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UNIVERSAL LIFE

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1. Benefit structure (including underwriting and reinsurance), values, and surplus requirements

2. Asset-liability matching

3. Taxes, expenses, and administration

4. Consumer protection, including the company's obligations, at time of sale

5. Marketing, sales compensation, and replacement questions

MR. ROBERT L. COLLETT: Universal life insurance's conceptual roots go back at least 20 years, yet it has been offered in the United States only for the last several years. For most companies, it's just now coming out, or is still on the shelf, or in the thinking stages. Certain companies, in particular, Hutton Life, Life of Virginia, and Great Southern Life, here in Houston, have made primary commitments to universal life insurance.

These companies are excited by the product. Their actuaries find them intellectually and emotionally attractive. Many other companies, at this point, have a somewhat different posture; they approach the product defensively. They want to have such a product available for their agents, but they're not necessarily interested in innovating with respect to product type. Many fear that the product may prove too complicated. All of us want the tax questions answered.

Certain companies feel they're having trouble devising replacement rules which will be equitable and successful in preserving assets, preserving clientele, and preserving profits. They are worried about agent survival and the product distribution systems. There is some criticism of universal life perhaps as a savings product more than an insurance product, and I have heard at least a comment or two by people who are wondering if there are newer generations that may already be making universal life passe' even though it's just now here in spades.

Having made these comments, let's talk about universal life as it exists today; as it has emerged in the United States. It's a product which is responding to a number of forces, problems, and needs.

Jim Parrish of Fidelity Mutual, Vice President and Actuary, is most interested in universal life at this point. Fidelity does not have a product on stream, but definitely has one on the shelf. Gary Monnin,

Senior Vice President, Chief Actuary of American Founders Life Insurance Company is our other panelist. We would like to begin by asking first Gary, then Jim, to give us some information about where they are at this time.

MR. GARY P. MONNIN: American Founders is a small to medium-size stock life insurance company owned by Anderson Clayton Corporation. The distribution system was primarily branch office up until about 3 years ago. We are gradually moving into a PPGA distribution system. Our growth has been consistent with the industry; we haven't broken any records.

We're struggling as every other company is with expense control and growth. We analyzed universal life at first from a defensive posture and later from an offensive posture. We have been on the street with an offensive program since February 15; we don't have a whole lot of experience yet. We recognize that universal life can help in conservation, but our approach is to be an offensive company.

When developing universal life, we looked at what was in the industry and came out initially with a product design that was low-commission, low-load. Our discussions with the field force indicated that this was not a wise choice. Before releasing the product, we went to a higher-commission, higher-load. So far, the reaction has been good from the field. Some of our top agents are not overly enthused, but proposal requests are coming in, we're receiving applications, and every indication is that we are going to be able to recruit to it, as well as get our existing field force excited about it.

MR. JAMES N. PARRISH: My comments will center on the considerations which influence a traditional mutual company to develop a universal life product. My initial remarks will share our experiences on Items 1 and 2 of the program outline from the mutual company standpoint.

The traditional ordinary product has been the mainstay of Fidelity Mutual throughout its existence. For the last 10 or 15 years, we have been operating as a total financial planning organization in the upper income market. Our corporate strategy has been, and will continue to be, to develop and support full-time agents who provide financial counseling to the upper income market. To accomplish our objectives, we have to provide competitive products on a timely basis which meet the needs of our market.

During the summer of 1980, our sales vice president and I put on a road show for our field managers and leading producers in which we discussed the forces affecting product development during the 80's. These forces were inflation and high interest rates, consumerism, competition, a changing work force and changing family units, a changing regulatory environment, and an increasing burden of federal income tax. These forces are the same ones which are now causing so much attention in the industry to be focused on universal life.

By May of 1981, we felt compelled to begin serious planning and development of a universal life product. This decision was the direct result of continuing inflation, growing consumerism, and increasing

competition for investment dollars in our marketplace. We were concerned about the uncertain tax questions, agent acceptance of the low-commission structures, the replacement implications, and the increased administrative requirements. We had to proceed; to do otherwise would be burying our heads in the sand. We have to be prepared for the day when our consumers, or our competition, require us to make available a universal life product. We also want to be able to track some of those savings dollars that we lost in competition in this era of inflation. If that time does come, we cannot afford to wait a year for the product to be developed. We want to be able to pull it off the shelf and sell it as quickly as possible. We do not plan to sell it, in any event, until the IRS clarifies the tax question from the company standpoint. So ours is a completely defensive posture.

Our first decisions revolved around the question of how we could effectively compete in this market as a mutual company. Should we develop the product in the mutual company? Should we buy a stock company? Should we form a new stock subsidiary? Since the bulk of our business is produced in less than a dozen states spread out geographically from California to Massachusetts, we decided that the likelihood of finding an existing stock shell with the right combination of states was very slim unless we were willing to pay a premium price for a shell licensed in most of the 50 states.

We, therefore, focused our attention on the formation of a new subsidiary along with the possibility of issuing this product from the mutual company. Knowing that the formation and licensing of a sub could take several years, we decided that we had to proceed with both the subsidiary route and the mutual company route at the same time.

We contacted a reinsurer, whom we considered knowledgeable in tax matters, to discuss ways of issuing a competitive universal life product on Fidelity Mutual paper. I emphasize competitive because without some sort of a reinsurance mechanism, the interest rate that the mutual company would be able to offer on the cash value fund will make the product unsaleable. We considered the following reinsurance approaches: 100% coinsurance of the mutual company's universal life product into the sub; 100% coinsurance into a non-life tax status sub of a reinsurer (this would also give us protection from the dividend question); 100% coinsurance into a Phase II negative reinsurer with funds withheld. Under all approaches, the mortality risk within our retention would be retroceded back to Fidelity Mutual on a YRT basis. The retention of the sub would be quite low. The retention of the mutual company is much larger. Modified coinsurance with an 820 election could also have been considered; however, because of the mod-co 820 tax questions, this was not a good option for us. It's one thing to count on mod-co savings and not pay them out, but it is quite a different thing to pay them out and then have the IRS pull the rug out from under you. Of course, this may now be a moot point since the IRS issued proposed regulations on mod-co March 19. Experience refunds paid or credited under mod-co treaties after March 18 will no longer be treated entirely as premium income under the proposed regs. The portion of the experience refund allocable to investment income derived from the assets relating to the reserves on the policy reinsured must be treated as investment income by the ceding company.

At the same time, we were finalizing approval of a new life insurance sub in its state of domicile, and preparing submissions for approval to our major states of operation plus all states in which Fidelity Mutual operates. As it turned out, we perceived a lessening of momentum in the universal life arena by the end of 1981 which caused us to table the mutual company product and continue with the product for the subsidiary only. We also happily found ourselves with approvals of the sub in 10 or 11 states, including 4 or 5 of our major states, by January with the likelihood of approval in several others by mid-year. In addition, the rash of major companies entering the market that we expected after the first of the year had not materialized. Although we didn't feel that way last summer, we found ourselves leaning towards 100% coinsurance of a mutual company product into the sub. This meant that we could quickly file a mutual company version of the subsidiary product in the event that our current reading of the situation was wrong, and a product was needed nationwide to protect ourselves.

Last May, concurrent with our discussions with the reinsurer, our product actuary, through a consulting actuary, began work on a universal life product which we could use in either the mutual company, the sub, or both, depending on the number of licenses we had for the sub at the time that a decision to sell the universal life product was made by management. We decided on the usual Option A/Option B benefit structure with modest front-end loads and first-year fees.

Since a modest, or low-load necessarily implies a low-commission structure, we did a considerable amount of soul-searching before finalizing our choice. Our feeling was that universal life products are a response to the consumerist movement as well as inflation. We, therefore, wanted our product to be good for the consumer. We were also aware of the influence of competitive pressures in the universal life area. These pressures are felt in product design, administrative capabilities, compensation to the agent and in the replacement of existing business. Products being released currently are basically two types: low-loads with low-commission structures, and high-loads with high-commission structures. The effect of these competitive pressures on the choice of basic product design and agency compensation was particularly troublesome to us. Our product, originally scheduled to be on the shelf and waiting on April 1, was delayed by at least a month while we reexamined our decision to go with the low-load and low-commission product. We ultimately decided to proceed with the low-load/low-commission design in spite of competitive pressures to pay whole life-type commissions at the expense of the consumer. This decision was due both to a realization that a change to a high-load product could set our project back by up to six months and to our commitment to be fair to the consumer.

Although universal life is touted as more understandable from the policyholder standpoint, we found that pricing considerations were considerably more complicated. Profits will arise primarily from mortality and interest, but are greatly affected by levels of expense loadings (versus actual expenses). Because of the high visibility of these product components to both consumer and the competition, implicitly conservative assumptions set at issue cannot be counted on as a source of future profits on this product. Competitive interest rates and

competitive mortality risk charges will have to be maintained over the life of the policy. This implies a thorough analysis of the product's profitability and surplus impact at the time of development with a careful matching of company expenses and policyholder loads.

Profit studies, using a return on investment concept, were used by our consultant to balance the individual universal life profit components with our company objective. This was a departure for us since asset share surplus goals, as a percentage of the reserve at a specified duration, has always been our norm. The basic flexibility of the product implied a need for considerable profit testing under a variety of scenarios. Profit runs were made to study smokers, non-smokers, Option A policies, Option B policies, various face amounts, variations on the interest spread, sharp reductions in the portfolio rates, variations in annual payments, payments ceasing in 10 years, variations in commissions, variations in lapse rates, etc.

A model office was also constructed based on two sets of production projections to show the expected growth of the company over a 20-year period and the financial results expected to emerge. The model office gave us a year-by-year aggregate picture of the cash flow component of our universal life product. We, therefore, have a basis for estimating the amount of surplus which will be required to maintain this product. Although the first year strain is lower than it is on our traditional products, it is still considerable. The surplus deficit reached a maximum in the model by the eighth year and changed direction by the twelfth year. Although we put a generous amount of surplus into our sub when it was formed, additional surplus contributions will be needed if production follows the projections in the model office.

A separate, and equally perplexing issue for us is the question of investment strategy for this product. There was no question in our minds that assets and liabilities had to be matched. There did not seem to be, however, a clear resolution of the question of how we should invest these funds. The highly visible universal life interest credited rate will be greatly influenced by competition. Failure to maintain a competitive rate could lead to lower sales and increased withdrawals on existing policies. If these withdrawals occur when the market is depressed, we may be forced to liquidate assets at a loss. We, therefore, need to immunize ourselves against this possibility. Unfortunately, the need for competitive rates may limit our ability to immunize ourselves as much as we would like.

If funds are invested short-term, maximum liquidity will be achieved with the flexibility to reinvest continuously at higher yields in an "up" market. This is particularly true for periods in which short-term interest rates exceed long-term rates. If a normal yield curve relationship is reestablished, however, the company will be at a disadvantage since competitors who invested long-term will have locked in high-yields for longer periods.

After a lot of discussion, we decided to go short-term with monthly interest rate changes to start with. This decision was made, in spite of a growing theory, that one-year interest guarantees or indexing might result in more favorable tax treatment. Our feeling was that the

dividend question would probably be decided on more fundamental issues. A short-term investment posture will give us maximum flexibility for a prospective change when the situation is clarified.

MR. THURSTON P. FARMER: When you decided to increase commissions, Mr. Monnin, were you able to increase loads commensurately or was there some squeezing in the profit margin?

MR. MONNIN: We kept a pretty good matching of commissions and loads. Our profit picture stayed the same.

MR. BILLY N. JOYNER: What kind of return do you expect your mutual policyholders to receive from a downstream stock company organized to sell universal life?

MR. PARRISH: We sought a return on investment of about 20% or more. Our model office projections, which were done based on various assumed levels of money that were put into the project, ranged from 20% to 30%.

MR. GERALD A. FRYER: Mr. Parrish, when you brought in your low-commission, low-load scale, what were you assuming about agent productivity? Were you assuming that they would sell higher volumes and more policies, or that some of the agents would be forced out of the business?

MR. PARRISH: We made the assumption that for our particular agents to want to sell this product at all, it was going to be because they were forced to sell it. We felt that they would be forced because of the competitive pressures that were being made upon their clients; perhaps their clients calling them and asking about it. We felt that the kind of client they are working with, being a more sophisticated buyer, would be aware of various kinds of universal life products on the market, so they would have to live with that structure.

MR. COLLETT: Jim, what are the implications for asset transfers between the mutual company and the stock company in the event you rewrite business from one to the other?

MR. PARRISH: That would have been one of the advantages of having the product in the mutual company. We may end up having the product in the mutual company; but, if we are forced to transfer assets from the mutual company into the stock company, we are going to be doing it as a defense. That would be better than having the assets flow out to someone else.

MR. COLLETT: Gary, would you comment on the asset matching question from American Founders' point of view.

MR. MONNIN: We spent a great deal of time with the investment people trying to solve this problem. We considered the extremes of all short-term investments and a short-term index, or of investing long and trying to protect ourselves using futures.

Perfect immunization is the ideal target on universal life. Certain companies are protecting themselves by investing in futures. We have a

disadvantage in that the state of Texas doesn't allow futures as an investment. We had to solve the problem some other way. We looked at competitive interest rates. We looked at the different scenarios; the inverted yield curve versus the traditional yield curve. We looked at the competition; at the interest rates being paid. To be competitive on our interest rate, we had to determine the interest rate to be credited on a more intermediate basis (as opposed to short-term). We were forced to determine the appropriate investments to back such a decision.

We set an interest rate which we guarantee for one year; all money that comes in will be at the guaranteed rate for 12 months. After 12 months, it will roll into the then current rate for a new 12-month period. We use an index external to the contractual provisions of the policy and approved by the Executive Committee. Thus, we are able to tell the field that we are using an index, and it will have some benefit if the IRS decides that indexing is okay as far as the dividend treatment is concerned.

We are not investing long (I think long now means 5 years). We have a formalized approach of investment strategy in terms of investing both short and long, and we have a maximum limit on the investment. We also have a target portfolio mix and a target average duration of the portfolio. Our investment department is keenly aware of what's happening. They constantly monitor the index. They're looking at what interest rate we'll be crediting the next year and are reacting as rapidly as possible.

We also took another step when we introduced the product in terms of internal replacements. We knew that we would be receiving internal replacement. We knew we would have cash values being rolled over and we knew that the assets behind those cash values wouldn't be invested appropriately. So prior to introducing the product, we started building a short-term contingency fund for allocated assets to be used for these cash value roll-overs. We started preparing a pot of short-term money prior to the introduction of the product.

MR. RICHARD W. KLING: In your research phase, did you consider the viablity of a back-end loaded product?

MR. MONNIN: We have both in one. We have a front-end load and we have a substantial surrender charge.

MR. COLLETT: The Texas Insurance Department has quite recently appointed a technical committee to deal with the subject of universal life. They had their first committee meeting this week. I would like to give Jim Livingston an opportunity to tell us a little bit about that committee and what it may do.

MR. JAMES L. LIVINGSTON: A committee was brought together by Chairman William P. Daves to draft a regulation for the state of Texas by which they would review and approve universal life policy forms.

They are currently approving universal life policy forms. The major exception is that Ted Becker, their life actuary, has been reluctant to approve any externally indexed products. External indexing was the main topic of the committee's discussion.

After some ground setting, we spent our first day on the appropriate disclosure requirements of universal life; (1) disclosure in policy forms, (2) disclosure at point of sale, and (3) disclosure through annual reporting to policyholders. We came up with essentially what has been proposed by the other states that have come out with departmental regulations. I think the one thing that did cause a good deal of discussion was the recommendation by the staff at the State Board concerning the use of corridors; a level of cash value below which only the guaranteed rate is credited. They recommended that the corridor should be included in the nonforfeiture provision of the policy forms. They have approved several policies for companies who are using a $1,000 corridor in their interest crediting method and it's not mentioned in their policy forms. Typically, those companies are disclosing the corridor in their illustrations and sales material, but the State Board asserts that that is inadequate. Our committee discussed it at length and a small majority felt that disclosure was not needed in the policy form itself. Those policy forms state that interest will be credited at the discretion of the company. The question arises that the company could use sales illustrations where they credit current interest of 12% on all monies in excess of $1,000, then later decide that they were going to pay the current interest rate on money only in excess of a $2,000 or $3,000 corridor.

The second day we addressed Ted Becker's primary concern; that is, the possible reserve or surplus requirements that should be put on externally indexed products. There is certainly a risk in externally indexed products that doesn't exist on other products. We talked about the nature of that risk, the different types of indexes, long-term, short-term, the natures of the contracts where there are surrender charges involved, where there is a six-month deferral of granting cash values. We talked about the appropriate methods of immunization and protection in the way the assets are invested. Fortunately, we had two representatives from Occidental who gave us some insight on what they're doing to support their T-bill product.

There was a consensus that there is a need for some sort of special diligence with indexed products. The fundamental problem is, if we require extra surplus or reserve requirements for companies with indexed products, we might be penalizing those companies who are most diligent. Naturally, the Occidental representatives claim to be extremely diligent in the way they were backing their product guarantees with their asset mix.

Unfortunately, for Ted Becker and his staff it would be much easier to have a reserve requirement of X + Y x Z associated with any indexed product, but that was something that we are nowhere near being capable of determining. So, the due diligence type of report that is being discussed in the California Department might be what we're left with. Unfortunately, few insurance departments are going to have the expertise necessary to review a company's investment strategy relative to their product and type of index and determine whether or not that company is being prudent in the way they set up their business. So that left us in a box that we weren't able to get out of. We're planning on talking about it further at the next meeting.

MR. COLLETT: Jim, do you think there is a chance that your committee will recommend the use of the actuary, as they do in some other countries where the burden is placed on the actuary, to make sure that the assets match the liabilities and are satisfactory?

MR. LIVINGSTON: That's an awfully big leap. Such a solution is not possible soon, but we do believe it to be a good solution for the mid to long-term future. We will probably allow companies to put the burden on their actuaries to justify holding something less than an arbitrary provision that our committee will recommend.

MR. MONNIN: We all know there are three major tax issues with universal life, one is the deferral of taxation on the interest build-up in the cash value, another one is the non-taxability of the death benefit, and the third one is the possibility of the excess interest, and/or reduction in mortality charge, being treated as a dividend. There is also the major tax revision, or stopgap proposal, being presented to the Treasury concerning the repeal of Section 820 (modified coinsurance).

The ACLI has been active in recent weeks. They have met with the Treasury, but the Treasury has not given a favorable reaction. They also met with the Finance Committee last week. I spoke with Steve Bickel who is heavily involved in the tax area. His comments were pessimistic opinions. He believes that it's likely that there will be a ruling that excess interest is to be treated as a dividend. He thinks that the ruling will not be retroactive.

There have been two companies requesting letter rulings on excess interest on annuities. The indications are that the rulings will be negative. One of them has withdrawn the request and the other is still pending. So the feeling in the industry is not very optimistic. Whatever changes are going to be beneficial to us are going to have to be legislative changes.

MR. DENNIS LORING: I just want to confirm that from everything we have heard, the general approach of the IRS is going to be to try to treat everything uniformly (for a change); so the annuity excess interest question, the excess interest on universal life, and even excess interest on variable life will probably all be considered dividends.

MR. MONNIN: The latest that I have is that the ruling would come within two to three months and that excess interest would be considered to be a dividend. However, the definition of excess interest is not clear; indexed policies might not be considered as having excess interest. On the one-year guarantee, the IRS will probably take it in terms of interest credited versus the valuation rate; indexing and one-year guarantees may not be meaningful.

As far as expenses go, Jim talked a little bit about his pricing assumptions and theories and we have gone through a similar analysis in terms of analyzing expenses. There are extra front-end costs such as computer generated proposals. There are some companies that are purchasing Apple Computers for their agents meeting certain production requirements. There will be an additional front-end cost associated with it.

Maintenance costs also require you to analyze your own situation; but there are additional reporting requirements involved in universal life. There is a large start-up cost for most companies. In our case, we run 62 CFO. We are fortunate in that we spent a lot of money to purchase an extensive software package partially justifying it based on the fact that we were going to do it anyway to get off the 62 CFO. In our case, universal life was just the first step.

There is, for most companies, a substantial front-end cost associated with administration. There is a reeducation of the Home Office. There is a reeducation of the field. Both are start-up costs which will not continue once the education process is done. I know a number of companies, ours included, that made some forward projection of expenses. If everything we hear about universal life is true, our unit costs are going to decline rapidly in the next three years because production is going to be so great. You have to make your own judgment, but there may be a reason for some forward projection of unit costs.

We have already mentioned consumer protection. Jim Livingston gave the report on consumer protection from the side of solvency.

Every company has to take a stand on how much protection they are going to give the consumer with regard to the tax issue. Jim says he is not issuing the plan until the tax issue is resolved (that's great consumer protection). Other companies, like American Founders, are issuing the product right now despite that the tax issue is not clear.

We took this very seriously. We had to prove to our corporate parent that we were not seriously jeopardizing the policyholders. They wanted us to do everything possible to analyze the potential impact on the policyholder. We looked at the situation where an adverse tax ruling would come three years from now. We looked at the implication on the policyholders if that ruling were retroactive on previously tax deferred interest. We looked at the impact on the policyholder under the worst taxability of death benefit scenario we could think of. We analyzed, down to the policyholder level, the implications of a retroactive adverse tax ruling. We also addressed the question of what we would do if the ruling were negative from the policyholder's point of view.

We developed an approach whereby universal life could be converted back into a traditional product. We analyzed the policyholder's position if he had never converted to universal life versus where he would be under the conversion to universal life, and a conversion back into a traditional product. We did not commit ourselves to this product to our field force because if the decision were negative, we would be affected by the situation at that time. We did come out with an approach where the policyholders would not be severely affected if they went through a double conversion. We looked at a single premium endowment for cash value roll-over; we looked at a non-par product and we also looked at an annuity. Some combination of these would have worked as far as the traditional products were concerned. The only danger is that the conversion could have a serious impact on 818(c).

We educated the agents about the tax situation. We did a little show and spent a lot of time explaining the tax issues and warning them about

potential abuses. We talked about such things as putting too much cash value in relation to the death benefit (even though our policy has the typical corridor of $10,000 or 10% of cash value) so that, at the time of sale, they don't attempt to abuse this cash value versus death benefit. We also informed the agents that we had done the study of converting back to a traditional product; but we did not commit to anything (we did not tell them what the traditional product was).

We also developed a disclosure statement which states that the tax issues are not clear. We require this disclosure statement to be signed by the policyholder and we receive a copy.

We went as far as we could go to protect ourselves against the dividend question. We have our non-contractual indexing method with the one-year guarantee. We were very concerned about the policyholder and we have attempted to educate him. We give out a policy summary even in states where the policy summary is not required. We have done everything possible to inform the policyholder of the possible adverse consequences.

MR. COLLETT: Gary, what happens if your preliminary term company ceased writing business that clearly qualified for the 818(c) election, then it is determined that the universal life does not qualify?

MR. MONNIN: There would be an immediate tax problem. We have priced our product such that we are not relying on 818(c). As we become a universal life company, we are going to be releasing a lot of 818(c) reserves without setting up any additional reserves. Our parent knows the situation; they are willing to take that risk and back us with surplus when the situation requires it. We are taking 818(c). I personally feel as though it is legal and it is justifiable. Some companies are taking 818(c), but they are not spending it.

MR. COLLETT: Jim, you are trying to protect the consumer by offering a low cost, good buy product. What other thoughts have you had?

MR. PARRISH: That was it. If we issue the product, we are going to prepare disclosure statements to make the consumer aware of exactly what he is buying.

MR. DONALD L. ADDINK: Since this meeting has been on inflation, and universal life addresses many aspects of inflation, and because competition frequently does not address itself to the interest rate, but to the target premium at point of sale itself, have either of the panelists addressed the question of consumer protection in terms of inflation particularly, with regard to the interest rate used in the target premium calculation? The extremely high interest rates used in target premium calculations may be building an obsolecence in the premium itself, since it relies on inflation (whereas the benefit does not). Instead of using something like a real rate of interest in the premium calculations, so that the benefit has to be increased due to inflation, the premium itself would be increased because of the excess interest that is built up inside the contract.

MR. MONNIN: We are not attempting to sell the minimum premium on universal life and we do not have a target premium calculator, although

we will. We illustrate universal life under a number of interest rates. Our illustration system uses the guaranteed rate plus another interest rate. Our policy summary shows three interest rates. We are not providing the policyholder with a target premium. Maybe he is not getting all the disclosure he needs, as far as the continuing benefit is concerned, when the interest rates change from that illustrated.

MR. PARRISH: We are in the same position as Gary is in. The product that we have on the shelf will not be sold with a target premium indicated. Products which are sold with target premiums may not have had the fact considered that in any proposal based on high interest rates over long periods, more coverage will be needed. We would be happy to illustrate the other way for the policyholder if he wants it that way, but I don't think he knows that he wants it that way.

We considered using the target premium approach with the high-load product. This was discarded.

MR. A. DOUGLAS POAPST: We do not have a universal life product yet, but we are introducing one in Canada shortly. We have the policy illustration system working already. The product will have automatic indexing as to the death benefit related to consumer price index up to three times the initial amount. One part of the illustration will come out as the guaranteed interest rate in the contract which is 3 or 4% (two funding options) and the other will be entirely up to the agent's discretion to a cap of 20%. He also must choose an inflation rate. The real interest rate, in excess of interest over inflation, cannot be more than 4%. If he wants to illustrate a premium based on 15% interest rates, he is also going to have to incorporate at least an 11% inflation rate for the death benefit.

MR. COLLETT: Let's go on to the fifth subtopic. Jim, would you like to comment first?

MR. PARRISH: The old question of replacements was very troublesome to us. As a mature mutual company, we felt that we had a lot to lose from replacements of our existing business into a universal life product. We do recognize, however, that this is just one part of a more general problem which is not unique to universal life. The way we have been pricing our newer products in recent years made it so that you can have a policyholder who had a policy issued to him a number of years ago who might just be able to figure out a way he is better off with the new product. A number of questions arise to which there are no easy answers. How many replacements will you have? Should replacement be encouraged? Should the agent be compensated for the replacement as new business or should some modification be made? Can we minimize or abort the replacement? We have been giving some thought to trying to keep the money in the mutual company in the event we do have replacements. We will have a problem with the assets that are backing these up.

MR. MONNIN: We do not have our final rules, but we are living under some temporary ones regarding internal replacements. We analyzed the advisability of replacing our own business. The two key items were the expense assumption and the interest assumption. There is a question, for example, of whether or not to allocate any first year sales overhead, or

Home Office, or similar expenses to the replaced policy. The implication is if you can support paying first year overhead expenses in your analysis, then you can encourage your agents to do it and you can let your marketing department take credit for it. If you can't afford it and if you exclude them, then you can't give your marketing area a whole lot of credit for replacing its own business, since they are not paying any of their salaries by doing it.

The interest assumption is one that we really struggled with. If you take an old non-par plan that has loans on it, for example, your interest return is going to be very low; but at the same time, can you analyze your universal life policy assuming 15% rate of return for the next 30 years? Are you going to distort your statistics or your dollars of profit based on interest rates? The question of interest rates is very critical. We have both non-par and par business and we had to analyze what appropriate interest rates do we use in analyzing the universal life profitability. Our analysis was basically to look at dollars per thousand of profit in the existing business with higher lapse rates versus dollars per thousand profit in the universal life plan that would replace it. If you can do that, and you are happy with all of your assumptions, then it is an easy decision. You just choose the one where the dollars per thousand profits are higher. Unfortunately, it doesn't work that way.

Another consideration is your field force. How much control do they have over the business? How loyal are they? How much in-force business does each agent control? The decision will be influenced by what impact your field force can have on you. So even though the numbers can be generated to prove one set of assumptions, the assumed reaction of the field force must have an impact on your decision. Commissions on internal relacements require two basic decisions: do you want to encourage replacements; and how much do you pay? There are two possible items to pay commissions on: the cash value rollover; and the new premium. A third question is whether or not you require the policyholder to roll available cash value into universal life in order to pay compensation. You do not necessarily have to pay your agent a commission if he is going to take all your cash values and move them into his money market funds and start up new universal life plans. My conclusion is that I would just as soon not have anyone touch my existing block of business. Other companies have come to conclusions that they are better off replacing their existing blocks with universal life. They claim that the profits are better by doing it. In our case, it is a matter of determining the best approach to use without aggressively replacing our own business.

MR. COLLETT: Is universal life a product for all seasons and all distribution systems? What are your opinions as far as limitations, if any, in that regard?

MR. PARRISH: We are definitely committed to the same distribution system that we have now, a career agency force. We think that this product can be adaptable to that environment. If the situation changes where this becomes a product that is very, very important, we think that our agents will adapt to it as to one of the products that they have in their portfolio. We wouldn't do it if we didn't think we were moving away from our basic corporate philosophy.

MR. MONNIN: We are consistent. We attempted to make sure that we were't slipping into a new distribution system by mistake. We do not feel that we are with universal life. We feel as though it can fit in and there are cases where it can be used. Our market appears to be the same in that we are targeting for the higher income business needs. Universal life seems to fit in most cases, although there are certain cases that it does not fit.