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EQUITY PRODUCTS OF THE 80's

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Discussion will cover developments in life insurance and annuity products which are funded in a separate account of a life insurance company, including recent and current developments as well as forms which are expected to come into being in the next several years. Specific topics to be discussed include the following.

1. Product design
2. Taxes
3. Investment policy
4. Regulations
5. Marketing and sales
6. Effect of general account business

Mr. Ross Hanson: I would like to open with a short discussion of variable life. It is surprising to me that it was 13 years ago that actuaries of New York Life (Charles Sternhell, John Fraser, and Walter Miller) presented a paper to the Society of Actuaries describing how one could design a life insurance product that was funded in a separate account, and that we still have not really developed a large business in this direction. During the 1970's about 15 companies actually registered products with the Securities and Exchange Commission. A number of events intervened. First of all, there was the question of regulation. The National Association of Insurance Commissioners believed that variable life insurance ought to be regulated by the states, and the Securities and Exchange Commission asked "Is this really an exempt security and if it is not an exempt security ought it not to be regulated under the federal securities law?" There was a conflict there.

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There were a couple of notions that were associated with variable life insurance at the outset which I think were not invalid but were inaccurate. One of these notions was that a variable life insurance policy is a policy of life insurance in which the amount of insurance is determined by the investment results of the separate account. This notion came out of the variable annuity idea that the amount of variable annuity payout was intended to vary with the investment results of the separate account. However, I don't think this really carries over well into the variable life insurance idea and as we are going to discuss this morning, the industry has moved away from that position and now wants to offer separate account products in which the amount of insurance is determined in some other way. Universal Life is the predominant idea here.

The other notion that was originally held, and once again would carry over from the variable annuity idea, was that the separate account assets were to be invested in a diversified portfolio of common stock. The idea here was that over a long period of time the investment results of a diversified portfolio of common stock will track very closely with the increase in prices, and if one starts at some year in the mid '30's and follows up to the mid '60's he will see that is a reasonably good assumption. Prices increased over that period of time about 4 times and the yield on common stock tracks that very closely. However, a little examination of that idea shows that it is not the best solution. There is really no logical reason why one would say that the funds of the separate account must necessarily be invested in common stock. It would seem as though the correct notion would be that the assets ought to be invested in whatever investment vehicles the investment manager thinks is in the best interests of the policyholders at the time, and we are now coming to that. We are now beginning to see that there ought to be quite a diversification of investment opportunities available to the separate account. I am sure our panelists this morning will talk about some of these ideas. In the variable annuity area we have seen now for a long time the idea of using separate mutual funds as underlying securities for a unit investment trust. One of the companies now offering a variable life insurance product goes that route and we are going to see more and more of that as we develop variable life insurance products in the '80's. The two erroneous notions that the amount of insurance had to be tied to the investment income of the separate account and the separate account assets had to be invested in a diversified portfolio of common stock impeded the development of variable life insurance. The performance of common stocks in the '70's was not overwhelming although it was not much worse than debt securities. However, the management of the life insurance business faced with the question of regulatory turf, the start-up expenses, the transformation of the agency system into a marketing force able to sell a registered security, and the question of whether or not variable life was a sound product, tended to lose enthusiasm for variable life insurance in the mid-70's. In my opinion that was a mistake on the part of the management of our business. I think if we had gone strongly into variable life insurance in the early '70's we would be in a much better market position today than we are. The life insurance business is truly facing a crisis in the '80's and we must try to find the kind of product that will get us out of that crisis. When I say product, I don't mean the life insurance risk taking only. Product means to me those services which come at the time of sale, during the conduct of the contract and at the time of execution of the contract. Joe Crowe is now going to give you a short discussion on product design primarily related to variable annuities.

MR. JOSEPH F. CROWE: Thank you, Ross. My comments this morning on equity products will focus on the annuity area for a couple of reasons. One, we have a little more history on which to draw in the annuity area than in life insurance products backed by separate accounts. Secondly, I have very limited familiarity with variable life.

There are some clear implications drawing on what we learned in the annuity area for life insurance products funded by separate accounts, and I would like to speak briefly about two particular elements of the product. One is flexibility of funding options which Ross alluded to and the second is their expense bearing capacity.

We have learned in the last several years that it is very important in annuity products funded through separate accounts to have flexibility in funding options. This flexibility includes having more than one separate account available for the policyholder to choose from and allowing the policyholder with restrictions to move from one funding option to another. This is important because different purchasers have different interests and are willing to take more or less risk. The same policyholder may be interested in different types of investments at different points of his policy lifetime and having these multiple funding options opens the product up to a broader base and certainly can improve persistency over the life of the contract. As an example of how different individuals might have different interests, an individual purchasing an annuity and planning to let this annuity accumulate to be the major source of retirement income is likely to be a little less willing to take risks than someone for whom the product is a supplement to a company pension plan and Social Security, and may be more inclined to the general account funded product. A company may be very wise to have a general account option or a money market fund available within the product. In the early to mid '70's companies that were selling annuities with only common stock options available experienced some severe persistency and sales difficulties when the stock market went straight down for a couple of years.

The final point I would make on flexibility is that it is important to keep in mind in drafting the product and setting up administrative procedures that there will be funding options coming along in the future that have not even been thought of now and it is desirable to structure products that permit other options to be added. I don't know how many people would have projected five years ago the level of interest in money market funds that we are experiencing right now.

In discussing the expense bearing capacity of equity products I would like to briefly review the history of deferred annuities. The industry has sold deferred annuities for decades, but through the '60's excess interest played a relatively minor role (sales of these products were not tremendous). When these products were sold the purpose was to provide a defined benefit on retirement. Thus, individuals were funding an accumulation account to provide monthly income as opposed to merely accumulating some savings to determine what will be done at a later date. These products had a set of cash values which reflected some fairly substantial up-front surrender charges. When variable annuities were first sold they took a different form. For one thing the same defined benefit concept did not exist because the amount that would be available upon retirement depended on the interim investment experience. What happened was that as money came

in there was an up-front charge - a load. The money that was left after the up-front charge started accumulating and as these types of annuities became more and more popular policyholders started asking the question "If I am just putting this money in to accumulate why do I have to pay this up-front charge?" Over the period of the '70's there was a significant amount of downward pressure on this up-front sales charge, and it is not at all uncommon today to have annuities which have no charge at time of sale. If an individual puts in $1,000, then $1,000 is invested in the separate account and starts accumulating. There are surrender charges and in many cases ongoing annual administrative charges at similar levels to what the credit card companies charge for administrative expenses. Also, there is the margin between the gross earnings of the separate account and what is credited to the policyholder. The net result of this switch in the type of charges is that the annuity product cannot bear the same level of expenses that was traditional prior to the '70's, and the expenses, including commissions, are quite a bit lower than was traditionally the case. Despite lower commissions, sales have done very well and, in fact, have increased very dramatically over the past several years. Funding flexibility and lower expenses may be elements that carry over into the development of variable life products.

MR. JOHN N. AKE: I will focus on the SEC regulation of variable products. I noted that Ross used the term "Equity Products of the '80's" when he set up this panel. Actually I look at these as variable or investment oriented products because equity in the investment area means common stocks, but most of the insurance variable products that are now available are in a large part not common stock products but are more into the area of high yielding fixed income securities. I would like to spend a brief time reviewing how the SEC got into the area of regulating investment-linked insurance products. While we may not think about it, insurance products are in many ways similar to securities. That is, an investor or policyholder is asked to put up money and is promised a return (perhaps guaranteed) by an insurance company in some distant future. That return may be a function of some event - his death, a death in the family, an accident, his retirement, or even the lapse of time such as in an endowment policy. Historically the SEC had not been involved in regulating insurance policies. They were viewed as regulated adequately by the states, and the types of products that were being offered to individuals - the fixed sum life insurance policy, the fixed sum endowment policy, and the fixed sum annuity product were not viewed in the same manner by the SEC as products such as a bank savings account and certificates of deposit.

During the early to mid-1950's products began to develop along the lines of an equity product in that the policyholder participated in the underlying investment performance of the portfolio. This originally arose out of group annuities that were offered to employers who had undertaken certain retirement obligations as part of union negotiations under the Taft/Hartley National Labor Relations Act. Employers were seeking to reduce the amounts of premium they would have to pay for a group annuity for their employees. One of the ways of reducing premiums was to take more participation in the investment performance of the insurer. Those products, including not only the direct group annuities, but also products similar to those developed by CREF during the 1950's, gradually expanded into a product that was being offered to the normal policyholder in which that policyholder would begin to participate or have some direct participa-

tion in the underlying portfolio securities. The policyholder was told that he was buying an annuity that would be invested in common stocks. If those stocks increased in value his benefits would increase. The SEC became interested in regulating that policy because of the policyholder's participation in the underlying investment performance. That is, the SEC felt that the purchaser, the policyholder or the investor, should be aware of the risks that were involved in giving his money to another entity that would manage or invest the money. In the '60's through a series of court cases the SEC firmly established the fact that while variable annuities were still annuities in the state regulatory sense, they were also subject to SEC regulation. During the end of the '60's and early '70's, as variable life insurance was developed, this commission administratively expanded that rationale so that variable life insurance products were seen as subject to the SEC regulation.

There are really two broad parts of the SEC regulation here. The first is the Securities Act of 1933. The Securities Act requires that a purchaser be given a prospectus that describes all material aspects of any investment that he is making, that a prospectus be filed with the SEC and that it be subject to review by the SEC in order to determine the adequacy and completeness of the disclosure that is given to the investor. The second part of the SEC's regulation - the part that impacts most directly upon insurers and annuity issuers, is The Investment Company Act of 1940. That Act sets forth certain structual requirements for a company whose business is investing in securities. Those requirements include requiring a board of directors in which there are outside directors who are disinterested from the management, placing certain restrictions upon affiliated dealings, (that is, dealings between the general account and separate accounts), placing certain limitations upon the charges that can be taken out of those investment separate accounts, and also placing limitations upon the loading structure that can be used for annuities. I think that this directly affects many of the people in this audience if they get involved in variable annuities because the SEC's regulation will in large part establish certain parameters with respect to the sales loading issues, with respect to expense loading, and mortality charges that are made against separate accounts that are offering variable products.

Finally, I want to briefly comment about the model variable life insurance law that was developed by the NAIC during the early 1970's. The NAIC, in an attempt to keep the SEC out of regulating variable life insurance products that were being developed, designed a model law hoping to duplicate the SEC's regulation. After duplicating the regulation the NAIC anticipated that the SEC would forego regulating variable life insurance and allow the states to regulate under the model law. That was a misplaced hope by the NAIC. They adopted the variable life insurance model law, but the SEC felt that the law itself was inadequate in the sense of what should be regulated and decided to exercise its jurisdiction over variable life insurance. Thus, the variable life insurance industry was saddled with a model law which was developed to duplicate the SEC's regulation and to keep the SEC out, but didn't serve that function. Therefore, the model law was a duplicate type of regulation. The model law was developed particularly to accommodate two products arising in the 1970's in the variable insurance area - the New York Life product and the Equitable product. Since those two products were fixed premium products, the model law said that this must be what the variable life insurance is going to look like so that if a product fits this design

it was acceptable but if it doesn't fit it was not acceptable. What we are seeing now is a defect in that analysis in that variable product designs are near development which are not in line with what was developed during the early '70's by New York Life or the Equitable, and the law that was set up by the NAIC is unnecessarily constrictive as to what products can be sold at the present time. The insurance industry now is moving to eliminate or to substantially modify that law.

MR. HANSON: John, your last allusion to the regulation is quite important to us because it is hoped that the NAIC will adopt a modification of the VLI regulation at the December meeting this year which will take away a good many of the strictures that you referred to. Let's hear from Jack Barger now on the very important part of variable products - the marketing and sales aspects.

MR. JACK P. BARGER: Before I start on my prepared comments I would like to congratulate the Society and its members for the foresightedness in anticipating things that are going to happen. I have been participating in your meetings for about the last four years and it is amazing to me how you folks are willing to jump into the fray and talk about things that are going to happen 5 and 10 years into the future. I contrast that to what is happening in the typical agents organizations. They are not even discussing some of these ideas yet. They haven't even accepted some of the things that you were talking about 3 and 4 years ago. I applaud you as a group and as individuals who are willing to "bite the bullet" and look on to the future.

In the early '70's variable life was the darling of the industry futurists. It was what we might call the "new wave", the new dimension that would carry our industry into the 21st century. We had just begun to feel the impact of inflation and variable life seemed to be the logical answer to this new menace. But what happened? Here we are 10 years later and its impact on the industry, at least as far as new sales are concerned, is practically zero. Well, why should that be? We have in the last 10 years been through the worst inflationary period in our nation's history. Our industry's standby, whole life, has suffered from ever increasing attacks not only from consumerists but from within the industry as well, not to mention the FTC. I think the answer to our question can be found in what the public and the industry perceive variable life to be, and we have already alluded to this a couple of times this morning. The dictionary defines variable as the opposite of fixed but variable life has been perceived as equity-based life, and, of course, there have been good reasons for that perception since most variable life policies are indeed equity-based policies. We all know that equities in general have not been a very good inflation hedge. We, in effect, have seen the same phenomenon in variable annuities, and I submit to you that the packaging that has recently triggered the break through in variable annuity sales will be the same trigger that will launch variable life into its place in the sun. What I am referring to, of course, is the fact that the word variable as we have heard already this morning does not necessarily mean equity. Variable could mean a money fund as the underlying investment vehicle in the same way that it does in the variable annuity. Why limit ourselves? Why not a bond fund or an option income fund? These funds produce ordinary income as contrasted to capital gains, and we all know the advantage that that gives to a life company. Why not an equity account with a portfolio that would consist of

common stocks but with one major difference; that no stock would be allowed to remain in the portfolio longer than 364 days. In other words, sell before a long term gain is made. If one likes the stock, go back the next day and repurchase it. That way all the gains are always short term and taxed as ordinary income. All these investment vehicles and techniques have been used in variable annuities where there has been more than one separate account. At least one variable life product has used this technique. The policyowner can switch from one account to another at will, or he or she can have fractional accounts in any manner and rearrange this configuration at any time.

I think that the time has arrived for the variable product. I think that the ultimate product will probably encompass universal life flexibility and variable life separate accounts. As you know, Hutton Life originated what we now know and refer to as universal life back in 1978. We hadn't been out with the product more than 3 months before we began trying to figure out a way around the NAIC model regulations on variable life so that premium flexibility was available. Obviously with access to over 4,000 equity licensed people within the E. F. Hutton system, who also hold life insurance licenses, we are in a very enviable position to market a variable product.

Since I was to focus on the marketing of variable life let me address for a moment why the agent and the client might warm up to this product. It's obvious why the company would - who wants to be on the investment risk these days? In the past the industry worried about mortality risk and now that seems to be the least of our concern. The big worry now is the investment risk. The client is yield happy. Universal Life has done its share to encourage this but that isn't the real reason since Universal Life hasn't had enough impact on the marketplace as yet. IRA accounts, CDs and money market funds during the last few years have made Americans yield sensitive as never before. They want performance. I think they want performance to the point that they would be willing to accept a moderate rate of fluctuation in the principal account. I am not saying that everyone is ready for this, but I am saying that there is a market and it is a growing market, particularly in the area of larger premium sales. Americans are becoming more tax conscious. The life insurance contract is the most tax-efficient financial instrument available. When we begin to couple the tax features with a separate account patterned after financial instruments that clients are already accustomed to, I think we are going to see the return of the saving dollar to our industry in spades.

What about the agent? How will he or she react? If we could package this product in such a way as to give a commission to the agent that while not equal to the whole life commission, approaching it, I think you had better tool up your Policy Issue Department because you are going to have more activity than you can handle. However, it won't happen overnight. The introduction of universal life was traumatic to the agency system but it has caused the alert agent to be more open to change and to further new product breakthroughs. As a result, the ideas that we are talking about now are going to be more readily accepted.

MR. HANSON: I am going to exercise my perogative as Moderator and instead of having our panelists go on with their prepared commentary on the other three subjects I am going to let those subjects come forth from your questions.

MS. JANE A. CRISE: I have a question for Mr. Barger. You correctly pointed our that variable life was supposed to be the product to take us into the 21st century, but the stock market went downward and its popularity waned. Suppose that over the next 10 years inflation averages 2% and prime rate fluctuates between 5 and 6%. Do you see the possibility that universal life type products could also wane in popularity?

MR. BARGER: We feel that the most important facet in the policy is flexibility. I think as more and more people understand what universal life does then perhaps in the product we refer to as universal-variable life flexibility will be every bit as important as the yield itself.

MR. ARNOLD A. DICKE: There are some companies right now who are apparently doing well selling a variable life product. Are these products developing sufficient compensation to make them interesting to agency forces to sell? Along that line, in reading over some of the material that is coming out of industry groups that are working on the regulatory changes needed for universal life II or universal life-variable, it seems that the companies offering the product were interested in not tampering with one rule - I think it is the SEC rule 6e-2 that relates to the sales loads. Is there some magic in that rule that is allowing us some great advantage in developing appropriate compensation schedules for universal life II if it is going to succeed?

MR. HANSON: I am going to let Jack answer your question but before he does let me just make a couple comments on my own. First of all, rule 6e-2 is the rule which provides the exemptions from the federal securities laws for variable life insurance. The law provides that the sales load cannot exceed 9% of the gross premium over the lifetime of the policy. The Equitable Life Assurance Society and the SEC agreed that 20 years was the life expectancy of a life insurance policy. The mechanics of the rule are that one starts with the gross premium and deducts from it specified amounts which are allowed under the rule. For example, the following items are deducted: the yearly increase in cash value attributable to premium payments, the cost of mortality in that year, any amount set aside for dividends, and a specified amount for administrative expense. What is left must not exceed the limit in the law for sales load. That does not limit what can be paid in commissions. It just limits what is allowed for sales expense. I think that most companies will pay commissions quite close to the traditional levels.

MR. BARGER: I believe that an agent will work for anything that will produce enough dollars in his or her pocket to allow maintenance of his or her current standard of living. I think the universal life probably exemplifies this point fairly well. When we first came out with the product the commission structure that we built into the contract was at about a third the level of whole life. The first quarter of this year we did 8 times the volume of applications that we did in the first quarter of the previous year and that was the same experience we had from the previous year. I think this points up to the fact that people will work for less money percentagewise if in turn their pocketbook is rewarded. Our people report to us they are making more money selling universal life than they ever dreamed of making, even though it may be less in terms of percentage of premium. I think the same sentiment holds true in the variable life contract. If the public will buy it, it will create a new marketplace that

did not exist before, and I believe the public will. I don't think the commission percentage will be a problem.

MR. AKE: Variable products are being sold by traditional forces and a whole new sales force - stockbrokers. Stockbrokers started to sell annuities with a roaring business the latter part of the '70's because they were tax-shelters. They weren't selling them as retirement vehicles, they were selling tax shelters. They don't sell the same way as your traditional insurance salesman. Therefore, there are two sales forces out there. Each sales force has different perspectives of what is a meaningful sales compensation level because of the business each has historically been in. The stockbroker who was selling the variable annuity or a universal life or a variable life insurance policy probably will take a lower percentage commission because it is a much more high volume business. The insurance salesman coming out of the general agency system is looking for fewer sales at a higher commission rate. I think when you ask whether or not these commission structures or sales loading structures are going to encourage people to sell the product one must differentiate between what force he is talking about.

MR. BARGER: The securities oriented person selling these products is accustomed to make 3 to 4% of the premium. However, 75% of our business Universal Life comes from the non-securities sales force. I agree with what you say, John, but I also see a trend in our industry of seeking a product that the public will buy. I think what is happening in the industry is that whole life is increasingly hard to sell. Therefore, agents are relegated to selling term, and term rates are going down to the point where you can't make a living selling it. Therefore, to stay in the marketplace the seller needs a product that the public will buy and still yields enough commissions to warrant the time spent making sales presentations.

MR. DICKE: E. F. Hutton did later introduce a higher commission Universal Life product and I know that product had some effect in the marketplace too. However, I think Jack's remarks are certainly well taken as a strategic basis.

MR. HANSON: The point is, you pay whatever commission you need to pay to get the product sold, but you must disclose to the Securities Exchange Commission the portion of the premium that you are receiving for that purpose.

MR. ALLAN D. AFFLECK: Several panelists have mentioned the desirability of having more than one investment option both from a marketing and a persistency point of view. Some of our clients have asked us to explore the possibility of having a real estate separate account invested in mortgages and other real estate instruments, but we have always found the problems of liquidity and valuation to be almost insurrmountable. My question is whether you have explored these possibilities and what problems you see there and whether you think from a marketing point of view having that kind of an additional investment option is going to be important in the future?

MR. HANSON: The variable products advisory committee is currently concerned with this question. In Great Britain insurance companies have for a long time now been investing in real estate, and when you ask an Englishman what

are the problems they just say "What problems?" The only thing which seems to be a useful devise here in making real estate feasible is to have a reasonable deferment period. That is to say, if somebody wants to redeem his interest in his policy which is invested in real estate then the company needs to have a reasonable right to defer redemption until the liquidation can take place. Most of the people I've talked to from Great Britain, who have been familiar with this investment have not seemed to see the same kind of problems that we think about - liquidity and valuation, etc. As I mentioned earlier, the variable products advisory committee is addressing this question and trying to make a recommendation to the National Association of Insurance Commissioners as to what rules, if any, ought to be implemented to make possible the use of real estate as an underlying security for variable products.

MR. AKE: I will say that I know there is one company about ready to file with the SEC with a variable annuity that is funded by real estate. The annuity or insurance product invested in real estate is not subject to any of the same limitations that are imposed upon an annuity or insurance policy product that is invested in traditional securities because of the way the Investment Company Act works. You will find that you probably have a great deal more flexibility in product design, commission structures, charges, and liquidation rights with a product that is invested in real estate.

MR. CROWE: I would like to make a brief comment that this is an example of an additional funding option that can offer significant attractions. The problems are valuation and liquidity, but as Ross pointed out, they are not insurrmountable. One observation I would make is that in the short term real estate may be less attractive than would have been the case two or three years ago. People are beginning to wonder whether or not the growth in real estate values has peaked.

MR. AKE: Another thought I would throw in doesn't involve real estate, but there is one small company that is working on developing a life insurance product that is funded by gold.

MR. THOMAS F. EASON: I would like to address item 6 on the program "The Effect on General Account Business". Our universal life panel yesterday touched all too briefly on transition or rollover problems which arise when new money or investment oriented products are introduced. Addressing Mr. Crowe, initially, could you comment on the problems you see and, in particular, the scenarios that you expect to emerge among the larger companies as they introduce non-traditional products and try to deal with the clear interest of many field personnel in taking existing values and transferring them into products which promise more participation on part of the policyholder and current high returns?

MR. CROWE: One of the items we did not get into on the program is taxes and there are a number of open questions from a tax point of view which I am sure you are aware of. One of the concerns that companies should be aware of when it comes to the question of existing policyholders and their funds is the unanswered tax question from a policyholder's view on some of these new products. If the product were introduced and existing policyholders were to change over to it they expose themselves to some financial risk. My only point is that I think it would be desirable to have some resolution as

to what the tax treatment would be before this be done. My general comment would be that long term what is in the policyholder's best interest is also in the company's best interest; and if it makes sense for the policyholders to be given an opportunity to switch over, a way should be found to do it with proper disclosure.

MR. EASON: I wonder if I might zero in a bit further. Let's exclude the tax questions which are still extant with respect to the universal designs. Those questions apparently do not exist on variable products such as Equitable and John Hancock's. What are companies like those two doing with respect to the transition and rollover problems?

MR. HANSON: The question of taxation of the life insurance company issuing variable life insurance has not yet been examined. The statute does not clearly define how a life insurance company is taxed that issues variable life insurance. Section 801g deals with variable annuities and does not specifically mention variable life insurance. I think nobody really knows yet what the ultimate taxation of variable life insurance is, whether it be universal life issued in a separate account or the fixed premium variety. I think the prospectus that is issued by John Hancock, or Monarch, or Equitable will disclose that. It is an open question but I think that the life insurance company ought to take the view (this was expressed yesterday in your panel and I think it is correct) that in the long run the tax code has to be modified so that there is a reasonable taxation of our business. There is no reason to expect that if we introduce products which are in the interests of consumers that we are going to have to pay a higher tax bill on account of that.

MR. EASON: Ross, could I encourage Mr. Barger to put himself in the shoes of a larger company marketing person and address the question of appropriate compensation on rollover business?

MR. BARGER: Every night when I go to bed I pray, but before I pray I thank the Lord that I am not a chief executive officer of a large mutual or stock life insurance company. I'll address your question in two different ways. One, our company does not have that type of rollover problem and I have not spent too much time worrying about it. The topic today is variable life, variable annuities and how these products impact the general account business. I view this not from a replacement standpoint but from a sales standpoint. Will general account business continue to be sold? I think the answer is that it will continue to be sold in the immediate future because it takes a long time before one turns a sales organization around. People will hang on to something for a long time that they are comfortable with. The longer term picture is more doubtful. I really can't address the question of conservation of general account assets. I do not really know if there is an answer.

MR. CROWE: This compensation question is difficult because the company is giving up something financially in the short term with long range benefits. Do we want to pay extra compensation in that case? A possible way to approach the problem is to not pay any additional compensation on the roll-over beyond normal renewals that might occur but to provide compensation for any increased business or new business sold. This is very likely to occur if some of the policies are 10 or 15 years old, and there is an attractive new contract, and a specific reason to make contact with the policyholder

exists. Approaching the compensation this way seems to be good for the agent, the policyholder and the company.

MR. HANSON: One thing that I think we have to do is be very honest about whether or not the replacement is in the interest of the policyholder. I am far from convinced that switching to the universal life-type product is necessarily in the interest of the policyholder merely because this year we are apparently crediting to the cash value a specified interest rate which seems to be larger.

MR. BARGER: Only about 30% of our Universal Life business is replacement business.

MR. DICKE: The posture that older companies are taking that have a universal life product is that commissions are not paid on the rollover money unless there is some amount of increase, for example, a doubling effect. Universal life commission calculations often have separate components. For example, part of the commission may be based on premium and part based on per thousand face amount. A company may pay full commissions on the relevant component that is doubled. For example, if premium is doubled and face amount is not doubled then full commission would be paid out on the premium component. Our experience showed that it is probably better to require both premium and face amount to double or increase by some multiple if a commission adjustment is to be avoided. Is that kind of structure going to come up in variable life testing; does it make sense?

MR. HANSON: I would expect to see the same selling considerations in variable life as in universal life. The level of commission that you need to encourage the agent to sell the product will be the same, the difference is, of course, the nature of the agent himself. An account executive of a broker/dealer is not a life insurance salesman and is used to making capital transfers. His idea is to call somebody and ask them to put $10,000 into this universal life policy. Apart from that I don't see why the compensation wouldn't involve the same principles as universal life.

MR. DICKE: I was referring to intra-company replacements. Of course, replacements of other company's products involves different considerations.

MR. DAVID M. SYRETT: Acacia had paid full first year commission on intra-company rollover to universal life until about a week ago. We have now replaced that schedule with a complex set of formulae which will decrease rollover commissions.

MR. CROWE: This is a slight departure from the immediate subject but if we have been selling a variable annuity, and have a block of in force business, then introduce a new product that may be more attractive in some respects, we have been required by the SEC at the time of introduction of the new product to go back to every policyholder and tell him that we have a new product that he or she may want to make future payments into. Therefore, the question of what to do for existing policyholders is answered in large measure by the SEC once you are selling an SEC registered product.

MR. HERBERT WEISS: My question is "Would a fully participating variable annuity in a separate account be taxable to the company?" Fully participating here means with respect to expenses and mortality, as well as investment.

MR. CROWE: I am not sure of the implications of the mortality and expense participation within the separate accounts but under the section of the law which defines how a variable annuity is taxed, any investment income or unrealized capital gains that are passed on to the policyholder are excluded from the company's taxes. For qualified business the company excluded any realized capital gains, but non-qualified business incurs a tax on realized capital gains. Therefore capital gains can be relatively unattractive in a non-qualified separate account.

MR. WEISS: Do you see any tax effect of the fact that the product would be fully participating in investment, expenses, and mortality? In other words, the policyholder bears the expense and mortality risk.

MR. CROWE: If that were to happen the contract would not qualify as an annuity under the definition of a variable annuity for tax purposes. I think that the mortality risk has to be on the insurance company side. If the product does not qualify as a variable annuity it would be taxed differently.

MR. HANSON: Joe is correct that the mortality risk has to be taken by the life insurance company. I think it is possible (I am strictly giving an opinion without much support) to include in the numerator of the determination of the net investment factor the cost of the minimum death benefit. In that way any death claims which involve the minimum guarantee could be charged to the policyholders, but I don't have any factual experience to support that. Basically, I think the answer to your question is that the mortality and expense risk must be taken by the life insurance company. The company makes a specific charge for those risks. A deduction is made from the assets of the separate account to indemnify the insurance company for taking the risk. One of the important disclosures the company makes to the Securities and Exchange Commission is to what extent that risk taking is compensated by the charge which is taken from the separate account. That income, which is transferred from the separate account to the general account, I believe is taxable income to the life insurance company.

MR. DIETER GAUBATZ: Mr. Crowe, your initial presentation stated that there should probably be more than one funding option in the variable type annuity. Could you give us perhaps a minimum number that we should have? Say, the company is just not large enough to offer the whole spectrum. Also, what should the base funding option be?

MR. CROWE: I think the base funding options will change over time and that depending on the market to which you are selling, it may be desirable to keep the funding options to the minimum. Perhaps five or six options would be manageable and understandable. In today's environment money market funds are important as an option because people are interested in short term rates. General accounts may be a very desirable option. There are some people who may want to use general account funding for at least part of their contribution and a combination stock fund and a medium or long term bond fund for the remaining portion. I feel the real estate is another option which over time would be very good. Three or four years from now there may be funding options that have not been defined. An example of this is the money market funds which were not around a few years ago.

MR. HANSON: I think it is possible also to introduce very specific ideas. For example, a given company may feel that its policyholders might like to invest in a mutual fund which totally invested in ecological projects or other social projects, or specific industries or businesses which have some specific social content. There is no limit as to how specific you can be in the choice of the underlying investment philosophy providing you disclose it properly.

MR. AKE: One of the problems that a company starting out in the variable market has is the possibility of having several funds each one small in size. For example, if a company has $10 million in separate account assets and has ten funds, then each fund has an average of $1 million in assets. Funds this size can be uneconomical to run in that there is inefficiency and also since the funds are small they cannot take advantage of investment opportunities in the marketplace. There must be a critical mass below which funds are inefficient to maintain.

MR. CHARLES CARROLL: It is my understanding that replacement probably does not exist for the current marketers of variable life because, to the best of my knowledge, there is no single premium product available which would receive the built up cash value on the old policy. Are single premium designs available or possible for variable life?

MR. HANSON: Yes, I believe that Monarch Life Insurance Company sells a single premium life variable life insurance policy which is fully registered. I don't know of any real limitation on design as long as proper disclosure is contained in the Prospectus. There is a limitation in design in the VLI regulation at the state level that was spoken of before which is going to be amended (we hope) by the NAIC.

MR. CARROLL: I have a follow-up question for Jack Barger. It would seem that such a single premium design that was especially heavily investment oriented might be an interesting vehicle for a broker/dealer.

MR. BARGER: We feel that there is a large market for such a product, and are looking for ways to overcome the regulatory obstacles involved.