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UNIVERSAL LIFE UPDATE

*Moderator: THOMAS F. EASON. Panelists: WAYNE D. BIDELMAN, ANDREW F. BODINE, ALLEN D. BOOTH, ROBERT W. BUECHNER**

QUESTIONNAIRE

Panel moderators Tom Eason and Lynn Peabody developed a questionnaire containing many of the current topics relative to Universal Life. The questions were sent to sixty actuaries known to have some involvement with the product so that they might (indirectly) guide the discussions. (Forty of the persons surveyed were in fact persons suggested as panelists or workshop chairmen.)

Brief general answers to the questions were solicited, as well as an optional answer which could be completed by the respondent. In addition, the actuaries were asked which questions were most pertinent for the panel discussion from their perspective and that of their employer. Nearly fifty usable responses were received.

The questions below were deemed the best. A summary of the responses received is given.** The questionnaire was not designed, nor is it represented, to render scientifically valid responses. It has served as a tool to help ensure the most pertinent and interesting discussion topics. Neither the questions nor the responses are comprehensive, but both will provide a useful basis for professional discussion of Universal Life (ULI).

1. Business Mix. ULI has been described by some as a whole portfolio wrapped up in one product.

WILL ULI BASICALLY REPLACE MOST OF THE OTHER PRODUCTS FORMERLY SOLD BY THE COMPANIES?

Total	Only	Mult.		
24	16	8	[a]	Yes, it is indeed "universal" and essentially can be structured like most standard products.
3	3	0	[b]	No, it will only be sold by a few agents, and the remaining agents will sell traditional products.
0	0	0	[c]	No, it will be used almost entirely for replacements.
27	19	8	[x]	Other:______________________________.

* Mr. Buechner, not a member of the Society, is President of the Legal Professional Association, Buechner, Haffer and O'Connell, Cincinnati, Ohio.

** "Only" refers to the number of respondents who checked one answer only. "Mult." indicates a multiple response, including this answer. "Total" is the sum of a single and multiple responses.

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

DO YOU BELIEVE THAT ULI PRODUCTS WILL GRAVITATE TOWARD THE STRUCTURE OF TRADITIONAL PRODUCTS, BUT MAINTAIN THE POTENTIAL FLEXIBILITY?

Total	Only	Mult.		
13	11	2	[a]	Yes, it is necessary for agents to sell the product.
1	1	0	[b]	Yes, because the public is not ready for such a nontraditional product.
6	5	1	[c]	No, ULI is too different to be compared to traditional products.
12	11	1	[d]	No, both type products will coexist since each has its own strengths.
12	9	3	[x]	Other: ______.

3. Commissions. Some experts assert that ULI 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?

Total	Only	Mult.		
4	3	1	[a]	Low-load or 20-35%.
5	4	1	[b]	Roughly half of traditional.
11	10	1	[c]	With improved productivity, 60-80%.
21	19	2	[d]	Traditional levels for annual premiums under $600 or so, graded down for larger premiums.
5	4	1	[x]	Other: ______.

4. Indexed Product. Several ULI products use a fund with investment return linked to a financial index.

FROM THE COMPANY'S VIEWPOINT DO YOU LIKE A PRODUCT SUCH AS "T-BILL LIFE" OR "BONDED LIFE"?

Total	Only	Mult.		
11	9	2	[a]	No, market for indexed product is transitory.
18	15	3	[b]	Yes, with product choice or changes as needed.
14	11	3	[c]	Yes, temporarily, for tax reasons.
8	4	4	[x]	Other: ______.

5. Investment Considerations. The crediting of high current interest rates on ULI products makes investment strategies a critical element of a company's success.

SHOULD COMPANIES BE CONCERNED ABOUT THE POTENTIAL INVESTMENT RISKS TIED TO ULI?

Total	Only	Mult.		
33	22	11	[a]	Yes, a competitive product has the same potential risk as high yielding annuities.

14	3	11	[b]	Yes, primarily because of the potential impact on existing business.
1	1	0	[c]	No, not a problem for more than a few companies.
1	1	0	[d]	No, since declining interest rates will minimize potential problems.
10	6	4	[x]	Other:________________.

6. Coinsurance and Risk. Some experts assert that coinsurance via a properly positioned subsidiary of the company or a reinsurer can minimize the financial risk of adverse tax rulings on ULI excess interest.

WILL THIS TECHNIQUE WORK DURING THE TWO OR THREE YEARS IT TAKES THE IRS OR CONGRESS TO ACT?

Total	Only	Mult.		
12	10	2	[a]	Yes, there is a better than ever chance.
13	11	2	[b]	Yes, solid reasons and tax planning practically require it.
6	6	0	[c]	No, such arrangements are likely a sham.
1	1	0	[d]	No, it isn't needed because the adverse ruling won't happen.
1	1	0	[x]	Other: ________________.

7. High Interest Problems. ULI advertising stresses "high-interest." Illustrations are shown for many years. React, please, to the following assertions.

7a. FAILURE TO DISCLOSE THE SHORT-TERM NATURE OF THE YIELDS MISREPRESENTS THE PRODUCT.

Total	Only	Mult.		
13	12	1	[a]	The buyer understands the difference. Showing guarantees is enough.
11	6	5	[b]	A "standard" projection at 8 percent or so should be provided.
15	11	4	[c]	Tight rules and new disclosure methods are needed.
14	8	6	[x]	Other: ________________.

7b. POLICYHOLDER DISSATISFACTION WHEN RETURNS DROP BELOW PROJECTIONS WILL RESULT IN A DAMAGING ROUND OF DISINTERMEDIATION FOR ULI COMPANIES.

Total	Only	Mult.		
16	10	6	[a]	The public will understand since rates will be down elsewhere.
27	20	7	[b]	Good relative performance and thoughtful service will minimize this problem.
3	3	0	[c]	Those who live by the sword will die by the sword.
7	4	3	[x]	Other: ________________.

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

SHOULD A LINE BE DRAWN SETTING SOME MINIMUM AMOUNT AT RISK?

Total	Only	Mult.		
9	6	3	[a]	No line is needed or desirable.

10	5	5	[b]	Retirement income (and other permanent forms) have no amount at risk in some years. A major change in the law is needed.
15	11	4	[c]	Yes, an NAIC model definition would be useful.
16	12	4	[d]	Yes, the IRS should give the industry guidance.
6	3	3	[x]	Other: ____________________.

9. Impact of Adverse Events. Some companies say ULI will prosper even if adverse events alter present product characteristics. WHAT IMPACT DO YOU FORESEE FROM THE FOLLOWING EVENTS?

9a. CONFIRMATION OF 1980 HUTTON RULINGS TOGETHER WITH A MODERATELY ADVERSE EXCESS INTEREST COMPANY TAX RULING?

Total	Only	Mult.		
15	10	5	[a]	ULI will still be the majority nonterm product by 1984.
21	16	5	[b]	ULI will be offered by most companies but with mixed success.
17	8	9	[c]	An improved ULI product linked to special separate accounts will emerge.
0	0	0	[x]	Other: ____________________.

9b. TAX RULINGS ARE HARSH ON THE COMPANY SIDE, FORCING A SCALED-DOWN INTEREST PASS-THROUGH; AND IRS REFUSES TO GIVE A GENERAL REVENUE RULING WITH RESPECT TO INDIVIDUAL POLICYHOLDERS?

Total	Only	Mult.		
13	6	7	[a]	Stock companies will continue to compete with reasonable success.
32	22	10	[b]	Differentiated products will emerge, attempting to end-run the Company tax ruling.
6	3	3	[c]	A few companies may linger on, but ULI will lose all momentum.
5	2	3	[x]	Other: ____________________.

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

WHAT IS YOUR VIEW?

Total	Only	Mult.		
18	15	3	[a]	Most likely scenario.
11	9	2	[b]	No compromise is likely. The courts will play the key role.
7	4	3	[c]	Adverse IRS rulings will be released within six to twelve months.
6	4	2	[x]	Other: ____________________.

MR. THOMAS F. EASON: Our panel this morning consists of an attorney and author, an accomplished consultant, a leading coinsurance expert and a senior company actuary whose small company has scored considerable success with the new line of products.

Mr. Robert W. Buechner, JD, CLU, is President of Buechner, Haffer and O'Connell in Cincinnati. Bob's specialty is tax planning. He is a graduate of Princeton and the Michigan Law School. He has spoken at over 100 tax forums and is coauthor of a book recently published by the National Underwriter entitled Why Universal Life.

Mr. Wayne D. Bidelman, FSA, is Second Vice President-Reinsurance, at Security Life of Denver. Wayne's specialty is in the use of reinsurance for financial and tax planning.

Mr. Allen D. Booth, FSA, is a consultant in the Milwaukee office of Towers, Perrin, Forster and Crosby. He consults on product management, strategic planning and financial projections.

Mr. Andrew F. Bodine, FSA, CLU, is Vice President and Actuary of Inter-State Assurance Company in Des Moines. His company's success with ULI speaks for him. In 26 months, Inter-State has added $12.4 million of ULI premiums and $400 million of in force - more than the total company in force at the beginning of 1980.

Unless otherwise stated, the views expressed by the panelists are their own and not necessarily those of their firms.

I would like to begin with a short survey of the roughly 300 people who have now assembled. It is designed to give the panel perspective on the composition and attitudes of the audience. Although I will announce a rough distribution of the responses for the record, no scientific conclusion should be reached on the results, just as you have been cautioned not to place undue credence in the expert survey responses on which this panel is based.

If you or actuarial associates in your current place of employment are involved in active study, development or marketing of ULI or a similar type of nontraditional life insurance product, please raise your hand. My count makes that roughly 90 to 95 percent of the audience.

Let us now obtain a rough idea of your personal sentiment about ULI. You will have three choices. Do you believe that the product is required to make constructive progress in today's economic and marketing environment? We will call this the "positive orientation." Do you believe that the product is necessary to prevent unwarranted or undesirable replacement of existing permanent products? This will be called the "defensive orientation." Are you undecided or sufficiently caught between these two alternatives that you simply seek more information? This I will call the "undecided" or "wait and see" orientation.

If you have a generally positive view of ULI, please raise your hand. That looks to be 50 percent of the audience.

If you have a generally defensive orientation, may I see your hands. I count 20 to 25 hands or 7 to 8 percent.

If you are undecided and don't fall into either of these categories, please raise your hands. Thank you very much. The balance of the audience having voted, it appears that nearly half of us here have a "wait and see" view.

The first question deals with business mix. We have an interesting array of responses. The lead speaker is Andy Bodine.

MR. ANDREW F. BODINE: The magazine I have in my hand is the May, 1982, issue of Life Insurance Selling. It's the second publication I've seen in the marketing area that's devoted entirely to the subject of ULI. The editor of this magazine, Larry Albright, CLU, makes some statements on page 8 which are very important. They typify my view and I think they typify the view of our company as we approach the ULI environment. I want to read a few words from it for you: "Universal Life is not the problem. It is rather a manifestation of the many economic factors impacting negatively on the life insurance business. Those factors include inflation and high interest rates. The real problem, as I see it, is that the life insurance business has been losing its share of the consumer's financial dollar and agents are finding it harder and harder to make a good living. I suspect that if Universal Life were to disappear tomorrow, some agents and some home office people would be happy. But I think their reaction would be a mistake. Universal Life is not the problem; it's a potential solution to at least some of the problems facing the life insurance business. Perhaps Universal Life is an excellent solution or something less. The Universal Life issue actually is part of a much larger issue - the survival of insurance companies and agents."

The ULI design can be structured like most standard products. ULI can do many things that traditional products cannot do, such as increasing benefits at a later date with a different underwriting classification for the increase than for the base coverage, providing for cash surrenders without a proportional reduction in risk benefits and the obvious flexibility of making premium payments and benefit changes somewhat randomly.

One of the key questions is that of policyowner discipline with respect to actually making premium payments. A related question is how to define persistency under these circumstances. A low level of premium payments may be in conflict with the actuarial assumptions and product design. Most of the ULI products I've seen do not compete very well with pure term products if it is the insured's intention not to develop a fairly significant level of cash values.

It's difficult to consider this question without also considering the many varieties of agents' compensation and expense load designs which are already available for ULI as well as the potential for further innovation. These subjects will be covered more fully later. My current position is that traditional products will be replaced, not only by a similar but flexible ULI concept, but by ULI products which provide more favorable total results for the policyowner through changes in expense loading structures and agency compensation formulas.

Individual life insurance products have been heavily criticized for years in these two areas and our major defense to our critics has been something like, "You just don't understand the basic necessities of our industry and the things we must do in order to run our business." Primarily in these two areas, ULI is a vehicle which gives us the opportunity, if we are strong enough to take advantage of it, to improve the product for the customer. These new wrinkles in products will make life difficult for us for a while because we all find change hard to accept. The major impact of change will be on the distribution compensation system.

I foresee some products surviving in current traditional form. These include pure term coverage, which is currently available at extremely low initial premium charges, and, I might add, at an extremely low agent compensation level. I also see pure annuities surviving. There will likely be survival of many specialty products which have not been adapted to the ULI form or principles, but which may very well be in that category in the future. One example would be a multiple life policy where no benefit is paid on the first death.

With respect to replacing our own policies, we found it difficult not to do so when we felt the ULI product was far superior for the policyowner. If we did not permit our own policyowners to switch, we believed they would soon be approached by agents from other companies. Although we don't want to lose the financial base from these policies, we feel that it's better that the insurance stay with our own company than move on to another one. Apparently several companies are stating that their own policyowners have a similar opportunity, but they limit the amount of commissions paid to agents on such roll overs and there are implicit restrictions due to the large portion of current policies in force with sizes smaller than the minimum sizes required for ULI.

In our consideration on the investment yield available to be credited to ULI, we reflect that such roll overs will have had funds already invested in prior years and we are not really receiving new dollars available for investment at the current higher yields.

Consider one further thought about replacements which we believe to be very provocative and which may well have growing significance in the future. Placing policies in force does not really put any of our companies into a current statutory net loss position. The policies are financed by existing surplus which, in most cases, came from prior years' earnings. Earnings on current policies being sold are, in one sense, not needed to bring the policies to their own break-even point. They are needed for the continued financing of future sales. As our valuation assumptions and product designs produce smaller margins for companies, and as ever-increasing lapse rates destroy pricing assumptions, there will be increased pressure for policies to carry their own weight through pricing to meet expenses as they are incurred. This can be done by rearranging the costs or by loadings which match the incidence of expenses. One effect of the changes will be to immunize companies against lapsation. I expect the industry will move in this direction with the end results being not so much a pure concept of zero surplus drain as it will be a much smaller amount of surplus needed to support each new policy sold.

MR. WAYNE D. BIDELMAN: In principle and certainly in theory, I don't disagree with anything Andy has said. A problem with the survey type of question is partly terminology. Are we talking about ULI as it currently looks? Are we talking about ULI as if the current scenario continues as is with respect to insurance and tax laws, high interest rates, etc.? Andy has properly responded to the question based on status quo.

Will ULI, as it currently looks, replace most other products currently sold? I don't think so. Will an unbundled type product replace most former products? This is more likely so. The unbundled type of product is probably here to stay in some form. The buying public will likely never again look at things in the same manner they did before the current economic situation of high interest rates and high inflation. They will tend more to always ask, "What return do I get for funds held?", and "What will this insurance product actually cost?"

I have talked to people in companies who have been writing ULI. They are already desirous of or have developed new forms of the product. It is likely the start of an evolution, taking new direction based on the winds created by the economy, Congress, the Internal Revenue Service (IRS), state insurance departments, the buying public and even those who market insurance.

There will be many products other than ULI, even as one contemplates this evolutionary product. Just as all companies didn't get into the mutual fund business, it's likely that all companies will not get into ULI. For many companies it may be virtually the only product. If for no other reason than pressure, there will always be competing products. I doubt there will ever be an "answer all" insurance product - not when each company must find a somewhat unique way to compete, not when there will always be such as Section 79, Individual Retirement Annuities, Retired Lives Reserves; not even when there exists a tax law that views companies differently depending on their type. ULI may replace many of the life insurance products previously sold, but it's not likely the end of all other forms of life insurance. It is also not just a gimmick product dreamed up by replacement artists.

The business mix question is one that every company must eventually answer. Perhaps those responding to Tom's straw poll as taking a "wait and see" posture are taking the correct posture for their companies, given the regulatory uncertainties, and if their future success can afford that posture. ULI is <u>an</u> answer to the current economic situation and the current marketplace. Only time will tell whether it is <u>the</u> product for the life insurance industry.

MR. EASON: Wayne has referred to the evolution of the product. By some measures, ULI is already in its third generation of product development. The second question asks whether ULI and traditional products can coexist and asks whether ULI will begin to look more like traditional products.

MR. ALLEN D. BOOTH: I must define my approach to this question so as to allow some latitude for my discussion, and to avoid stealing thunder from the following question which is on generally the same topic. Some parts of the current question imply a focus on agent compensation. Other parts focus on the general subject of product design. My response will center more on design as a cause of commission trends. Later, my focus will be on compensation needs and distribution techniques as a causal factor.

I view product design as evolutionary, not absolute. It is doubtful that the expert has yet been developed who can create the ideal product. If created, it would certainly be ideal only for a short period of time due to an ever changing environment. Some advances in product design are small - minor technical or theoretical advances that give a company a slight competitive edge. Others are more dramatic, resulting in a new vision of how things might be done. The ULI concept was a major breakthrough which advanced the theory underlying both split life and adjustable life.

It can be argued that E. F. Hutton Life gave a measure of credibility to the ULI concept. A major visible force in the marketplace adopted the concept and gave it momentum. This was important since it gave many thinkers a new frame of reference and an opportunity to develop minor improvements on a major breakthrough. Importantly, the original Hutton marketplace and distribution system influenced its conceptual design decisions. Initial thinking in other companies often started with the Hutton premise regarding product design and commission and load structure (i.e., the three factor commission structure).

Unfortunately, this structure, which appeared appropriate to the Hutton environment, was not appropriate to others. Therefore product development experts in other companies were forced to rethink some things. Much of the rethinking had to occur relative to the loading and commission structure because the Hutton scenario didn't fit the typical career agent, personal producing general agent or broker environment. Hutton would probably indicate that they had more success with their second product featuring higher commissions.

It was necessary and natural for this rethinking to result in higher levels of compensation in newer ULI products. It was needed in order to support the income needs of established sales forces. The trend in commissions since Hutton has been upward - approaching ordinary life levels in many companies. The approach has been altered away from the three factor approach to something more approaching a standard percentage of premium method.

When I think of the commission trends, I don't think in generation terms. I see the commission trend as movement within a generation. The so-called "second generation" will be more profound - another dramatic breakthrough as opposed to a minor technical or theoretical advance. "Second generation" means a breakthrough in the ULI product's approach to cash values and the attendant asset base. The time may be right for our industry to give the consumer an asset choice. This may involve some, any or all of:

- An equity account resulting in a ULI corollary to variable life. In this concept, we again encounter Securities and Exchange Commission (SEC) limitations, including field compensation constraints. That might breed yet another pattern of commission rates which would be viable only within the specific equity based environment.

- A short term account - basically the way the ULI product now operates. This means short portfolios, money market funds, and so on. The buyer receives only marginal long term security.

- A bond fund account, invested in longer fixed dollar investments, perhaps with adjustment for asset value, but surely with interest guarantees of meaningful duration. Taken to the n-th degree, the longer term fixed dollar base can approach, within ULI, an ordinary life type of result. That is, we can structure a nonequity based product which will allow the buyer to secure his future with long term guarantees, to seek high current results through short term investments (at the risk of higher future cost), or to choose from among several options.

Viewed from this second generation scenario, I conclude that we can, as industry leaders, fashion a product with all, or at least many, of the strengths of ordinary life, but with far greater flexibility. Flexibility is the key word of this next decade and will give staying power to the ULI concept.

An equal number of respondents to Question #2 indicated that more ordinary commissions are necessary to sell the product and that traditional products and ULI will coexist since each has its own strengths. Each group is correct. The products will coexist. Those ULI products which are sold must adequately reward the sales person.

MR. BODINE: Although I answered this question by indicating that the products will coexist, since each has its own strengths, I am not in disagreement with the first survey response, particularly over the short term. Soon after our product was introduced, even with relatively little ULI competition, it became apparent that agents believed a higher level of commissions was needed to interest them in selling it. We found this perception of higher commissions should be in terms of a high percentage of premiums and not as dollars per policy. As the agent's commission level is increased, a company is faced with a product design question as to the pattern of loading to be used. Given the natural reluctance to make significant changes, many companies will decide to achieve agent and customer acceptance by avoiding front end loads. This decision will create other product design complications such as surrender charges, the requirement of minimal renewal premiums, and nonforfeiture penalties upon default in premium payments in order to bring the product to a profitable position over a period of time.

After product design flows through its second generation phase, in order to achieve agency acceptance with the traditional structure, we will see a period of perhaps five to ten years of experimentation with different patterns of compensation and expense charges. These will be aimed at achieving immunization from persistency by matching charges with incurred expenses, commission patterns which achieve a level of acceptability for the agent without being either inadequate or excessive, and a level of total expense charges which is acceptable to the consumer.

Although this suggestion would involve a higher front end charge to the policyowner, which is not acceptable in current traditional products, I think it can be shown that this pattern could lead to improved net costs over twenty years with otherwise similar assumptions. I see both of these patterns of product design existing in much the same way that both participating and nonparticipating products have existed in the past. Some policyowners have shown a preference for paying a higher premium (as for mutual policies), in exchange for an expected improved return over a period of years. Other policyowners have shown a preference for a lower premium without any expectation of dividends.

MR. EASON: The third question addresses more of the broad considerations involved with commissions. Messrs. Booth and Bodine will respond, and Mr. Buechner will give a special additional response.

MR. BOOTH: Participating and nonparticipating products did exist side by side for years and paid commissions that were widely divergent, ranging from maybe 25 to 125 percent, depending on the company and the market. Thus, I have some difficulty with the word "common" which is used in the question. Insurance products exist only to serve a market. There is no value in a product, only in the ability of a product to produce useful results in one or more markets. It is more valuable to discuss this from the point of view of markets than of products.

One market that has a meaningful future is the payroll deduction market. Here I see the product going in two different directions. On the one hand we will find the marketing of rather traditional kinds of payroll deduction life insurance programs through employers. On this business I expect the commission levels will settle just below typical ordinary life levels.

I also expect to find a number of larger employers giving substantial support to the payroll deduction plan. This may include such things as the employment of a benefits counselor on the staff of the employer. In this scenario I see commissions settling near group term commission rates.

In addition, I see a future for second generation product designs. If an equity based product is forthcoming, its commission structure will be influenced by the extent to which the SEC becomes involved.

Personal sales have always been a backbone of our market. I refer here to the classic sale of life insurance to a family breadwinner with the objective of providing security for the family. In this market (which may be "soft" for ULI), I expect commission structures to evolve to whole life levels.

The main market, the one we all like to discuss, is advanced sales (the up-scale market). ULI seems to be particularly well suited to serve this category of markets (estate planning, deferred compensation, pensions and key person). Many companies regard these as "blue chip" markets served by the expert agent and characterized by larger size policies. It's the image for which we all like to strive. I expect ULI to serve this market, and to do so effectively; but it is in this market that we encounter a more knowledgeable consumer who will be better equipped to evaluate alternative products. It is here that I expect to see competitive commission and load structures developed. I don't see any magic in a number such as the $600 amount referred to in the survey responses, but some logic for a graded commission scale is present.

It is not beyond our imaginative process to envision ULI with a negotiated commission. Agent and buyer could indirectly or directly negotiate a fee-type commission. Worse, many current products do allow some mixing and matching of planned premium and lump sum or recurring lump sum payments through which the agent can determine his commission. I fear the upshot of this in terms of discrimination in the marketplace.

Nearly one-half of the survey respondents agreed with the basic premise that, in two or three years, traditional commission levels will prevail for annual premiums under $600 or so, graded down for larger premiums. I gave that response. But commissions must adequately compensate the agent for services performed. Economic equilibrium will prevail. The extent of grading for larger premiums will not be as great as is implicit in the original three factor ULI commission scales.

MR. BODINE: The traditional approach to compensation of agents can lead to either inadequate or excessive first year commissions, depending on the issue age, type of plan and amount of insurance sold. The near term trend will be for many plans to provide compensation in amounts similar to the traditional products through a transitional phase of agency acceptance of ULI. Over a period which will be considerably longer than the two or three years mentioned in the question, different compensation designs will be tried.

Computer technology now permits more use of multiple piece commissions which could be used to develop a formula for adequate compensation without being excessive regardless of the issue age, plan type or amount of insurance. When direct charges for such commissions are made, we must also deal with the concept of an acceptable level of expenses for the policyowner. I predict an interplay among these elements over a longer period of time so that ultimately competition in the broadest sense will lead to the appropriate level of compensation. There will always be specialty marketing approaches, specialty products and different company philosophies so that both higher and lower levels of commissions will continue to exist.

MR. ROBERT W. BUECHNER: As an attorney, I am troubled by the commission question. Based on the Chartered Life Underwriter pledge, which is essentially a rephrasing of the golden rule, and based on ethical standards, agents should not be selling products based simply on what commission they are to receive. Life insurance agents may be agents of the company they represent, but they also have a dual role. They become the agent of the person they purport to serve, and in serving that individual they do a disservice if they sell a product based simply on the level of commission they will receive.

The selling of inferior products will eventually result in discrediting the agent and in the product being replaced. As the consumer becomes more aware of what commission levels are and what is happening, we may see a lawsuit filed against some agent who sold a product just because it resulted in a higher commission.

The time has come when agents must consider the propriety of charging fees for their services. Something has to be worked out on an individual basis with the client. A client would probably prefer to pay a fee to an agent to obtain a better product rather than pay a commission of an unknown and possibly excessive amount.

MR. EASON: In preparing for this session we assumed the audience would have a high degree of product knowledge. It might be helpful for those of you who do not have that high degree of knowledge to realize that there is a great deal of disclosure within the operation of ULI which makes the relationship between compensation paid and the loading in the contract that is charged to the policyholder more visible than with traditional products.

We will now examine another area of considerable interest, and that has to do with interest. Out of order, we will address Question #7 entitled "High Interest Problems." The expert panel polled last December was asked for a reaction to the two assertions in Question #7. Our panel will now discuss these two assertions.

MR. BUECHNER: On the issue of interest rates and what should be illustrated in the proposals, I am a firm advocate of showing at least three interest rates: the current interest rate, an intermediate interest rate (such as 8 percent) and the guaranteed rate. I have three reasons for this:

1) We're really trying to enhance consumer awareness of what interest rates are all about. Many customers have a fairly good understanding of interest rates and know that interest rates may not stay where they are right now.

2) Disclosure results in some protection to the agent and to the insurer in terms of what may happen in the future.

3) This type of disclosure anticipates that interest rates may change. If we have sold a product based on the fact that interest rates may change, and have shown that the product still has great potential, then we are in a position of having done something to discourage disintermediation.

One of the key things about interest rates that cannot be overemphasized is that there must be complete disclosure. The company cannot purport to pay 14 percent interest on cash values when it pays only the guaranteed rate on the first $1,000. This issue has received some exposure, but companies that pay less than the current rate on some minimum amount must disclose that fact.

MR. BOOTH: The responses given by the expert panel were almost evenly spread across the four possible responses, perhaps indicating the difficulty we have with disclosure in general. I'm in substantial agreement with those who selected the three-rate projection approach except that I have some difficulty with preselection of a standard interest rate. I dislike regulatory proscription of disclosure methods and standards since too often they serve to prove something that was not intended to be proved, and artifically color future design improvements as craftsmen scurry to maximize mandated disclosure results.

There is currently a wide gap between guaranteed and current values. This serves to render the guarantees ridiculous, to destroy their credibility, and to give a lack of credibility to the current numbers. Surely we expect to show both guaranteed and current results on our ledgers. An initial problem with which we must deal is that of getting the guaranteed basis in front of the buyer. When proposals show current values on page 1 and guaranteed values on page 2, we must wonder how many salesmen actually manage to get page 2 out of their briefcases.

Philosophically, I agree that failure to disclose not only misrepresents but also sows the seeds of destruction. I agree with Mr. Buechner that failure to disclose is dangerous.

I once did some work for a company selling a nontraditional product. Being worried about disclosure, I devised a chart to go with the proposal. This chart presented the level annual premium at current rates required to make the ULI product permanent (i.e., term to 100) at each of several interest rates, including both the guaranteed and the current rates. Alas, the Marketing Department defeated the proposal. I applaud those of you who are using an approach like that and making it stick. I feel we should be disclosing: a) the premium required to produce ordinary life at current rates, and b) a time period equivalent to an extended term period if premiums are discontinued.

MR. BIDELMAN: In many respects, the problems are no different here than they have been in the past. A buyer should be a planner and, whether with good intentions or not, the agent is trying through illustration to help the prospect plan for his insurance needs and to represent the probable costs. Only because the future holds uncertainties does one need to plan. Only because the future holds uncertainties do we have this type of problem in the first place. Representation of policy financial features has always been a problem. Dividend scales cannot be guaranteed into the future. Tax effects cannot be guaranteed into the future.

However, a company and its agents should not take a "let the buyer beware" attitude. The "not guaranteed" caveats should appear in all illustrations and perhaps even in the policy. I also believe in the process of a worst case/best case scenario with the worst case being the guaranteed rate illustration and the best case being the current rate illustration. An intermediate rate, perhaps of the prospect's choosing, should also be shown. I oppose the thought of tighter rules and new disclosure methods.

MR. EASON: I'm going to ask for an additional straw poll. How many of you in this audience believe that interest rates on intermediate term money - say three to five year money - will be below double digit rates within five years? Next, how many believe that we will continue to have double digit interest rates for five years? A slight majority of this group appears to believe interest rates will drop. Bob, will policyholder dissatisfaction result when rates do drop, and will there be disintermediation for ULI companies?

MR. BUECHNER: I think we all understand that interest rates are at an absolute all-time high in comparison with the inflation rate. There has never been such a spread between inflation and interest rates as we now have. That indicates to me that if the government's policy of holding down inflation continues, there will have to be some downward movement in interest rates. In any event, the whole question of whether interest rates come down or not, especially with regard to ULI, depends in part on the investment philosophy of the company. If the company is investing for the short term, the interest rates that are available under the ULI product are going to reflect short term trends. If the company is investing for the longer term, the rates are going to be much more stable. But there's a tremendous risk to the company in this case. If the rates go up, the company is left with long term investments of decreased market value and with prospects for some hefty disintermediation.

I want to touch quickly on something we will cover at greater length later. One of the possibilities of current IRS involvement in looking at company taxation, and even of possible Congressional action, is that it may be necessary for companies that want to treat all their interest as excess interest to guarantee that interest for a three to five year period. If that's the case, companies will have to make some long term investments in order to make the guarantee. What about the risk of disintermediation in that case? One of the solutions is that there will be something very similar to a fair market value adjustment. I doubt that anyone will ever call it that because most consumers don't understand what a fair market value adjustment means on any type of interest product. What we're more likely to see is the attachment of surrender charges to ULI products. The size of the surrender charge will be indexed to the current interest rate. If interest rates go down and the company is paying less interest, it is possible there will be no surrender charge on inforce policies. If interest rates go up, and the company is able to invest its current dollars at a higher rate, the surrender charge will be higher. The whole question of interest rates ties in to what tax decisions come out of Washington, and how companies choose to deal with those decisions.

MR. BOOTH: The relative performance is the most critical thing. What is important is not whether your product is paying the interest rate specified in the original proposal, but whether your policyholder is receiving a rate of return which he deems to be fair and equitable. I doubt that we will see much disintermediation in those companies which have been diligent through their agents in efforts to disclose. When a policyholder feels deceived, the disintermediation potential is enhanced. The real bottom line is going to be the amount of premium and/or increase in premium required to support the plan of insurance - not the actual interest rate. That is why I stongly favor disclosure of a gross premium based on several interest rates.

MR. EASON: We will resume the normal order with Question #4. From the company's viewpoint, Allen, do you like a product which has an index feature?

MR. BOOTH: My answer to the question is "No." The market for such a product is transitory. Twenty-five percent of the respondents agreed with me, yet I believe that this response is swimming upstream because we hear a good deal about indexing these days. Consider the reasons for indexing: 1) federal income tax considerations, 2) consumer confidence, and 3) management facing less frequent but more profound excess interest decisions.

I believe that tax laws will eventually be enacted giving fair and equitable treatment to the various types of life insurance products. A major motive for indexing is to circumvent IRS regulations and/or letter rulings on excess interest. It is inconceivable that the ultimate basis of tax law will give favor to any product type merely because it is artifically linked to an index. I deem this reason for indexing to be stopgap.

Consumer confidence may be a more valid reason for indexing. Our industry has not enjoyed high marks in the confidence area lately. Consider the FTC report and Tobias' book, The Invisible Bankers. If one works for a relatively unknown company or for a company with less than an enviable reputation for fair treatment of its customers, indexing has far more appeal.

A management which is inclined to abdicate its responsibilities for managing a product line might like to have an external index upon which to rely. By indexing, we place implicit pressure on our investment departments to perform according to the index. Furthermore, we place our investment people in a high risk position should market conditions seem to favor an alternative course. I see indexing as a short range phenomenon which will utimately give way to a broader base of guarantees.

MR. BODINE: My response to this question was also negative. From the company's viewpoint, I would not be in favor of an indexed product. The reasons for this are the investment risk, investment flexibility and design flexibility coupled with computer programming complexity. Although several reasons can be listed with respect to consumer and agent preferences for an indexed product, most pressure for indexing lies with the company's desire to minimize federal taxation. This taxation protection may be temporary or permanent. In any event, it seems that many investment opportunities would be lost or drastic investment risks taken if indexing is required in order to achieve a competitive after tax yield. Companies could restrict their investments to only short term securities in order to maintain the continuing investment flexibility necessary to match indexes. If so, a major portion of the investment community would withdraw even further than it already has from the long term commitments upon which the industrial community has come to depend.

Long term indexes would not seem viable with the expected continued volatility of interest rates. For long term investments, it is hard to understand what kind of hedges would be available (such as interest rate futures) which would be adequate for risk protection if a significant portion of the insurance industry were dependent upon them. The types of securities which could be so hedged and the volume of such investments available would likely be inadequate for the industry as a whole. This seems to me to be an excellent example of the consumer being hurt by the "tail wagging the dog." It would be preferable to have investment departments able to consider the opportunities which would be best in the long run for the policyowners (and this is a difficult enough task in itself) without being additionally bound by the restrictions of an index for tax protection. Indexing could also have a severe impact on corporate profitability and stockholders for an extended period of time.

MR. EASON: Notwithstanding the views expressed by our two panelists, I draw your attention to the fact that the most popular response to the survey question was "Yes, with product choice or changes as needed."

Question #5 deals with investment considerations.

MR. BODINE: The biggest investment risk has already been touched on in a prior question - that of disintermediation - and it is very similar to the risk associated with high yielding deferred annuities. To the extent that ULI is sold with emphasis on insurance benefits, and because there is more to be lost on surrender in terms of these benefits, the risk is likely to be a somewhat smaller risk than for annuities. Under currently assumed tax applications, a company might be successful with conservation efforts against surrenders by pointing out that interest earned on the ULI cash values can be used on a pretax basis to pay term insurance costs. The term protection cost must otherwise be paid with after-tax dollars from other sources.

One method of countering disintermediation due to pressures from non-ULI investments would be the establishment of significant surrender charges over the lifetime of the policy. With a few exceptions, our companies have let the forces of competition keep us from adequate protection. Where surrender charges are being used, they are generally for a relatively short period of time and seem to be intended only to recover acquisition expenses. These charges can be grossly inadequate to protect against losses due to high interest rates if longer term investments are used. The situation is comparable for ULI products and deferred annuities. Disintermediation due to pressures to roll over assets to other ULI policies may also exist, but this would generally be minimized by various combinations of surrender charges, first year expense charges and premium loading charges.

When companies are forced to reduce the current interest yield on ULI policies because of a drop in the available investment rates, the rates for available alternatives are also likely to be less attractive. Policyowners would be less likely to surrender their funds quickly in favor of other products if a good marketing job had been done to explain the downside risk and the likelihood of fluctuations over long periods of time. This has a lot to do with corporate pressures for competitive growth, the control exercised over the agent in making sales projections, the type of agency force used and the market in which products are sold. There's much inconsistency in this area among companies.

Much has been written on the subject of immunization against the risk of loss due to a change in interest rates. There are no final answers yet to this subject. The C-3 Risk Task Force, operating under the Society's Committee on Valuation and Related Problems, made a presentation recently at the Society meeting in Houston. Indications are that much discussion and development is ahead of us in this area.

Immunization must be considered not only with respect to the rate of cash flow to meet withdrawal demands, but also with respect to yield rates in comparison with any rate guarantees which might exist. In looking at the four combinations of investments - long term or short term as interest rates are moving either upward or downward - the lesser risk between the two negative combinations consists of being invested short term while rates are moving downward. Taking this position overlooks what might be a very important consideration - the possibility of interest rate guarantees for a considerable period of time to minimize the amount of yield lost in federal income taxes. Although loss of assets would certainly be unattractive if it occurred because currently payable yield rates had dropped, it would not be as tragic if it did not result in significant capital loss or significant surplus strain. Those who would be locked into the payment of higher yields might find the situation worsening under these circumstances as they attract a substantial amount of money which cannot be invested at rates adequate to meet obligations. A company might move to protect itself by changing the interest rate guarantee for new monies to be received after some given date, but that could prove to be difficult to administer, especially for small companies like my own.

Another type of investment risk to consider is that for companies which depend heavily on planning concepts with goals for growth which may be heavily dependent upon interest sensitive products. Various plans for corporate expansion and general operating costs are closely tied to production and resultant asset and profit growth. This should be recognized as being very volatile. Companies should have alternative strategies ready to implement in the event that a significant change in interest rates were to heavily impact its sales and premium volumes.

Another investment risk is that related to the competitive nature of the product. With interest rates being so prominent in the promotional material, it is important that a company offer the highest yield it can support. The competitive pressure is likely to narrow the spread between the actual earned rates and those which are used as credits to policy values, which increases the risk that this spread will be inadequate for desired earnings.

Another risk could be the expansion of investments to types which have a less exactly measurable yield in order to hopefully improve the overall performance. I have in mind items such as oil ventures, real estate projects, interest rate futures and bonds with convertible features. It becomes a very difficult management task to decide how much yield rate can be imputed to the eventual capital gains or losses which might result from such investments. Even after the amount of gain or loss becomes known, I have found it an interesting challenge to decide how to spread these gains or losses over a period of time, rather than merely adjust the yield rate in the year in which the gain or loss is realized.

MR. BUECHNER: One of the things of which we're all aware with ULI is that the products don't all look alike, and neither do the investment opportunities that are available to the consumer. In a very short period of time, we're going to see ULI products that have surrender charges with variations in them to take account of the type of investment risks that the company undertakes. We have already seen products that offer the consumer a choice of whether his investment is in a high interest rate fund, equities or real estate. There are products that offer a current interest rate or an interest rate that is indexed.

One of the things of which we must be mindful is that companies that are offering a high current interest rate may be able to continue to offer such a rate even though they may be losing money on it. How or why? Because they can always adjust their mortality charges. The mortality charge is one of the hidden factors of the ULI product. It creates tremendous flexibility in terms of what the product looks like to the consumer. If interest rates drop and the company feels that, in order to maintain the policyholder's level of satisfaction, it has to keep its interest rates high, one might see some adjustment in the mortality charges. That is where the company will make its profit. The ULI product is one that lends itself to some mystery even though the unbundling is supposed to make all of its charges readily apparent to the consumer. Consumers are not very knowledgeable about mortality charges and what it means when mortality charges increase. They might say, "Well, it's just because I've become older." This is an area of significant flexibility for the insurance company.

MR EASON: We'll now press Wayne Bidelman back into service in his area of special expertise, Question #6 which deals with coinsurance and risks.

MR. BIDELMAN: If a company feels it must market ULI before the tax ramifications are clear, it should do everything possible to protect against adverse exposures. The company, to be competitive, should be in a Phase II negative tax position since otherwise it is taxed heavily on investment income and cannot compete adequately in the interest rate it credits on the policy. A Phase I company (taxed heavily on investment income) will likely want to establish a stock company subsidiary (in a Phase II negative tax position) and market the product through the subsidiary. There are three alternatives if the subsidiary is not yet licensed in all states in which it is desired to market the product: 1) don't market in those states yet, 2) market in the parent and take the tax lumps, or 3) market in the parent and coinsure into the subsidiary. There are some negatives to this last approach. There is a potential IRS problem, particularly with Section 482 regarding intercompany transactions. In addition, retention in the subsidiary is likely to be much smaller than that of the parent company. Accounting and contract work can become complex. The subsidiary will still have a dividend exposure on the policy. The positive to reinsuring in the subsidiary is that it gets the accounting for the product in the preferable company for tax advantages. The IRS may consider that such a transaction has a proper business purpose for the temporary period until licensing is completed in the subsidiary.

There are three reinsurance solutions for minimizing the dividend exposure on excess interest and the indeterminate premium element for a Phase II negative company writing ULI. The first is coinsurance. The advantage of coinsurance is that all financial risks are passed to the reinsurer including the dividend exposure. But this can be a disadvantage if investment responsibility is also transferred to the reinsurer. If you don't want to pass the investment responsibility to the reinsurer, coinsurance is not the vehicle to use. Another problem is that you must cede virtually 100 percent of all issues, and you may cede a good portion of the profits as well if the program is not carefully designed. It's unnecessary to use coinsurance if the only desire is to pass the dividend exposure. One must also find a reinsurer in the correct tax position.

A second solution is modified coinsurance with the Section 820 election. This has the disadvantage of the stigma associated with Section 820 since it is being studied by the Treasury for possible repeal. Anyway, the election is likely not necessary for passing the dividend exposure.

A third solution is modified coinsurance without the Section 820 election. This has the advantage of keeping assets and investment responsibilities with the ceding company. There is no Section 820 stigma, and there is currently no formal Treasury movement that adversely affects this transaction. Some negatives to this approach are that it's untested, it has the potential of being costly and complex, and one must find a company (probably one taxed as a casualty company) to be the reinsurer. As with any other arrangement, one must cede virtually 100 percent of all issues to pass the dividend exposure.

There are several arguments as to the likelihood of success in using modified coinsurance without the Section 820 election to pass the dividend exposure. One argument against it is that there is no Treasury code provision authorizing it. There really shouldn't need to be such authorization, and there is no code provision <u>not</u> authorizing the approach. If a coinsurance arrangement passes the dividend exposure, there is no reason to believe that modified coinsurance cannot do so. Another argument against this arrangement is that the Treasury Department currently takes a negative view of reinsurance transactions. Even if this is true, a properly designed arrangement with valid risk transfer should establish proper business purpose. A final negative argument is that such an arrangement is costly and complex. The treaty is complex, but, if properly designed, excess risk transfer takes place at a cost comparable to that for Yearly Renewable Term (YRT). The administrative work is little more than that under a self-administered YRT arrangement.

MR. BOOTH: My answer to this survey question is "Yes." Solid reasons and tax planning practically require a reinsurance technique. We might find a scenario similar to that for modified coinsurance with the Section 820 election. Great benefits can be obtained in the short range, if everything happens to fall into place just right, even with the stopgap tax proposal and its potential 87 1/2 percent deduction for interest credited. Some small to medium size companies could well benefit greatly by passing the investment (excess interest) risk to another party.

In the long range, the scenario must go in another direction. We will not long achieve by subterfuge that which we cannot achieve in a straightforward manner. If your company is inclined to pursue this hedge, be careful to plan for the day when the loophole is closed.

MR. EASON: Based on a discussion at a recent Indianapolis Actuarial Club meeting, it appears that the chances for company tax matters to be resolved in the Congress during 1982 are relatively good. The IRS, however, may seek ways to modify the tax treatment of ULI to the policyowner. We next address this area.

MR. BUECHNER: The amount at risk needed in a ULI policy in order to make it life insurance is a question open to debate. It's likely the IRS will eventually come out with a revenue ruling citing several abuse cases and say that in such situations the ULI policy does not qualify as life insurance for purposes of treatment under IRS code Section 101 (a). The type of abuse case likely to be attacked might be one with a $1,000,000 cash value and a $10,000 pure death benefit. In the book, Why Universal Life, we propose that a constant percentage of the cash value be used to purchase the pure death benefit. We base the calculation on the cost of a death benefit at age 60 equal to at least 10 percent of the cash value. Thus the life insurance benefit would be higher at younger ages and lower at older ages.

The American Council of Life Insurance's (ACLI) proposal used two approaches to define what the permissible level of risk is for purposes of determining whether or not a product is life insurance. Their first proposal was that the premium payments should be limited to the amount required to mature the policy on the latest maturity date. Their second proposal was to classify the cash value as a life insurance cash value if it was equal to or less than that of a single premium necessary to purchase whole life insurance or to endow the contract after a stated period. Any cash value in excess of the single premium amount would be classified as an annuity. The ACLI approach is a restrictive one. What characterizes a product of life insurance is whether there's enough risk to put the life insurance company in a position of risk shifting and risk distribution. If the amount at risk is small in comparison to the total cash value, the company is in a position where it is simply taking on an investment risk. It's imperative that companies establish a minimum pure death benefit so that the policyholder cannot inadvertently place himself or herself in a position where the policy will cease to be a life insurance contract. The burden is on life insurance companies to bolster the minimum rather than for the IRS to give comfort in this area.

MR. BODINE: This question puts me in a difficult position. I can find fault with almost any suggestion set forth as being reasonable, but I haven't been able to come up with any good suggestion of my own. I readily acknowledge that it doesn't seem practical or reasonable to permit abuses of the federal income tax laws - something which could happen under liberal interpretations of some ULI designs. In particular, it doesn't seem reasonable that a policyowner should escape income tax on excessive investment earnings by hiding such amounts under a life insurance contract. The key word here is "excessive." Reasonable life insurance protection should not be taxed as income to either the insured or the beneficiary, nor should the normal cash buildup under a permanent plan be subject to such taxation when that buildup is reasonable under level premium risk theory.

With hedging out of the way, and taking a clear position, I favor the net single premium endowment approach just discussed. Some guidelines should be established for use by the IRS which can be used for estate planning services. Maybe this guideline could be developed as a compromise among representatives from the National Association of Insurance Commissioners (NAIC), the ACLI and the IRS. Then the American Institute of Certified Public Accountants could be the binding arbiter.

There are bound to be many questions revolving about practical situations which make a solution far from simple, even if the above position was to be generally acceptable. What would be the situation if cash value excesses arose at some point and were later eliminated by partial surrenders? What is the situation where the policyowner and the insured are different persons? What portions of the cash value, premiums or earnings would be used for payment of the periodic risk charges prior to death? What kind of administrative records would be needed? The matter is complex.

MR. EASON: This is certainly an area where actuaries and attorneys should be friends. I'm going to take another straw poll. If you look at the responses from the experts' survey, you will find that the majority believe a line needs to be drawn setting some minimum amount at risk. There is disagreement about whether a line should be drawn by a change in the law, whether an NAIC definition would be useful, or whether the IRS should give the industry guidance. All were proposed and all attracted some interest. How many in the audience believe that a line does need to be drawn, setting some new standard for a minimum amount at risk in ULI? My count makes that at least 80 to 85 percent of the audience. How many of you who just voted think a change in the law is needed? I see ten hands. How many believe an NAIC model definition would be useful? Your response appears to be roughly half of the remainder. How many find that the IRS should give the industry guidance? I see a smaller number of hands, perhaps one-fourth of the audience. It is clear that this group believes an NAIC model would be useful.

We turn now to Question #9 which has two parts. This is where we try to project what might happen if adverse events do occur. Many believe they are imminent. Others believe they are likely but will be deferred. Some may believe that the matter is too thorny for the folks in Washington to deal with until they hire some of us in this room to help them understand the problem.

Some companies think ULI will prosper even if adverse events alter present product characteristics. What impact does the panel see from the confirmation of the 1980 Hutton rulings together with a moderately adverse excess interest company tax ruling? The progress of the stopgap federal income tax proposal is certainly involved. Let us see what our panel has to say.

MR. BUECHNER: The tax treatment to the policyholder is on fundamentally firm ground. The Hutton ruling was not well reasoned, and it wasn't supported by much in the way of legal research or the citing of cases which, as an attorney, I like to see. On the other hand, the ruling came out correctly. The policyholder question should continue to be resolved on the basis of favorable tax treatment.

Even if there is a moderately adverse excess interest ruling, there will be some safe harbors for companies that are willing to guarantee rates for a period of years. Companies that are concerned about maintaining full deductibility are going to have an "out" - either something that will be legislatively ordained for them or something that will work its way through the judicial system. For companies that are not interested in guaranteeing rates for a three to five year period, the ACLI stopgap legislation would assure stock companies a deductibility of 87 1/2 percent of excess interest and an 80 percent deductibility for mutual companies. That is still a high level, and, if the legislation is passed, companies that are looking to deduct a substantial portion of the excess interest will still be permitted to do so.

MR. BOOTH: My response to this question is two-fold. ULI will be the majority nonterm product by 1984, and an improved ULI product linked to separate accounts will emerge. In response to a previous question, I indicated that ULI's most valuable characteristic is flexibility. I believe that wholeheartedly. It is unnatural to force on the consumer a product with a premium and benefit structure designed by an actuary. None of us has the wisdom required to produce an ideal fixed premium, fixed benefit that will fit all consumers' needs. The less than enviable reputation accorded our industry today is a result of such attempts. While we argued against the validity of the infamous Federal Trade Commission reports, the undercurrent discovered there was the failure of our traditional products to respond to the changing needs and wants of our consumers. We deserved that blow as an industry, even if it was below the belt.

One reason for our failure to perform according to the changing perception of consumer needs has been the stifling regulatory environment. Fortunately, many advances have been made on the regulatory front, and we now have fewer impediments to innovation. I am not convinced that ULI will be the majority nonterm product by 1984. That may be too soon, and ULI may not be the ultimate vehicle. I am convinced that the primary product in our future will not be a confining whole life product - particularly not a nonparticipating whole life product. Other pro and con arguments relative to the merits of ULI versus whole life, such as interest, tax environment and commissions are symptoms of the times, not necessarily influenced by the real flow of dollars between the consumer and the insurance company.

MR. BIDELMAN: The key in this scenario is that the rules are basically known, and we can react better. There will no longer be an excuse for mutual companies to stay away from ULI. Depending on the excess interest ruling, mutuals may wish to sell through a stock subsidiary.

Under current tax code and with a moderately adverse ruling on excess interest, credited interest rates will have to be lowered from current levels unless: 1) the ruling defines clear criteria for full deduction of excess interest amounts and one can appropriately adjust the product, 2) one may market through a different company to circumvent a moderately adverse ruling, or 3) some viable reinsurance opportunities still exist. If none of these approaches are viable, I feel strongly that the business mix question, Question #1, must be answered "No." The product may have only mixed success just like any single traditional product of the past has had only mixed success. Assuming something higher than a four or five percent rate could still be credited, an "after tax deferral" marketing spiel should still have decent success. The product should not die and will likely still be a major nonterm product by 1984.

MR. EASON: The second part of Question #9 addresses the same general areas of IRS activity and tax rulings which affect the company and policyholder. One interesting observation I made from the results of our unscientific survey was that a number of experts responded positively to the option that differentiated products will emerge attempting to circumvent an adverse company tax ruling. I perceive that a great deal has happened within the membership of the Society of Actuaries and in the Law Departments of companies around the country. It used to be that, if there was doubt, you didn't do it. It seems we have learned that we can indeed deal with complex tax planning matters and with complex legislation. With competition deepening every day, more companies are taking more business risks. Many of us in this room are the beneficiaries, therefore, of more work.

MR. BIDELMAN: The problem with the second scenario in the question compared to the first is that we still don't know all the rules. One might feel more comfortable about the policyholder's tax position since it's doubtful that the IRS will be harsh to both parties.

The product will not die because: 1) the return will be at least as good as that on most of the more traditional products, 2) it has the flexibility needed in the marketplace, and 3) newer products can be designed that circumvent the tax ruling. The product may lose some momentum unless the tax ruling can be circumvented. It will no longer be competitive with alternative investments. Without that feature, the agent may find it difficult to compete and lower commissions may not be palatable. Term with annuity, term and a no load mutual fund, or other alternatives may take a lot of the sales (although an adverse company ruling may affect annuities as well).

There will be a real effort to circumvent the ruling, just as has happened with other products in the past. Even so, there must still be some caveat to the policyholder. If a harsh ruling on the company side leaves a gap (for example, if excess interest is not considered a dividend if the interest rate is indexed), products can be redefined. Reinsurance might be used by a company not affected by the ruling, or the product might be marketed through a subsidiary not affected by the ruling. If the agent can be induced, and the product still be made competitive (with reasonably competitive interest and mortality rates which I think are possible), there's no reason to expect this scenario to kill off the product. However, with respect to the business mix question, this scenario is a real setback to those who believe that the product will be the universal product to the exclusion of all others.

MR. BUECHNER: On the issue of a harsh, adverse ruling by the IRS, we must note that the IRS is not a court of last resort. In fact it is not a court of any resort, and its determination is not going to be the final one. There will be substantial litigation following any adverse IRS ruling. There is also the possibility of additional legislation being proposed.

Tongue-in-cheek, here is what we can expect if there is an adverse ruling. One month after the adverse ruling, the Equitable Society, Life of Virginia, and Lincoln National file a declaratory judgment action in the Washington, D. C. District Court to have the IRS action declared invalid. Two months after an adverse ruling, E. F. Hutton, Lincoln National, Transamerica Occidental and others push through legislation to prevent funding to the IRS of any dollars that will be used by them to collect taxes on the nondeductibility of excess interest. Three months after an adverse ruling, Massachusetts Mutual announces the formation of an off-shore subsidiary to sell ULI and to take advantage of our foreign tax treaties. Six months after an adverse ruling, Penn Mutual announces that, after complete consideration of the IRS ruling, it is forced to reduce its interest rate available under its ULI contract by four-tenths of one percent.

MR. EASON: We have one last question. I would like to give credit here to Lynn Peabody who was the moderator of the panel in Orlando. Lynn and I put these questions together back in December. At that time, the question addressed the possibility of a compromise that would restore competitive parity between stock and mutual companies. I wish I had the time to give you a "blow by blow" description of all of the things that have taken place as competitive parity was sought by the ACLI. I suspect you'll hear about that at Panel Discussion 8 - Tax Parity For Individual Life Insurance Products.

MR. BIDELMAN: Based on the survey response, I am taking a minority view. If one keeps track of what's going on in Washington, one could change his mind daily on this question. Currently there is a fair chance that the ACLI stopgap package could be an ornament on a Christmas tree of legislation attached to a debt ceiling bill. However, I don't feel that the assertion in Question #10 is accurate, at least within the foreseeable future. Even the current industry parity proposal presented by the ACLI remains highly controversial, and it's short term as well. Even if Congress passes the proposal, it contains no concrete long term answer since it is only a two year stopgap.

The current ACLI stopgap proposal does not address the excess interest issue, nor whether ULI qualifies for the nonparticipating tax deduction. Neither does it contain what net amount at risk definition must exist to qualify ULI as life insurance. It will be even more difficult for the industry to agree on what tax parity is when it comes time to formulate a permanent solution. If Congress acts by the end of 1983, it is possible they would support the Treasury's position. Therefore, short term, it will not be Congressional action based on an industry parity proposal that addresses ULI issues. Likely (and hopefully) industry lobbying efforts would head off a pure Treasury bill being passed - if life insurers can react quickly enough.

A proposal for change addressing tax parity under the existing tax law would, of necessity, be extremely complex and lengthy. Note the problems with the original ACLI proposal. One of the problems is that we're currently forced to patch a bad law.

It is impractical to believe that an industry proposed parity package can get a quick (within two year) passage. This is partially due to necessary compromise on issues, after which a recheck of parity must be studied and agreed upon. It is also due to the often overlooked fact that other financial institutions are not going to sit idly by while the life insurance industry gets a tax change which will enable it to pay high current interest rates to their clients tax free (or at least tax deferred) to both parties.

ULI tax treatment issues may be resolved by the Treasury, or perhaps they may be ultimately resolved in the court. The Treasury wants to tax excess interest. They will attempt to call it a dividend or try to tax the policyholder. Unfortunately, if they choose to call excess interest a "dividend", I don't expect a moderately harsh ruling. In other words, if they don't say, "If it moves, it's a dividend", the door might be open to some type of product redesign.

By this time next year the excess interest question could still be in limbo, Section 820 could be gone or suspended, and we could have no general revenue ruling with respect to individual policyholders. No Universal Life issues will be settled by Congress based on an industry parity compromise.

MR. BUECHNER: The IRS may take a harsh stand against the treatment of excess interest on ULI, but this will not be the final say. A number of companies have committed tremendous resources to the development of ULI, and they will not sit back and watch their investment of time and money go by the wayside because of an IRS ruling. There could be some tremendous litigation battles, and I believe the IRS would be ill-advised to try to take on the various ULI companies in court.

The IRS will not be on firm legal footing if it does make a harsh excess interest ruling. The potential for litigation over this matter would be immense. Consequently, it makes tremendous sense for a compromise to be worked out legislatively. In fact, this is probably the only way that the treatment of excess interest can possibly be handled in a way that is fair to all concerned in the long run.