we had in force. The second was the amount of risk that we were willing to incur with an early release of Universal Life. And there is the obvious tax and investment risk. In addition, there is a pricing risk where we would have a very low margin in the product and hope to maintain it through adjustment of mortality and investment income charges over the long run. The last risk is the capacity for internal replacements that a given company has. I would suggest everybody evaluate that. It has to be a part of your marketing and your release strategy. But in the end, at least with Maccabees, I do not think it is up to the company. I think it is up to the agent and the consumer. And the good news is that the agents did not really take over the project because they are not really committed to Universal Life yet. At least our people are not. I think the reason they are not is that they think that Universal Life is the same as whole life. The reason I say that is that our people are selling it the same way as whole life. They are using the same illustrations. The only deviation that we have found is that they look at the excess interest credit as being a dividend scale with a lesser level of guarantee than the common dividend scale they normally use.

I do not think agents understand the product. They look at the current level of interest rate and note that it is less than the money market fund will provide. They look at the mortality charges and see that they are more than re-entry term YRT scales. And, of course, the loadings are assumed to cover all of their commissions and home office expenses. So they really do not understand the product they are dealing with. They are constantly making comparisons with whole life, and their common complaint is that for essentially the same product they are not getting the same commission levels. So they have not made up their minds yet; they are not committed. Eventually I think the market will decide, and we are seeing evidence of this already. All of our qualified pension business, we feel, is subject to rollover. On the annual valuation of most cases of any significant size, there has been a Universal Life comparison made at the point of re-evaluation. So the potential rollover is there, and this will affect the long term business mix in the qualified pension areas. We are seeing a little bit in the non-qualified areas, deferred compensation and some of your large business cases, but I think that is just starting. As far as estate planning and personal insurance sales, we have not seen it yet. It does not seem to have the same degree of importance to these people. But again, the jury is still out. The unfortunate thing is that we would hope to see a decline in minimum deposit business which we have not yet seen. So that is still a lucrative sale.

I really cannot comment on the long term business mix. I think all of you know as much as I do about that if, in fact, anybody knows anything. We definitely have an evolving product. Some of the designs that have come out lately are significantly different from the original forms. Also, we do have pending tax and regulatory issues that are holding up a lot of company releases. So I think when those things are resolved, when a lot of the companies that are waiting come out with Universal Life, then we will see what mix of products evolve. In the long term, we see Universal Life being about half of our issues at prevailing interest rates in the 10% area, with about two-thirds of new issues at the 12% level and about one-third at the 8% level.

Of the three things I mentioned with respect to our marketing release strategy, the one that has emerged as the biggest problem, at least for

my company, has been the replacement area. We are a mutual company, and about 75% of our sales and 95% of our inforce is whole life insurance. We have the same concern as everyone else and that is, will the Cannibal Life scenario occur? From what we have seen so far, and it is obviously very early for us, is that no it will not. We have not seen any evidence yet. If it does occur, I think it will be slower than the original scenario depicted. Looking around, we see that there is a recycling going on. If you look at the industry lapse statistics, you see that lapse rates have been increasing, and this trend started before Universal Life was on the scene. The deterioration in persistency is generated by the economy and not necessarily by Universal Life.

In summary, with respect to business mix, I am sure that you can get a different perspective from half a dozen people in the room. The mutual companies, the stock companies, the small companies, the large companies, the specialty companies, companies in different target markets are going to have totally different perspectives.

The next subject is index products. The question was stated, "Several Universal Life products use a fund with investment return lined to a financial index. From the company's viewpoint, do you like a product such as 'T-Bill Life' or 'Bonded Life'?" There were four options given for the answer. Option A was no, the market for indexed products is transitory. Option B was yes, with product choice or changes as needed. Option C was yes, temporarily, for tax reasons. Option D was "other". And the answers were pretty evenly spread between A, B and C, with about half as many for D. The predominant one, by a small margin, was Option B, yes, with product choice or changes as needed.

I will offer the following scenario as to the evolution of products. The declared interest rate products will evolve into indexed products in order to maintain the interest paid deduction. They will evolve into separate account rate products, the registered universal variable life, in order to escape the investment risk involved in indexed products. I think we are seeing that evolution pick up momentum with a lot of the industry activity that is going on today. I do not think the question is, "Should a company do that?" I think they will be forced to do it. The question is, "What problems will be associated with going through that kind of an evolutionary scenario?" The first problem is with the indexed product. You may maintain the interest paid deduction, but you are going to trade that off with a loss of your investment margins if you match your assets. So the question is, "What do you do about it?" If you are willing to give up your investment margin by close matching with a short term index, then you are going to have to derive your income through increases in your mortality and expense charges. Some companies are doing other things. They are putting in surrender charges; they are grading the interest credits by some kind of an internal formula and a number of other things, but the bottom line is that you are going to lose flexibility and control over your product design. Long term you are also going to lose flexibility and control over profits and overhead expenses out of those products. I see no solution to that.

The last topic I was going to comment on was the investment consideration question. The question was stated, "The crediting of high current interest rates on Universal Life products makes investment strategies a critical element of the company's success. Should companies be concerned about the potential investment risk tied to Universal Life?" There were five options

given for the answer. Option A was yes, a competitive product has the same potential risk as high yielding annuities. Option B was yes, primarily because of potential impact on existing business. Option C was no, not a problem for more than a few companies. Option D was no, since declining interest rates will minimize potential problems. Option E was "other". The predominant reponse was yes. There are investment risks associated with Universal Life, but I do not think they are as high as high-yielding annuities. I would put them about half way between traditional whole life whose risks are increasing and single premium deferred annuities or guaranteed investment contracts.

MR. CHRISTIAN DESROCHERS: I have been asked to respond on four questions, two involving commissions and product design and two involving taxation.

Product Design. It appears that so-called "second generation" Universal Life products are being developed which provide more incentives to the agents, often at the expense of the policyholder.

Do you believe that Universal Life products will gravitate toward the structure of traditional products but maintain the potential flexibility?

Commissions. Some experts assert that Universal Life is most viable in the market when the original low load design is used. Others suggest that commissions to direct agents and PPGA's will move to higher levels.

What range of first year compensation do you expect to be most common in two or three years?

In discussing commission levels and trends in products, it is really not appropriate to discuss specific products or specific commission levels, but I would like to look at some trends and also analyze the reasons for those trends. Since its inception, certainly one of the most controversial issues surrounding Universal Life has been the level of commissions paid. In the earliest product designs commissions were often based on three elements: a) percentage of premiums, b) a per policy element and c) a per thousand commission, with the last two elements often varying by issue age. Occasionally, a renewal commission per thousand or, as Bob has mentioned, commissions as a percent of the contract funds were also made available. The percent of premium commissions on the earliest product forms were often consistent with the amounts paid on deferred annuities, and the per policy and per thousand elements generally matched up well with the expense charges, with the expense charges typically falling within the $20 per thousand constant allowance of the nonforfeiture law. Overall, commissions would generally fall in the 40%-80% range of traditional commission levels when a premium roughly equivalent to a non-par whole life was paid.

There were a number of problems with this multi-element commissions structure. Having developed the product, companies often found that it was difficult for the agents to understand the commission scales and for the companies to communicate them. Companies developed a number of devices to estimate commission payments, an example being tables to estimate commissions. Many even included a coded item on their proposals which indicated the commissions payable. Under this type of commission design, commissions became a smaller percent of premiums as premiums and/or face amounts increased. Traditional emphasis by agents on percent of premium commissions often resulted in complaints that commissions were too low. It is also difficult to match commissions to premiums if per policy and per

thousand elements are paid at issue. Even where a first year surrender charge is used, premiums received may be insufficient to support the commissions actually paid. Finally, for a New York licensed company, it may be difficult to demonstrate that such a scale complies with a reasonable definition under Section 213.

A number of later Universal Life designs use the concept of commissions based upon a stated premium. Commissions of a traditional level are paid up to a given first year premium, and a lower percent is paid on amounts in excess of that level. Constructed appropriately, this structure can duplicate per policy and per thousand element designs but eliminates many of the problems referred to earlier. Typically, however, products using these scales have higher commissions and loads than earlier versions.

Let us now consider the survey results with respect to compensation patterns and product design. If we look at total responses on product structure, Question 2, we see that there were fourteen affirmative answers and eighteen negative answers on the question of whether new Universal Life plans would become more like traditional products. Regarding the commission levels, roughly half of the answers indicated commission levels only up to 8% of traditional levels.

There are several reasons which can be cited to support the view that commissions will gravitate toward the traditional structures.

1) A number of the companies now entering the Universal Life marketplace are traditional companies who cannot support their distribution systems with low commission products.

2) Universal Life is often targeted at the upscale market. Many times the commissions on traditional products cover the cost of tax and estate planning. These activities really cannot be supported by lower commissions. Unless the cost of such service is unbundled, they must be supported somewhere in the product pricing.

3) Life insurance is not bought, it is sold, and price is not a concern in a large number of sales. Although a declining percentage, traditional permanent life products still constitute a significant share of the life insurance market. In certain cases there is still a great deal of control of business exercised by producers who tend to gravitate toward sale of higher commission products.

4) Universal Life writers who offer more than one product have sold larger amounts of their higher commission products.

On the other side, however, there are good reasons to believe that commissions will continue to be significantly lower than those paid on permanent plans:

1) There are many industry commentators who believe that the commission structure of traditional products is not viable in the marketplace of the 1980's. They say that for companies to be profitable, significant increases in agent productivity are needed, coupled with corresponding decreases in unit compensation.

2) Universal Life is an alternative to an all-term industry. The value of the transaction must remain competitive with "buy term and invest the

difference" schemes if it is to recapture a significant share of the so-called savings market.

3) Since Universal Life is an "unbundled" product, the cost of each of the elements is disclosed to the buyer. Consumers have demonstrated their unwillingness to commit dollars to heavily loaded products.

4) Not only are the absolute premium levels of traditional products decreasing, but increasingly, products are being sold in combinations which result in lower overall commissions to the agents. Through the use of term riders and flexible premium annuities, aggregate commissions on traditional products are trending downward.

Clearly, Universal Life commissions will gravitate toward some level, and the very wide variations currently found in the marketplace are likely to narrow. For the short term, the trend in compensation is decidedly upward, although agents and companies alike seem to recognize that it probably will not reach traditional levels. Most of the new products coming onto the scene have higher commissions, and companies offering low commission versions are under some pressure either to raise the level of commissions or to offer additional products. I know that my own experience was that the company I was formerly associated with went through two commission revisions that we actually used (and one that was not), but the agents were clearly agitating for more commission dollars. For the long term, however, commission rates are likely to trend downward, although they may not reach the levels that we saw on the original products.

At the present, the market for Universal Life is not very sophisticated from the consumer's viewpoint. To echo a point Bob made, the industry has not agreed upon disclosure standards. It is thus not only difficult to make meaningful comparisons between Universal Life products, but also difficult to make comparisons between Universal Life and competing traditional life products, be they whole life products or combination long term annuities.

Early press reviews of Universal Life have been numerous and generally favorable. The dissenters, such as Consumer Reports and Jane Bryant Quinn, have criticized excess loadings in Universal Life in comparison to "buy term and invest the difference" schemes. Even they, however, have generally agreed that the product is an improvement over traditional life products.

For Universal Life to maintain its credibility from the viewpoint of consumers and financial reporters, it cannot also be a "good deal" for the agent, at least in the traditional sense. Because of the disclosure of expense elements, it would be difficult to maintain the same degree of market acceptance for a product with traditional commissions and loads.

A final area to consider in the future direction of Universal Life products is the influence of the regulators. Universal Life was originally accepted by many insurance departments, even though it does not literally comply with the letter of the insurance code in most states, because it was perceived to be in the interest of the insurance consumers. Currently, New York is the only state to require legislative changes prior to allowing the product. It is regulated, however, to a much greater degree than traditional products. Currently, regulatory activity is increasing. In product pricing, various states have addressed items which include: a) limits on guaranteed rates for mortality costs, particularly for substandard lives; b) regulating

surrender charges; and c) controlling profit levels through regulations relating to indeterminate premium products. Without a significant price advantage for the consumer over traditional products, it may be difficult to maintain even the degree of acceptance which Universal Life currently has at the state insurance department level. Recently, public hearings were held in New Jersey and California concerning Universal Life regulation. A number of other states, including Illinois and Wisconsin, have been active in the area of Universal Life. Another very significant development which will affect the compensation is the interpretation which the New York Department puts on Section 213, at least to the extent that Universal Life is written through companies licensed in New York.

Amount of Risk. There is no accepted definition of the amount of insurance needed to assure that Universal Life will be treated as life insurance by the IRS.

As most of you are probably aware, Universal Life plans often provide two types or patterns of death benefit. Under one option, the death benefit is equal to a level amount of insurance plus return of the cash value. Under the second option, the death benefit is equal to a decreasing amount of insurance plus the cash value so that, under this option, the total death benefit payable is level. Because the amount of coverage decreases with increasing amounts of cash value, the amount at risk could become very small. To maintain some amount of risk at all times, Universal Life contains what has been labeled a "corridor amount", generally expressed as a fixed amount, usually not less than $5,000 and not more than $25,000; or a percentage of the cash value; or a combination of each.

When large amounts of cash accumulate under a Universal Life contract, the natural question arises of whether or not the contract will continue to qualify for favorable tax treatment as life insurance under the Internal Revenue Code. Section 101(a)(1) of the code provides that the entire death benefit payable under a life insurance contract is generally excludable from the income of the beneficiary. While life insurance is not specifically defined by the code, the case of Helvering v. Legierse is usually cited as providing an accepted definition. To qualify under this case and under 101(a)(1), a life insurance contract must involve risk shifting and risk distributions; that is, the risk of premature death must be assumed by the insurer.

A clear conclusion from the questionnaire is that those surveyed felt that some additional definition of minimum amount of risk is needed, either through a change in law or by action of the NAIC or IRS. If we look at some recent activities in this area, we can see what has been proposed. In 1978, the Carter Administration, in a proposal to tax cash value increases of certain non-qualified deferred annuities, attempted to define through legislation a standard for "significant life insurance protection". A contract would not be considered as providing significant life insurance unless it provided a minimum death benefit at all times prior to maturity not less than the maximum surrender value of the contract as of any date prior to maturity. As currently structured, most Universal Life contracts, particularly those which involve a fixed amount of coverage and a return of cash value, would not meet this definition. It should be stated, however, that this was a legislative definition and really has no precedent value nor is it currently being pursued by the current administration.

More recently, the ACLI Other Issues Group, a subcommittee of the ACLI Steering Committee on Company Taxation, has been attempting to set definitive guidelines for life insurance specifically directed toward Universal Life. In a memo to the ACLI Board dated March 5, 1982, two approaches to this were outlined. The first proposed guideline measures and limits premium payments based on a guideline premium defined in the contract. The second proposed guideline classifies life insurance cash values as amounts not in excess of the net single premium necessary to purchase the life insurance or to endow this contract after a stated period.

I have prepared a chart which gives an example of the two methods. Under the guideline premium approach, premiums necessary to mature the policy on the latest maturity date allowed are calculated on both a single premium and a periodic premium basis, using guaranteed mortality and interest and adjusted to reflect expenses. The periodic premiums are based upon the pattern chosen by the policyholder at issue. A Cumulative Premium Limit, equal to the larger of the guideline single premium or the sum of the guideline planned premiums, is set out in a schedule in the contract. If actual premiums exceed the limit, they may not be paid into the contract but may be refunded, paid into a flexible annuity, or used to purchase paid-up benefits. Of the two columns on the chart, one shows the Cumulative Premium Limit based on a single premium or the sum of the guideline plan premiums. I illustrate them only to give you an indication of what the limit is on the amount of premiums which are allowed to be paid into the contract. The premiums allowed under the Cumulative Premium Limit are quite generous since the amount of premium at age 95 exceeds the amount required to endow the contract, and the examples do not include the effects of accumulating those cash values with interest. While this approach both sounds and is, in fact, complicated, it has the advantage that it limits the amounts paid into the contract on a basis known at the time the contract is purchased. If followed, it assures the policyholder that the contract will remain, at all times during the life of the contract, life insurance.

The cash value test is simpler in concept, but somewhat restrictive in practice. Under that test, a product would be tested annually. If the cash value is not in excess of the required net single premium, based on the guaranteed mortality and interest to purchase the current total death benefit, the policy is considered life insurance. If cash values in excess of the net single premium arise, the additional amounts may be used to purchase additional paid-up insurance or to shorten the endowment period. Otherwise, any excess cash values will be treated as annuities.

Tax Compromise. Some experts assert that the fate of the Universal Life company tax treatment will be settled by Congress based on an industry compromise that restores competitive parity between stocks and mutuals.

Regarding the tax compromise, the questionnaire was distributed prior to the development of the stopgap tax package. If the measure holds together, the eighteen respondents who identified an industry compromise as the most likely scenario get an A for their foresight. At the levels currently proposed, the safety net for stock companies should result in only a slight reduction in the interest rates credited. Even if the ACLI stopgap tax package is adopted, a significant number of tax issues are unresolved. These include: a) whether companies will succeed in being allowed a 100% deduction of interest; b) whether Universal Life will qualify for the non-par deduction; and c) what constitutes an appropriate treatment of

Universal Life under 818(c). Finally, the tax treatment beyond stopgap must be resolved.

DEFINITIONAL GUIDELINES FOR UNIVERSAL LIFE INSURANCE

DURATION	SUM OF GUIDELINE PLANNED PREMIUMS	CUMULATIVE PREMIUM LIMIT	ATTAINED AGE SINGLE PREMIUM
1	$ 27	$ 438	$ 376
5	133	438	424
10	265	438	486
15	398	438	552
20	531	531	618
Age 95	1327	1327	1000

BASIS: Level premium endowment at age 95 issued to a male age 45 using the 1958 CSO ANB, 4% interest and a 20 percent expense loading. Net Single Premium = 365.09

MR. STEVE RADCLIFFE: My presentation today will cover three different topics. First, we will discuss the most typical type of reinsurance of the Universal Life product - YRT reinsurance of the mortality risk. Second, we will discuss some other uses of reinsurance, including: reinsurance of the "dividend or excess interest risk" with modified coinsurance, coinsurance of the investment risk, surplus relief, and other specialty uses of reinsurance. Finally, on a topic not related to reinsurance, we will consider the impact of various adverse events on the future of Universal Life. The adverse events are centered around the tax issues and declining interest rates.

As some of you already may know, we sent out a survey of questions on Universal Life to find out what you were interested in hearing about at this session. Most of our presentations are based on the response to that survey. However, reinsurance was evaluated as one of the least interesting topics to discuss. This did not surprise me because, a a reinsurance actuary, I have noticed that reinsurance usually gets a low priority in the design and development of Universal Life. I think that the reason for the outcome of the survey is that reinsurance is usually taken for granted. However, reinsurance of Universal Life is different and cannot be taken for granted. This is especially true for the design of your administration system to handle this product. Please allow me the indulgence of discussing this subject even though the survey indicated little interest in it. If I get only one point across today, it would be this - reinsurance is quite easy to take care of in the initial stages of designing Universal Life policies and administrative systems. On the other hand, reinsurance can be

very difficult to accommodate after the systems are designed and issuing policies. If you take care of your reinsurance needs up front, you will save yourself many headaches later.

Reinsurance of Universal Life will have to be different from traditional individual cession reinsurance. Traditional reinsurance is based on the individual cession card. This card transmits information on reinsured individuals from the ceding company to the reinsurer. The information is shown below:

Reinsurance Cession Card

1. General Information
   - Name
   - State
   - Policy Number
   - Auto/Fac.

2. Premium Information
   - DOB
   - Sex
   - Rating
   - Riders

3. Schedule of Reinsurance
   - Previous Inforce
   - New Applied For
   - Retention
   - Ten Year Schedule

The cession card is the cornerstone to traditional reinsurance. It provides the basis of reinsurance billing for ten years into the future. It also provides the information to the reinsurer for retrocession requirements. However, with a Universal Life product and the flexibility it provides, there is no way to guess the schedule of amounts of required reinsurance for the next ten years. Even if the policyholder makes no change in scheduled premium payments, the net amount of risk in future years (which will be a function of the credit interest rates) cannot be determined at issue of the policy.

Handling revised cession cards for each change in Universal Life reinsured amounts would be too cumbersome and costly. The only way to avoid this problem is to have the ceding company handle the administration and billing of reinsurance as an offshoot of the basic administrative system for the policy.

At each monthiversary when the basic policy is being processed, the amount of reinsurance can be determined and is equal to the total net amount at risk less the ceding company's retention. The amount of reinsurance will be multiplied by the reinsurance premium rate, which is usually just a function of the coding company's monthly mortality charges, to get the total reinsurance premium. This process is very easy to describe but a little more difficult to actually add it to the administrative package. However, it is much more difficult to add it once a system is already operating. It is much easier to add it during the initial design of the system. One company tried to handle this reinsurance process with a manual process until it

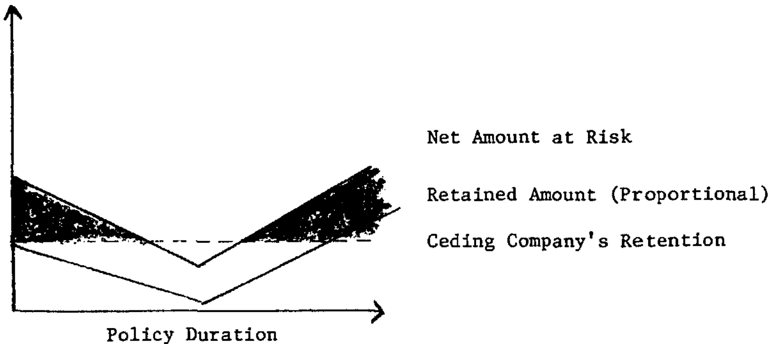
could add it to the EDP system. At first, it took only one-half day to prepare the monthly report. When I last contacted the company, it was taking two weeks, and the company was no closer to automating the system.

The self-administrative system takes care of the billing process, but the reinsurer still needs to handle its retrocession needs. This can be accomplished by a streamlined monthly reporting of name, date of birth and amount on reinsured lives for all issues and terminations. A review of these monthly lists allows the reinsurer to determine its need for retrocession.

There is another alternative, usually called bulk reinsurance, where there is no reporting of information on individual lives. The amount that you can send a reinsurer on this basis is usually very limited on a per life basis because the reinsurer must accept the risk of being over-retained on a life. At AUL, we retain $700,000 on individual risks and $250,000 on bulk risks. Usually, bulk reporting is "layered" with individual reporting. That is, the first $250,000 is sent on a bulk basis, and the amounts in excess of $250,000 are sent on an individual basis. The bulk concept is an undeveloped one, and therefore, the total capacity on this basis is rather limited.

There are two types of retention methods - proportional and non-proportional. AUL uses the non-proportional method where the ceding company keeps its full retention at all times on a life. Other reinsurers use the proportional method where the ceding company's retention is a fixed percentage of the net amount at risk at all times. The difference between the two methods is illustrated in the following diagram.

Illustration of Different
Retention Methods



Note: Shaded area represents the reinsured amount under non-proportional method.

Notice that the reinsurance under the non-proportional method can disappear then later reappear. We believe the non-proportional method has an advantage in that the ceding company is guaranteed that it will never exceed its retention. As you can see by the diagram, this is not the case with proportional reinsurance.

At the start of our discussion, we labeled this reinsurance YRT. Actually, the reinsurance of Universal Life that we have been discussing is usually handled on a monthly renewable term basis. We initially designed our reinsurance so that the premiums were calculated and reported at the end of each month and were deemed to cover the calendar month in arrears. With these assumptions, we felt that there would be no unearned premium reserve. This seemed desirable since it would avoid calculations of small reserve items at the end of the year. Another view is that the premium covers the period from monthiversary to monthiversary. In this case, you would have to hold unearned premium reserves. However, it is interesting to note that if you assume that policy changes can occur only on monthiversary, the reinsurance premium collected over the life of any given policy is the same under either method. The proof will be left as an exercise to the reader.

Phase II negative companies may want to transfer the "dividend" risk (i.e., the risk that the excess interest credited to the cash value fund will be declared a dividend by the IRS). This can be accomplished with a modified coinsurance agreement without the 820 election. The dividend has to be transferred to a reinsurer that is not affected by the dividend transfer. This includes non-life companies, Phase II positive companies and even Phase I companies. It is obvious that you do not want to make the 820 election because you want to keep the investment income in the Phase II negative tax shelter. Not many of these types of agreements are actually used, perhaps only 10% of all situations. A word of warning: these are very complicated and sometimes expensive deals (especially if all of the hidden costs of maintaining the agreements are added in), and they may not really provide that much protection. If the Treasury is really intent on treating excess interest as dividends and taxing those amounts, they probably will find a way regardless of any reinsurance treaty in place.

Coinsurance of Universal Life may be desirable for ceding companies that want the reinsurer to perform the investment functions. This idea may be quite desirable for small Phase I companies which do not want to support the overhead that a competitive investment department would require. Coinsurance for these companies to a Phase II negative reinsurer would kill three birds with one stone - it would transfer the mortality risk, the investment function and the tax problem all in one agreement.

Some companies may want surplus relief built into their reinsurance package. This can be accomplished with coinsurance, modified coinsurance or a combination of the two. It can also be handled through coinsurance with funds withheld or even a YRT scale with a high new business bonus. There really should not be a great demand for surplus relief on this product. From what I have seen so far, this product does not present an unusual demand on surplus.

There is another use of reinsurance that I have heard discussed but have not been directly involved in. Maybe during the question and answer period some of you might want to comment on it in more detail. The situation is unique to mutual companies. A mutual company that has purchased a stock subsidiary

to sell Universal Life may be licensed in states where the stock subsidiary is not licensed. In this case, the mutual parent would issue the Universal Life policy and then reinsure it to the stock subsidiary for the tax advantage. This arrangement could be used for a temporary period while the stock subsidiary obtains the necessary licenses. It probably cannot be used as a permanent solution unless there is another business purpose involved that would be acceptable to the IRS. I do not believe this technique is being used very widely. I interviewed two actuaries at different mutual companies before this meeting to find out if they were using the technique. Neither were, and the reason was that they were not 100% sure how the treaty would be viewed by the IRS. They did not want to take the risk of an unfavorable ruling down the road. Maybe someone in the audience who is using the technique would comment on his rationale.

Now let's switch gears for a moment and consider the impact of some adverse scenarios on the future of Universal Life. In the survey of questions that I mentioned previously, we asked the respondents to react to three different scenarios and how they might affect Universal Life. The survey was taken in January, 1982, and the respondents were actuaries involved in the development of Universal Life as selected by our moderators. The summary of this survey is shown on the next page, together with the responses made by the audience at the Orlando meeting.

As you can see, the survey respondents were quite positive about the future of Universal Life, and the audience was somewhat less optimistic. Admittedly, however, the respondents were a group of individuals working on the development of this product and would be biased toward optimism on its future.

I was surprised to see that 93% thought that Universal Life would continue to be the major non-term product at lower interest rates. I believe the audience's response is more realistic. However, it indicates that people like the product for reasons other than the high interest rate illustrations.

Another surprise was that the respondents, and maybe the industry, are taking a very aggressive attitude toward taxation. The message that I read from these results is that if the Treasury tries to tax the inside build-up of cash values of Universal Life, the industry will work to find a way around such a position.

Summary of Results

What Impact Do You Foresee From the Following Adverse Events?

Event 1: Stop Gap Scenario

1980 Hutton Rulings Confirmed and Moderately Adverse Excess Interest Company Tax Ruling

	Respondent's Choice	Audience's Choice
A. ULI will be the major nonterm product by 1984	28%	10%
B. ULI will be offered by most companies but with mixed success	40%	65%
C. An improved ULI linked to separate accounts will emerge	32%	25%

Event 2: Reagan Scenario

Interest Rates Drop to 8% by 1983

	Respondent's Choice	Audience's Choice
A. ULI will continue to be the major nonterm product	93%	15%
B. ULI will survive mainly in special markets (e.g. Pension Trust)	5%	83%
C. ULI will disappear except for a few specialty companies	2%	2%

Event 3: Disaster Scenario

IRS Refuses to Give General Ruling for Policyholders and Tax Rulings are Harsh on Company Side

	Respondent's Choice	Audience's Choice
A. Stock Companies will continue to compete with reasonable success	25%	1%
B. New ULI products will emerge that end run the tax rulings	63%	85%
C. ULI will disappear except for a few specialty companies	12%	14%