

CASH VALUE LIFE INSURANCE
FOR THE TWENTY-FIRST CENTURY:
SEGREGATED LIFE AND
THE INDIVIDUAL DEATH BENEFIT ACCOUNT

STEPHEN D. REDDY

ABSTRACT

At present, the life insurance industry is going through a difficult period. Several companies have failed, while many others have seen their capital positions eroded significantly. Competition has become stiffer, and sales targets have become more difficult to achieve. Even where sales have been good, they generally have been at reduced profit margins. Virtually all companies are tightening their belts, including some head-count reduction, to boost profitability and replenish capital. At the same time, regulators are becoming more vigilant and Congress is continually knocking on the door looking for more tax dollars.

Many of these and related difficulties can be traced to problems that have plagued the industry's long-standing bread-and-butter product, cash value life insurance (CVLI). The events of the 1980s and early 1990s are enough to make one question whether the evolution of CVLI is keeping pace with the rapidly changing environment in which it is sold. Many new products have been spawned during this period; however, upon closer examination, one might well conclude that the changes introduced during this period have provided more camouflage than real solutions. In this paper, I describe a new form of CVLI better suited for today's environment and the years ahead. This description is followed by a discussion comparing this new product form with the present form of CVLI. Finally, the paper concludes with a brief discussion of the effect of such a new product form on the key constituents.

I. CASH VALUE LIFE INSURANCE—THE NEXT GENERATION

The Product Defined

A new form of CVLI can be created by legislation that allows two new interrelated products. The first new generic product, which I refer to as

segregated life¹ (SL), is defined as follows: An SL policy is any fixed-premium CVLI policy whose loan provisions are worded such that loans are forced upon the policyholder at the maximum level at each premium due date. In other words, an SL policy is any fixed-premium cash value policy that contractually is always fully leveraged by the policyholder. The second new generic product, directly related to the first, is referred to as an individual death benefit account (IDBA). This is defined as is any investment account in any qualified financial institution that is held on behalf of the policyholder and is funded solely by policy loans derived from the policyholder's SL policy or policies.²

In other words, the IDBA provides a receptacle for the borrowed SL funds, the earnings on which receive essentially the same tax-deferred treatment at surrender and tax-free treatment at death that they now receive in a conventional cash value policy (part of the new legislation would grant this tax treatment of IDBA funds). The net effect of the introduction of an SL policy and its companion IDBA product is the literal segregation of the investment component of the cash value product from its mortality/expense component. That is, the portion of premium that normally accrues to the cash value is instead withheld, to be invested and accrued outside the contract. Universal life (UL) is often referred to as the "unbundled" product, but the UL policy is really unbundled in appearance only. The SL concept takes the next logical step and unbundles the product in substance.

In the event of surrender or death, proceeds from both SL and IDBA contracts are available to the policyholder. At surrender, the policyholder is entitled to the cash surrender value of both the SL and IDBA contracts. Normally, the bulk of the surrender proceeds comes from the IDBA contract, while the SL contract provides some nominal amount (that is, total cash value, less loan balance, less accrued loan interest). At death, each of the two contracts provides a material part of the death benefit. The SL contract provides something akin to the net amount at risk, based on the SL contract's cash value schedule. The actual proceeds are the SL policy face amount, plus the face amount of any paid-up additions, plus any current dividend

¹While I have chosen the name segregated life, at least for the purpose of this paper, the name integrated life also has appeal, particularly from a marketing standpoint. As the reader will see, the product described herein has elements of both segregation and integration. I chose the former name because much of the discussion in the paper focuses on the product in its segregated state.

²In this paper, SL and IDBA products are discussed in the present tense as if they already existed in order to avoid continuous use of the subjunctive mood. Use of the subjunctive mood or future tense has been limited to discussions of uncertain aspects of these new products and their potential ramifications.

accrued, less the loan balance, less accrued loan interest. The IDBA account balance constitutes the remainder of the death benefit. Therefore, the performance of the IDBA account affects the total death benefit, and underperformance could cause the total death benefit to be less than the SL face amount. The SL contract could guarantee that the total death benefit would never be less than the face amount, although some restrictions on the length of the guarantee or the types of IDBA funds that enable such a guarantee may be necessary.

For income and estate tax purposes, both contributions to and distributions from the SL and IDBA contracts are aggregated. The policyholder's net taxable income in the year of surrender is defined as follows:

$$\begin{aligned} \text{taxable income} = & \text{SL proceeds (including loans forgiven)} \\ & + \text{IDBA proceeds (including loans forgiven)} \\ & + \text{SL dividends received} \\ & + \text{IDBA dividends received} \\ & - \text{SL gross premiums paid} \\ & - \text{IDBA gross premiums paid,} \end{aligned}$$

where gross premiums paid include those paid via loan. This can be rewritten as:

$$\begin{aligned} \text{taxable income} = & (\text{SL cash proceeds} + \text{final SL loan balance}) \\ & + (\text{IDBA cash proceeds} + \text{final IDBA loan balance}) \\ & - (\text{SL gross premiums paid} - \text{SL dividends received}) \\ & - (\text{final SL loan balance} - \text{accrued SL loan interest} \\ & - \text{IDBA dividends received}), \end{aligned}$$

which reduces to:

$$\begin{aligned} \text{taxable income} = & \text{total cash proceeds} + \text{final IDBA loan balance} \\ & + \text{accrued SL loan interest} + \text{total dividends received} \\ & - \text{SL premiums paid.} \end{aligned}$$

Interest charged on the required policy loans is not tax-deductible, because this interest is essentially offsetting the tax-deferred earnings inside the SL

product. However, as with a traditional CVLI policy, the cost of borrowing (that is, loan interest) effectively becomes deductible at death or surrender because the taxable amount is lower than it otherwise would have been by the cumulative cost of such borrowing.

I anticipate that the administration and tax reporting of the SL/IDBA products would be as follows: The life company selling the SL policy provides the policyholder a form with each bill stating the amount of forgone premium payments (that is, borrowed cash values) associated with that bill. The policyholder then invests the borrowed cash value in the IDBA(s) of his/her choice and forwards copies of such forms to the administrator(s) of those accounts. The policyholder also notifies the SL company of his/her IDBA selection(s). Once invested, monies can be withdrawn or borrowed from an IDBA, subject to the account's specific withdrawal provisions. Monies can be transferred from one IDBA to another, again subject to particular or perhaps generic IDBA restrictions.

Withdrawals of money from IDBAs work much the same as withdrawals from IRAs. A grace period is allowed to accommodate a rollover into another IDBA. Upon a transfer or rollover of funds from one IDBA to another, the policyholder's basis also is transferred, thereby allowing the continued deferral of income-reporting by the new IDBA administrator. The SL company coordinates and records any movement of funds from one IDBA to another, while the SL policy may set limits on the maximum number and minimum size of associated IDBAs, the minimum amount of any contributions to them, and the frequency of rollovers to and from IDBAs.

Upon surrender of the SL policy, the burden is on the SL company to notify the IDBA administrator(s) on record. The IDBA administrator(s) then sends a 1099 form to the policyholder, indicating the taxable "distributions" during the year of surrender of the policy. (The policyholder does not necessarily have to cash in his/her IDBA accounts, but they must be subject to a gains tax as if all the IDBA account proceeds were distributed.) Another possibility is for the SL company to do all the reporting to the policyholder, who receives one form indicating his/her consolidated SL and IDBA results. Perhaps an annual report to the policyholder summarizing his/her holdings would also be desirable.

A 1035 exchange is triggered when one SL policy is exchanged for another. No change in IDBAs is necessary or even relevant to a 1035 exchange. When a 1035 exchange occurs, notification of the IDBAs' administrator is necessary only to note the identity of the new SL company. Deferred tax treatment of current inside buildup continues.

Finally, SL policyholders have a continuous option, exercisable at any time, to repay the SL policy loans in full, thereby opting out of the SL contract and converting the policy back to a standard CVLI contract. This allows the policyholder to shift the responsibility for investing the cash value to the SL company. Normally this is done by closing out the IDBA to repay the policy loans. Any excess earnings could also be poured into the CVLI contract as paid-up additions or dividend accumulations. Any interest earned in any remaining IDBAs from that date forward would become currently taxable.

The legislation required to get the SL/IDBA concept up and running may be confined to the tax code. In other words, it may be sufficient to just change provisions in the federal tax code so that the above-described tax treatment and reporting for SL/IDBA packages could take effect. No change in nonforfeiture laws, IRS definition of life insurance, or Securities and Exchange Commission (SEC) regulation of securities would be necessary, except for perhaps some technical language defining SL as a subset of traditional CVLI. Perhaps some state regulations need slight amendments pertaining to policyholder loans and solicitation requirements for SL products, but some state insurance departments might permit SL products to be sold without any new regulation, as was the case when UL was first introduced.

The Product Mechanics

Now that all the relevant components and rules have been defined, let us examine the mechanics of the SL/IDBA concept. The following are the key steps in the sale, administration and reporting of SL and IDBA products.

1. Agent explains SL/IDBA product concept to prospective buyer and provides illustrations of a company's SL product, either alone or in combination with a generic IDBA product.
2. Policyholder, as part of the application, signs form acknowledging that he or she understands the SL/IDBA product concept.
3. The initial premium due to the SL company is the first-year premium, less any initial loan value.
4. The SL company provides the policyholder with a form indicating the amount of loan value to be currently invested in IDBA(s) and general instructions on investment procedures and limitations. There does not need to be any time limit within which the insured must invest the loaned values—failure to invest in an IDBA simply results in lost income, loss of income tax deferral, or both.

5. The policyholder invests the borrowed cash value in one or more IDBAs. The investments must be registered as IDBAs to obtain the preferential tax treatment.
6. Each IDBA company, after receiving IDBA investment premium, registers the investment with the SL-writing company. The SL company records the IDBA company and product, and verifies that the total amount invested in IDBAs to date does not exceed the total cash value loaned to the policyholder to date.
7. At the end of each calendar year, IDBA companies exclude from any 1099 forms any income produced from registered IDBA accounts.
8. Before the end of each contract year, a premium notice is sent to the policyholder, indicating the gross premium due, the net premium due, and the increase in loan value to be invested in IDBAs. The notice also indicates the total loan balance required to be repaid to opt out of the SL contract and convert it to a conventional CVLI contract.

Steps 4–8 are repeated each contract year, except that the premium due and the IDBA investible amount in renewal years are based upon that year's premium and increase in loan value.

Upon a rollover of funds from one IDBA to another, the previous IDBA company notifies the SL company of the transfer, and the new IDBA company records the basis transferred. Upon a surrender of IDBA funds not associated with an SL policy surrender, the IDBA company reports the distributions, as any company reports withdrawals from CVLI policies. Upon a 1035 exchange of one SL policy for another, the previous SL company transfers all its IDBA data to the new SL company and notifies the IDBA company(ies) of the change so records can be updated.

Upon termination of an SL policy by surrender or death, the SL company ascertains IDBA fund values as of the termination date and provides a report to the policyholder. The report indicates the total net proceeds to the policyholder, broken down by face amount, cash values and policy loan balances for both the SL and the IDBA(s). The report also includes the amount of taxable gain in the policy, if any, reported at year-end. Each IDBA company also provides a notice, as of the SL termination date, indicating the account balance and alerting the policyholder that the tax preference treatment ceases as of that date.

The Product Illustrated

Tables 1–3 present product illustrations of the SL/IDBA concept. To enable this, a hypothetical participating whole life (WL) product was first designed for a nonsmoking male, age 45, with a dividend scale based upon a new investment return assumption of 10% per annum. Table 1 contains an illustration of this product's values under the assumption that dividends purchase paid-up additions. Table 2 contains a comparable illustration for the combination of an SL product with a variable policy loan rate and an IDBA rate of return assumed equal to 10%. Not surprisingly, the total cash values and death benefits equal those from the previous WL illustration. Finally, an SL product with an 8% fixed loan rate was developed by dropping the dividend credited rate by 200 basis points on both the base policy and paid-up additions. The same 10% IDBA return was again assumed. Table 3 contains an illustration of these products' combined results. In this case, some clear differences in the WL illustration are readily observable. The total cash values in the SL/IDBA package track fairly closely with their WL counterparts, but are slightly lower initially and somewhat higher after many years. The death benefits start out in tandem, but the WL values become quite a bit higher after several years.

These differences can be readily explained. The smaller death benefit under the SL/IDBA package results when a cash value is borrowed and then invested outside the contract to achieve a return greater than that of the policy loan rate. This extra return is not being used to purchase additional coverage as it would have in the WL contract via paid-up additions. The result is an increase in net cash value without a corresponding proportionate increase in the death benefit. While this could be considered a problem, it occurs under similar circumstances with a leveraged version of today's WL products. Of course, this occurs only when the loan rate is less than the rate that could be earned in the IDBA contract.

The higher death benefit under the WL policy causes a drain on the cash value, particularly in later years when the net amount at risk difference and the mortality rate are highest. This unintended side effect can be removed, at least for comparison, by adding a one-year term rider to the SL/IDBA package for the amount of coverage shortfall.

The slightly higher initial cash values for the WL policy are seemingly attributable to the fact that SL/IDBA dividends and cash value increases do not begin to earn the market rate of 10% until the end of the year when they are paid (one year later than the WL counterpart). The impact of this

TABLE I
WHOLE LIFE ILLUSTRATION; FACE AMOUNT = \$140,000

Year	(1) Gross Premium	(2) Guaranteed Cash Value	(3) Total Dividends	(4) Paid-Up Additions	(5) PUA Cash Value	(6)* Total Cash Value	(7)† Total Death Benefits
1	2,678	0	0	0	0	0	140,000
2	2,678	0	0	0	0	0	140,000
3	2,678	2,311	126	0	0	2,437	140,126
4	2,678	4,823	255	448	131	5,209	140,703
5	2,678	7,388	441	1,321	402	8,230	141,762
6	2,678	10,009	634	2,771	876	11,518	143,405
7	2,678	12,681	843	4,778	1,568	15,093	145,621
8	2,678	15,400	1,068	7,347	2,504	18,972	148,415
9	2,678	17,833	1,307	10,481	3,707	22,848	151,788
10	2,678	20,318	1,563	14,177	5,201	27,082	155,740
11	2,678	22,851	1,829	18,436	7,010	31,690	160,265
12	2,678	25,432	2,007	23,245	9,156	36,596	165,252
13	2,678	28,066	2,193	28,340	11,558	41,817	170,533
14	2,678	30,751	2,393	33,718	14,230	47,374	176,111
15	2,678	33,489	2,606	39,387	17,194	53,289	181,993
16	2,678	36,277	2,842	45,357	20,469	59,587	188,199
17	2,678	39,109	3,095	51,655	24,084	66,289	194,750
18	2,678	41,976	3,370	58,293	28,064	73,410	201,663
19	2,678	44,869	3,665	65,294	32,434	80,967	208,959
20	2,678	47,781	3,979	72,673	37,218	88,978	216,652
21	2,678	50,704	4,316	80,443	42,442	97,461	224,759
22	2,678	53,640	4,671	88,623	48,134	106,445	233,294
23	2,678	56,591	5,047	97,223	54,323	115,961	242,270
24	2,678	59,559	5,449	106,257	61,039	126,047	251,706
25	2,678	62,544	5,886	115,742	68,315	136,744	261,628
26	2,678	65,534	6,362	125,714	76,190	148,086	272,076
27	2,678	68,516	6,866	136,212	84,701	160,084	283,078
28	2,678	71,470	7,412	147,254	93,868	172,751	294,666
29	2,678	74,372	8,018	158,882	103,720	186,110	306,900
30	2,678	77,204	8,667	171,165	114,303	200,175	319,832

*Column (6) = (2) + (3) + (5)

†Column (7) = 140,000 + (3) + (4)

could be measured and/or removed by allowing the SL policyholder to borrow against the projected year-end dividend at the beginning of the year. Again, this is normally an issue only for fixed policy loan rates, where there might be an appreciable difference between the loan rate and the current market rate.

The remaining differences in total cash values are attributable to subtle differences in the interest crediting mechanics involved, the analysis of which is beyond the scope of this paper. Still, one should not be fooled or discouraged by the lack of a perfect equality between the consolidated values

TABLE 2

SEGREGATED LIFE/IDBA ILLUSTRATION; FACE AMOUNT = \$140,000; POLICY LOAN RATE = 10%

Year	(1) Gross Premium	(2) Guaranteed Cash Value	(3) Total Dividends	(4) Paid-Up Additions	(5) PUA Cash Value	(6)* Annual Loan	(7)† End-Year Loan Balance	(8)‡ End-Year IDBA Balance	(9)§ Total Cash Value	(10) Total Death Benefit
1	2,678	0	0	0	0	0	0	0	140,000	
2	2,678	0	0	0	0	0	0	0	140,000	
3	2,678	2,311	126	0	0	2,101	2,311	2,311	140,126	
4	2,678	4,823	255	448	131	2,192	4,954	4,954	140,703	
5	2,678	7,388	441	1,321	402	2,127	7,789	7,789	141,762	
6	2,678	10,009	634	2,771	876	2,105	10,884	10,884	143,405	
7	2,678	12,681	843	4,778	1,578	2,070	14,250	14,250	145,621	
8	2,678	15,400	1,068	7,347	2,504	2,027	17,904	17,904	148,415	
9	2,678	17,833	1,307	10,481	3,707	1,678	21,540	21,540	151,788	
10	2,678	20,318	1,563	14,177	5,201	1,659	25,519	25,519	155,740	
11	2,678	22,851	1,829	18,436	7,010	1,627	29,861	29,861	160,265	
12	2,678	25,432	2,007	23,245	9,156	1,583	34,589	34,589	165,252	
13	2,678	28,066	2,193	28,340	11,558	1,433	39,624	39,624	170,533	
14	2,678	30,751	2,393	33,718	14,230	1,268	44,981	44,981	176,111	
15	2,678	33,489	2,606	39,387	17,194	1,094	50,683	50,683	181,993	
16	2,678	36,277	2,842	45,357	20,469	904	56,745	56,745	188,199	
17	2,678	39,109	3,095	51,655	24,084	703	63,193	63,193	194,750	
18	2,678	41,976	3,370	58,293	28,064	479	70,040	70,040	201,663	
19	2,678	44,869	3,665	65,294	32,434	235	77,302	77,302	208,959	
20	2,678	47,781	3,979	72,673	37,218	-31	84,999	84,999	216,652	
21	2,678	50,704	4,316	80,443	42,442	-321	93,145	93,145	224,759	
22	2,678	53,640	4,671	88,623	48,134	-624	101,774	101,774	233,294	
23	2,678	56,591	5,047	97,223	54,323	-943	110,914	110,914	242,270	
24	2,678	59,559	5,449	106,257	61,039	-1,279	120,598	120,598	251,706	
25	2,678	62,544	5,886	115,742	68,315	-1,636	130,858	130,858	261,628	
26	2,678	65,534	6,362	125,714	76,190	-2,019	141,724	141,724	272,076	
27	2,678	68,516	6,866	136,212	84,701	-2,435	153,217	153,217	283,078	
28	2,678	71,470	7,412	147,254	93,868	-2,909	165,338	165,338	294,666	
29	2,678	74,372	8,018	158,882	103,720	-3,437	178,092	178,092	306,900	
30	2,678	77,204	8,667	171,165	114,303	-3,994	191,508	191,508	319,832	

*Column (6) = [(7)_t/1.1] - (7)_{t-1}

†Column (7) = (2) + (5)

‡Column (8) = [(8)_{t-1} + (6)_t] × 1.1

§Column (9) = (8) + (3)

||Column (10) = 140,000 + (4) + (8) + (3) - (7)

TABLE 3

SEGREGATED LIFE/IDBA ILLUSTRATION; FACE AMOUNT = \$140,000; POLICY LOAN RATE = 8%

Year	(1) Gross Premium	(2) Guaranteed Cash Value	(3) Total Dividends	(4) Paid-Up Additions	(5) PUA Cash Value	(6)* Annual Loan	(7)† End-Year Loan Balance	(8)‡ End-Year IDBA Balance	(9)§ Total Cash Value	(10)¶ Total Death Benefit
1	2,678	0	0	0	0	0	0	0	140,000	
2	2,678	0	0	0	0	0	0	0	140,000	
3	2,678	2,311	60	0	0	2,140	2,311	2,354	140,103	
4	2,678	4,823	121	214	63	2,212	4,886	5,023	140,473	
5	2,678	7,388	254	629	191	2,132	7,579	7,871	141,174	
6	2,678	10,009	391	1,463	462	2,116	10,471	10,986	142,369	
7	2,678	12,681	536	2,701	887	2,092	13,568	14,385	144,055	
8	2,678	15,400	691	4,334	1,477	2,059	16,877	18,089	146,237	
9	2,678	17,833	854	6,362	2,250	1,719	20,083	21,788	148,921	
10	2,678	20,318	1,023	8,776	3,219	1,711	23,538	25,849	152,110	
11	2,678	22,851	1,192	11,564	4,397	1,692	27,248	30,295	155,803	
12	2,678	25,432	1,266	14,700	5,790	1,662	31,223	35,153	159,896	
13	2,678	28,066	1,339	17,915	7,306	1,529	35,372	40,350	164,232	
14	2,678	30,751	1,416	21,199	8,947	1,385	39,698	45,909	168,826	
15	2,678	33,489	1,500	24,555	10,719	1,236	44,208	51,859	173,705	
16	2,678	36,277	1,593	27,991	12,632	1,077	48,908	58,230	178,905	
17	2,678	39,109	1,693	31,520	14,696	911	53,805	65,055	184,463	
18	2,678	41,976	1,802	35,151	16,923	731	58,899	72,364	190,418	
19	2,678	44,869	1,916	38,893	19,319	535	64,188	80,189	196,810	
20	2,678	47,781	2,037	42,750	21,894	325	69,674	88,565	203,678	
21	2,678	50,704	2,167	46,726	24,653	100	75,356	97,532	211,068	
22	2,678	53,640	2,298	50,833	27,609	-126	81,249	107,146	219,029	
23	2,678	56,591	2,436	55,065	30,767	-362	87,358	117,463	227,606	
24	2,678	59,559	2,580	59,424	34,136	-604	93,695	128,546	236,855	
25	2,678	62,544	2,738	63,915	37,725	-854	100,268	140,461	246,846	
26	2,678	65,534	2,915	68,554	41,547	-1,119	107,081	153,277	257,664	
27	2,678	68,516	3,097	73,364	45,620	-1,400	114,136	167,064	269,389	
28	2,678	71,470	3,294	78,343	49,941	-1,719	121,411	181,880	282,106	
29	2,678	74,372	3,520	83,511	54,517	-2,069	128,889	197,792	295,934	
30	2,678	77,204	3,762	88,903	59,369	-2,432	136,574	214,896	310,988	

*Column (6) = [(7)/1.08] - (7)_{t-1}

†Column (7) = (2) + (5)

‡Column (8) = [(8)_{t-1} + (6)_t] × 1.1

§Column (9) = (8) + (3)

¶Column (10) = 140,000 + (4) + (8) + (3) - (7)

of WL and SL/IDBA under the same assumptions. Many of these differences are confined to fixed policy loan rates, while others are either trivial or can be designed away in one fashion or another. In any event, these differences should not have any significance in the marketplace.

II. WHERE TODAY'S CVLI PRODUCT FALLS SHORT

What follows is an itemization of 13 problems with the present form of CVLI. Each problem is briefly discussed, including how or why the proposed form of CVLI may be better equipped to deal with it.

Certain Fundamental Trends in CVLI Sales and In Force Are Disturbing

This statement is based on (1) recent declines in the growth rate of new ordinary insurance volume written, (2) the growth in ordinary life premium relative to the growth in ordinary life insurance in force, and (3) the growth in ordinary life reserves relative to the growth in ordinary life insurance in force.

From 1980 to 1985 the amount of ordinary life purchased grew at an annual rate of 18.8%. This growth rate contrasts sharply with the six-year period from 1985 to 1991, when the annual rate of growth averaged only 2.3%.³ The high interest rates of the early 1980s combined with the early popularity of UL clearly drove the flurry of sales in the first half of the decade. Also, many of the sales in the early 1980s constituted replacement sales, both external and internal, which helped inflate the growth rate.

Not only did the sales growth rate slow down dramatically, but so did the growth of ordinary premium in force relative to the amount of ordinary insurance in force. The amount of ordinary insurance in force increased by a factor of 2.87 (\$1.98 trillion to \$5.68 trillion) for the 10-year period ending in 1991, while the corresponding premium in force increased by a factor of only 1.82 (\$34.5 to \$62.8 billion).⁴ This is consistent with the fact that more term, flexible-premium UL, and low-premium WL are being written in place of the traditional high-premium WL contract. In fact, the slower growth in in-force premium has occurred despite the fact that first-year premium *has*

³AMERICAN COUNCIL OF LIFE INSURANCE. *1992 Life Insurance Fact Book*. Washington, D.C., 1992.

⁴Ibid.

kept pace with the volume of business written. This could well be attributable to the fact that premium payments for UL tend to be both greater in the first year and less over the long run than those for traditional WL.

Finally, ordinary life insurance reserves have increased by a factor of only 1.87 (\$184 billion to \$344 billion) for the same ten years, compared with the 2.87 factor increase in the amount of ordinary life in force. This means the average reserve per face amount declined from 9.3% to 6.1% in just 10 years. While this is consistent with the trend towards lower-premium term insurance, it also suggests that the average age of policies might have shortened due to replacement activity during the period. One problem with replacements, of course, is that, even though premium income may be maintained, a large portion of existing cash values can exit insurance companies in the process.

What will be the impact of SL/IDBA on these CVLI sales and premium trends? While the total impact is impossible to predict with any certainty, a few general observations can be made with some confidence.

First, it is likely that SL/IDBA will also appeal to those who might otherwise favor variable life (VL) or variable universal life (VUL). Of course, SL/IDBA goes a step further by offering a virtually unlimited universe of investment choices, while VL and VUL only offer a few. Perhaps more significant than that, however, is that SL takes advantage of a much larger distribution system than VL and VUL, because any licensed insurance agent can sell SL, while only a National Association of Securities Dealers (NASD) registered representative can sell variable products. (It is unlikely that the NASD will claim jurisdiction over the SL product, because SL is really just a narrower form of traditional CVLI with policy loans as their primary investments. Furthermore, there is no need or justification for the NASD or SEC to govern any IDBA products that do not already fall within their control, because it is not those products that are changing, but rather the context within which they are being purchased, such context having new tax ramifications.) An SL product is also much simpler to bring to market than SEC-registered products because of the substantial time and expense associated with an SEC filing. Therefore, at least in theory, SL/IDBA will outperform VL or VUL, perhaps even making them somewhat obsolete, by virtue of its unlimited investment choice, wider distribution channel, and lower cost.

When sales of CVLI are being measured, it is important to distinguish between volume and premium. Ever since the advent of UL and VUL, premium income and profits for future years have become less certain. The

trends are clear, however: premiums are typically dropping off dramatically and continually in renewal years. The result of offering this extra freedom to policyholders is that permanent UL coverage is being replaced by quasi-term, quasi-permanent, low-cash-value coverage. SL presents life companies with an opportunity to reverse that trend, *by giving the policyholder more investment freedom in exchange for less premium freedom.*

The potential demand for SL/IDBA does not come solely from its value as an alternative to today's variable life products. Several other factors make this product more attractive to the insurance public and perhaps to life companies and regulators as well. The separation of mortality and investment components, both from a purchase and replacement perspective, should increase competition and benefit the consumer. The possibility of lower net insurance costs for a contract held until death or at least for several years, in exchange for higher charges in the event of early surrender, may appeal to many insurance consumers who view their coverage as a long-term commitment anyway. SL/IDBA packages may also have either lower or deferred acquisition costs, making the SL product or the SL/IDBA package more competitive than the present-day WL. Perhaps the ability to diversify the equity in a WL policy among two or more companies will appeal to a public that has been stung with some unexpected company failures.

Profit Margins Are Smaller Than Historical Margins

This fact has been hurting the industry for more than a decade now. Several factors have contributed. In the late 1970s, a Federal Trade Commission (FTC) report highlighted the low historical returns of a typical WL policy. This came at a time when interest rates were escalating to historical highs. More and more savings dollars were funneled into mutual funds and annuities over the next several years, reducing the amount that might otherwise have gone into CVLI. At the same time, UL made an impressive debut, but again at the expense of traditional WL dollars. This happened in three ways: the redirecting of new premium dollars into UL, the funding of new UL policies by leveraging or cashing in existing CVLI policies, and the cutting back of future renewal premiums due to UL's flexible premium structure.

UL, interest-sensitive life, traditional life, and annuities now all competed against one another in a crowded playing field, fueled by high credited rates that were also highly visible for the first time. Even some traditional life products began advertising the underlying interest rates in their dividend scales. Nonsmoker pricing was another innovation that helped squeeze

margins. Companies were also aggressively pricing policies by projecting a reduction in unit expenses through future growth. Many of these companies did not achieve their targeted sales, and this resulted in lower realized margins than the original pricing implied.

In short, the life insurance industry became much more competitive in the 1980s. A product revolution in a period of high interest rates spawned massive, and often justifiable, replacement activity, and companies were pressured to price aggressively to maintain market shares. Lower margins in products were a natural by-product of such an environment.

The precise impact of SL/IDBA upon profitability, or sales, is difficult to gauge with any certainty. Part of the difficulty in assessing this is that the sale of an SL policy is accompanied by an IDBA sale that may or may not be generated from the same company. Therefore, from an insurance company's perspective, it may appear more appropriate to compare the present-day CVLI product directly with the SL product alone. From the vantage point of all financial institutions that may be writing SL and IDBA contracts, however, the proper comparison is SL versus the combined SL/IDBA package. That being said, what is the expected impact on profitability?

1 Long-term persistency should be better in two respects. First, to the extent that SL displaces a flexible-premium sale, premium income will be higher. Second, segregation of the mortality and investment components allows replacement of only the SL contract or the IDBA, without requiring the replacement of both. Since many present-day replacements are rooted in policyholder dissatisfaction with the investment performance of the current contract, or expectations of better returns elsewhere, SL contracts may well be spared the bulk of future replacement activity. Though differences may still exist in the interest components of different companies' SL products, such differences will likely be smaller and less apt to be misunderstood or misrepresented in policy illustrations. The credited rates for SL products will hinge directly on the SL policy loan rates, which are clearly visible and, in many cases, the same from one company to the next. (In theory, the credited rate embedded in an SL dividend scale would equal the SL policy loan rate, whether it is fixed or variable, less an interest margin.) In addition, once an SL policy and IDBA policy are issued, virtually all the investment "action" will be in the IDBA, keeping most of the policyholder's attention focused away from the largely predetermined investment performance of the SL product. However, for those SL policies that do eventually get replaced, whether internally or externally, there is a good probability that the policy will be in less of a deficit position, if in one at all, by virtue of having

incurred lower acquisition costs than its present-day counterpart (the likelihood of this occurring is discussed later in this paper).

Now consider the expected profitability of an SL product vis-à-vis a traditional WL product. Suppose that SL acquisition costs become lower than those of WLs, because some of the pressure to pay compensation is absorbed by the IDBAs. Therefore, we have an up-front cost savings. What is not clear, however, is how the interest margins will be affected. Nominal spreads expected on a WL policy may be subject to fluctuation because of the particular investment strategy and the methodology for resetting dividend scales, especially the degree to which new money rates are taken into account. SL interest margins should be more stable, although perhaps somewhat lower, since SL investment income (policy loan interest) is riskless and very predictable. (Note that the SL policy need not be participating. It could be participating in the traditional sense, that is, through dividends, participating through excess interest credits, or simply not participating at all.)

How much lower SL interest margins will be is an interesting question. One argument that lower spreads will prevail is that the IDBA will also earn spreads and that competition will keep the total spreads between the SL and IDBA commensurate with present WL margins. An argument against that is that the SL product, with its lower acquisition costs and riskless assets, will be competitive enough with WL even with the same interest margins as WL (after adjusting for credit risk in the WL assets). After all, the IDBAs cannot exist unless the SL policy is sold first, which may allow the SL product to command a premium margin. Another argument against lower SL margins is that policy loans currently command a higher spread than nonloaned reserves, even though their proceeds generally cannot be invested on a tax-deferred basis.

Even with the uncertainty on SL acquisition costs and interest margins, the competitiveness of the SL product seems to hold promise. Even if acquisition costs and interest margins end up on the high side, that is, commensurate with WL, the product will still be competitive with WL, and agents will have the additional incentive of associated IDBA sales. If either compensation or interest margins come down, then from the policyholder's viewpoint the SL looks even better next to traditional WL. The total impact on profitability for insurance companies that sell SL products is indeed difficult to predict because of the many moving parts. One plausible result is that *SL products* will have lower interest margins, which are partially offset

by lower compensation. The lower profit margins may or may not be overcome by greater sales or better persistency. Of course, all this ignores the impact of IDBA sales in the same company.

To better understand all the potential factors influencing profitability, let us consider some formulaic expressions, albeit somewhat simplified, for both traditional WL and SL/IDBA. The formulas are not time-specific, but simply reflect the main components of profitability. The periodic profits for a WL product with face amount F can be expressed as the sum of the following four components:

$$\begin{aligned} \text{WL Profits} &= F \times (1000 - TV) \times \Delta q \quad (\text{mortality}) \\ &+ F \times TV \times \Delta i \quad (\text{interest}) \\ &+ F \times (GP - NP - Exp) \quad (\text{loading}) \\ &+ F \times (TV - CV) \times w \quad (\text{surrender}). \end{aligned}$$

Similarly,

$$\begin{aligned} \text{SL Profits} &= F \times (1000 - TV') \times \Delta q' \\ &+ F \times TV' \times \Delta i' \\ &+ F \times (GP' - NP' - Exp') \\ &+ F \times (TV' - CV') \times w', \end{aligned}$$

where all primed symbols represent the corresponding SL parameters.

To facilitate the comparison, consider an SL product derived directly from a WL product, so that all product values remain unchanged; that is, $TV' = TV$, $GP' = GP$, $NP' = NP$, and $CV' = CV$. If we then assume that experience is the same with respect to mortality rates (q) and lapse rates (w), then the excess of SL profits over WL profits reduces to:

$$\begin{aligned} \text{SL profits} - \text{WL profits} &= F \times TV \times (\Delta i' - \Delta i) \\ &- F \times (Exp' - Exp). \end{aligned}$$

IDBA profits can be expressed in a similar form:

$$\begin{aligned} \text{IDBA profits} &= F \times TV'' \times \Delta i'' \\ &- F \times TV'' \times Exp'' \\ &+ F \times (TV'' - CV'') \times w'', \end{aligned}$$

where all double-primed symbols refer to IDBA parameters, and TV'' and Exp'' are expressed per \$1000 of SL face amount.

The term $(F \times TV'')$ should approximate $(F \times TV')$, and we can define IDBA surrender charges as:

$$SC'' = F \times (TV'' - CV'')$$

Then, by making these substitutions, the excess of the sum of SL and corresponding IDBA profits over WL profits can be expressed as follows:

$$\begin{aligned} (SL + IDBA) \text{ profits} - WL \text{ profits} &= F \times TV \times [(\Delta i' + \Delta i'') - \Delta i] \\ &\quad - F \times [(Exp' + Exp'') - Exp] \\ &\quad + SC'' \times w'' \end{aligned}$$

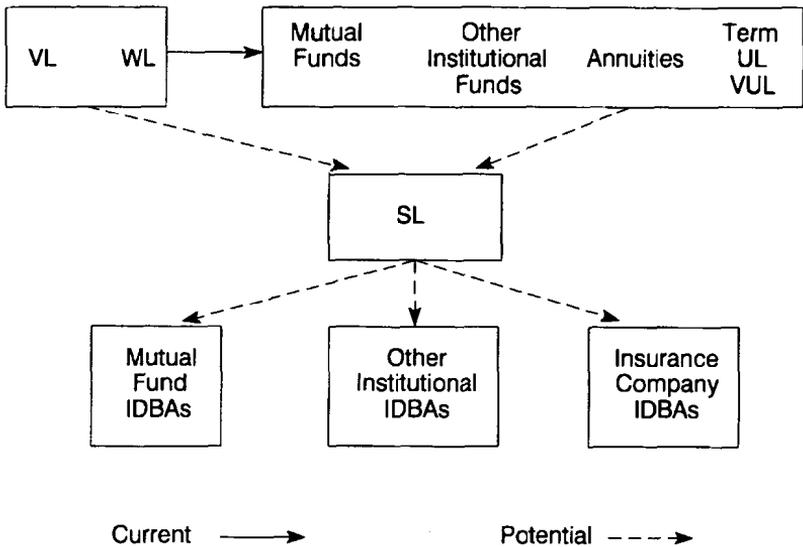
These somewhat simplified formulas suggest that the interplay between interest margins and expenses (including compensation) may be the key to the relative profitability picture. If an even further simplifying assumption is made that $\Delta i'' \approx \Delta i$, then it could be argued that SL interest margins and IDBA surrender charges will be available to fund the *excess* of total $(SL + IDBA)$ expenses over WL expenses, while keeping absolute profits the same. Of course, if any of the simplifying assumptions is eliminated, the potential change in profitability becomes more difficult to quantify. Unfortunately, the mere presence of so many variables in the profitability equation, as illustrated in the above expressions, will make it difficult to reduce the expected change in profitability to a simple expression.

The overall impact on insurance company profits is perhaps most difficult to predict because of the likely redistribution of investment funds among insurance companies, banks, mutual fund companies, and other investment institutions. First, it seems almost certain that the flow of funds into insurance companies will increase, because many sales of fixed-premium SL products will likely be displacing term and flexible-premium insurance product sales. There will also be new incentive for money that is currently invested outside the insurance industry to be redeployed as part of an $SL/IDBA$ package to gain tax-preferenced treatment. Meeting the net amount at risk requirements may suddenly seem like less of an obstacle because of the greatly expanded choice of IDBA investment vehicles.

What is much less clear, though, is what will happen to the money after the SL policies are sold. Insurance companies will no longer have captive funds to invest, but instead will have to compete for the funds with mutual fund companies, banks, and other institutions that can now offer tax-deferred

accumulation products in the form of IDBAs. Figure 1 helps illustrate the general redistribution of funds that will occur. The arrows at the top of the chart indicate the current general drift of funds away from fixed-premium permanent insurance products towards flexible-premium and term insurance products and noninsurance products.

FIGURE 1
REDISTRIBUTION OF FUNDS AMONG INSURANCE/SAVINGS PRODUCTS



In trying to assess the impact of this redirection of funds attributable to IDBAs, any analysis should take into account that a redistribution has already been and is still taking place today (away from WL and VL, as illustrated in the top portion of the figure). This trend, and efforts to thwart it, have been manifesting themselves through risky investments, aggressive and misleading sales tactics, and excessive unit costs.

Insurance companies will have the first crack at selling IDBA products. Effective marketing or packaging of IDBAs with SLs, perhaps with package discounts, may enable them to achieve a large market share and bring more money under management. A marketing strategy that pays different compensation on IDBA sales funded by the same company's SL product than

for "independent" IDBA sales has interesting possibilities. Paying lower compensation on internal IDBA sales can be successful if the company has enough investment vehicles to attract the policyholder (and the agent) and sales become easier because of a packaged approach. An alternative strategy is to pay equal compensation for internal and external IDBA sales, but offer a more competitive product inside. Still another strategy is one in which higher compensation is paid on internal IDBA sales because the company believes that targeting packaged sales will be more profitable.

The challenge for insurance companies is to optimize total profits from SL, internal IDBA and external IDBA sales, given that the unit profits can vary widely from each other and from traditional WL, and that the sales volume of each depends on how well positioned the company is, from both a distribution and product perspective, to capture market share in each product area. Even assuming that insurance companies wind up managing less money than now, by losing funds to outside IDBA contracts, they will still command premium margins on SL policy loans. In short, they may earn less from managing money, but more from renting it out.

In summary, SLs may enhance profitability through greater sales (both volume and premium), greater persistency, lower acquisition costs, and margins for rental of IDBA funds. However, insurers will also have to successfully negotiate their way through a new environment in which they face new competition in their roles as money managers. Companies that can attract equal or larger shares of investment funds than they do now will enjoy a considerably stronger profit outlook in this new environment. Companies that are unable to attract investment funds or that desire to focus on the SL business may need to reorganize their cost structures so that their SL profit margins adequately cover fixed expenses and capital requirements.

The Assets Backing CVLI Policies Have a Low Common Stock Component, Holding Down Long-Term Returns

It is well documented that stocks outperform bonds over the long haul with greater volatility in the short run. Insurance companies, under the burden of nonforfeiture laws and statutory accounting, have usually backed general account CVLI policies with a high proportion of fixed-income assets (that is, bonds and mortgages). The book values of these assets are much more stable than those of common stock, and therefore they do not expose the insurer to as much short-term risk. However, this added safety for the

insurance companies comes at a price to the policyholders. Their life insurance purchase generally is based on a long-term need that might be better funded by common stocks, just as retirement funds for people 20 or more years from retirement are heavily stock weighted.

The SL/IDBA package allows the insured to cure this problem, just as does VL, but SL/IDBA offers many more investment choices and potentially unlimited flexibility in moving from one to another. Of course, heavier investing in common stock brings with it the risk that the IDBA's value at the time of the insured's death will be less than the outstanding SL policy loan balance, resulting in a net death benefit that is less than the face amount. Perhaps an SL rider can cover any such shortfall, just as VL policies typically guarantee a minimum death benefit equaling the face amount.

The tremendous growth of mutual funds, combined with the greater historical returns of common stocks relative to bonds, suggests that stocks should somehow play a greater role in the CVLI business. The SL/IDBA product allows this to happen to a greater extent than VL and VUL, which thus far have commanded only a small share.

The Asset Portfolios Backing CVLI Policies Sometimes Are Laden with Undue Risks

To attain yields necessary to support dividend scales, many investment managers have been or are under pressure to take credit risk in the form of junk bond investments. Lack of diversification sometimes prevails with larger than prudent exposure to any one credit or class of investment. Liquidity and refinancing risks have hurt some insurers that were heavily weighted in commercial mortgages. Prepayment risk is the newest kind of investment risk that is common in pass-through securities and exotic collateralized mortgage obligations (CMOs), both of which might be material components of an insurer's portfolio.

Some risk-taking is necessary to achieve returns in excess of Treasury returns. However, the opportunity for imprudent risk-taking certainly exists and unfortunately has been exercised in many instances. Without control of the policy's underlying investments, the policyholder is at the mercy of the insurance company's investment policy and performance. SL gives the insured control over cash value funds; thus the insured has the capability to achieve great diversification and liquidity and avoid undue concentration in certain asset classes that have proved to be the undoing of some insurers. If

by no other means, *the insured achieves greater diversification by spreading cash values among two or more institutions.*

Of course, SL may be a double-edged sword that allows the insured to make imprudent investments inherently riskier than a CVLI policy would have allowed. Diversification of investment funds is not automatic and requires some initiative and prudence on the part of the policyholder and/or the writing agent. Even a well-thought-out, diversified investment portfolio does not assure the policyholder better returns than he or she might have had with a WL policy. Consequently, the SL product is appropriate only for those who understand the contractual differences, the ongoing policyholder responsibilities, the investment risks, and all the potential tax effects. Some safeguards will probably be necessary to prevent an unsophisticated prospect from being led into a contract without knowing that investment responsibilities have been shifted to him or her. At a minimum, a signed statement acknowledging the policyholder's duties and the general consequences of failure to invest the funds or poor investment performance will probably be necessary.

Cash Surrender and Policy Loan Rights Expose Companies to Liquidity and Run Risk

The ability of a policyholder to literally cash in a CVLI policy at any time or, alternatively, to borrow against it creates a burden for the writing company. These policyholder options make the timing of policy payouts difficult to project, but at the very least payouts will be accelerated. Both the greater uncertainty and acceleration of benefit payments create a greater need for liquidity in insurance companies' investment portfolios. However, the virtually unlimited access that a policyholder has to the policy's equity, whether through cash surrender or policy loans, cannot be fully hedged by the writing company without forgoing desirable investment opportunities that may be somewhat illiquid. In extreme situations, these policyholder options can cause a run on the bank, where policyholder surrenders become contagious and snowball until either illiquid assets have to be disposed of, possibly at fire sale prices, or regulators step in to help stop the bleeding.

With the SL/IDBA package, the policyholders give up some of those privileges, although the extent of the forfeiture varies from none at all to complete. Because the SL contract itself is always fully leveraged, the SL

writing company is fully protected from any run risk. Furthermore, the company benefits because mostly risk-free assets back the contracts, which appropriately carry a zero C-1 factor for risk-based capital requirements (policy loans will be entirely risk-free and constitute most of the SL policy's assets).

The IDBA writers, on the other hand, can offer a variety of products, some of which may grant policyholders full and immediate access to their funds, and others that may impose restrictions, perhaps going so far as permitting no withdrawals prior to death. All the IDBA products will be backed by invested assets (except for IDBA policy loans), which expose the writer to asset and interest rate risk. However, IDBA interest rate and run risk will be more controllable through product provisions, greater diversification of policyholders and associated SL contracts, and greater diversification by the writing agent.

For example, if company X has written SL business and runs into financial difficulty, the IDBA contract-holders who are associated with company X's SL policies, but who have invested away from company X, need not panic because (1) their money is not held by company X, and (2) a potential remedy, if necessary, is to replace the SL policy, which need not affect the associated IDBA(s). Of course, company X's IDBA policyholders may be under pressure to pull their money out. Company X, in this case, can benefit by having written IDBA business through more agents, or perhaps by placing some IDBA business directly through the home office, which leaves it less exposed to agent-induced replacement. The interest rate risk and run risk for IDBAs will be further mitigated by restrictions in fund transfers or early withdrawal or surrender. IDBA penalties will come on top of penalties already built into the cash value scales of the underlying SL products, so the combination will provide more protection to the IDBA writer. Of course, such IDBA products will have to compete with other IDBA products that are virtually penalty-free, have various degrees of interest rate risk, and pay various amounts of compensation, so any one IDBA product will look quite different from the next.

In a nutshell, writers of SL and IDBA products can place themselves virtually anywhere on the risk spectrum they choose to be. Some companies may choose to focus on SL business alone; some, including noninsurers, may focus on IDBAs; the rest may pursue both markets. However, a competitive marketplace and risk-based capital constraints may prevent some insurers from achieving a desired IDBA presence.

Policy Illustrations Are Not Standardized, Are Often Misleading, and Are Viewed by Many As Not Credible

As interest rates hit new highs in the early 1980s and UL joined the fray, competition for new premium heated up. During this period, illustration development sometimes became more important to companies than product development. At the heart of the matter was the illustration of values based upon current dividend scales, which themselves were often based upon the assumption of high interest rates continuing indefinitely. Vanishing-premium payment schemes both capitalized on and were highly dependent upon such dividend scales for this period remaining intact. Now that several years have passed, the original projections of most dividend scales have been lowered, and projected vanish years for such illustrations are not being realized. Many policyholders who did not really understand the vanish concept are now receiving nasty surprises as premiums do not vanish or perhaps do so only temporarily only to reappear at some later date.

Illustrations have been and continue to be a problem, because companies sometimes gain unfair advantage over one another, and policyholders are being misled in the sales process. Many discussions and proposals have left these tough problems largely unsolved.

SL policies go to the heart of the problem and *eliminate the primary cause of the policy illustration problem, that is, questionable interest rate assumptions behind the illustrations*. SL policies short-circuit the inherent difficulty in setting dividend scales by eliminating a key unknown, the policy's gross investment earnings rate for all years. (Actually, this is strictly true only for policies with fixed loan rates. But for both fixed and variable-loan-rate policies, the net dividend credited rate can be clearly defined as the policy loan rate less some specified spread.) For an unbundled form of SL, the excess interest component, rather than the dividend scale, takes on a more predictable form.

The important point is that policy illustrations, or at least their interest components, may become more standardized because they will most likely be defined as a strict function of the policy loan rate and a spread. Perhaps the spread incorporated in the scale will be required to be level to avoid manipulation and facilitate policy comparisons. Furthermore, illustrations that combine the SL product with a potential IDBA, if permitted, can be standardized by requiring that the IDBA be illustrated only with industry standard assumptions (similar to VL illustration requirements). While this does not provide the prospective policyholder with enough information to

properly evaluate his or her choice of IDBAs, it allows the choice of an SL product to be more focused and less biased by an investment earnings assumption. These illustrations can be supplemented by IDBA-specific illustrations, which will continue to be governed by existing regulations on the various products that fill the IDBA role.

SL/IDBA will by no means eliminate all illustration problems. The challenge of determining appropriate illustration assumptions may simply be shifted to IDBA products, rather than eliminated. Still, it appears that breaking up CVLI into *simpler* components (that is, SL/IDBA) will enhance the prospects of acceptable illustration solutions. In fact, the introduction of SL/IDBA will no doubt provide further impetus to address the current lack of uniformity in illustrating various noninsurance products that may fill the IDBA role.

Dividend Scales Are Incomprehensible to the Public

Regardless of how a company's scale is derived, the policyholder usually is not aware of the company's gross earned rate, retained interest spread, and net credited rate. UL has improved this situation somewhat by featuring a visible credited rate as a major component of the fund accumulation process. However, traditional life dividend scales are more difficult to understand, due to their bundled structure, and companies generally do not advertise their underlying credited interest rate, even though they could. Changes in the dividend scale can occur without a policyholder even being aware of the changes or the new credited rate. In many cases, such credited rates are nonlevel by policy year, which makes them more difficult to quote and compare with other dividend scales.

In any event, the lack of a visible credited rate increases the probability of greater inequities among blocks of policies. Such inequities may be completely unintentional, but nevertheless can arise because maintaining equity among such blocks can be a complex process and because a policyholder can neither easily assess nor intelligently react to his or her policy's performance. In short, competitive forces alone are not sufficient to ensure equity among traditional WL blocks.

The dividend scales for SL products should be somewhat easier to comprehend than their WL counterparts for much the same reason that illustration difficulties should ease. The net credited interest rate embedded in the scale can be clearly defined in terms of the policy loan rate less a spread.

The spread itself can even be contractually guaranteed. Therefore, the component of the scale that is likely to fluctuate the most for a WL policy and cause the most surrender activity will be much easier to follow for an SL policy. In fact, there may be little or no interest change in an SL dividend scale over the life of the policy with a fixed policy loan rate.

This is not to say that the derivation of SL dividends will become crystal clear to the policyholders. If the SL product has the traditional bundled structure, the components of the total dividend will still be unclear, even though the interest component will be easier to understand. If the SL product takes on an unbundled form, then the product will give the policyholder the advantage of clearly identifiable product components, as well as greater insight into the future performance of the interest component.

Nonforfeiture Requirements Constrain Product Development and Investment Strategies

It might help to first revisit the reasons that cash surrender values exist today. The combination of level premiums, increasing mortality, and an endowment provision at some high age results in equity building up in the contract. This equity rightfully belongs to the policyowner, who is responsible for paying premiums each year. But exactly how should this equity be determined? Current nonforfeiture laws allow companies to withhold from cash values an amount that crudely approximates unamortized acquisition costs. Some laws allow additional market value adjustments that approximate the gain or loss in specific fixed rate bonds that would be attributable to changes in interest rates. Aside from that, however, the nonforfeiture laws effectively shield the policyholder from principal risk by guaranteeing a minimum rate that must be credited to net premiums paid into the contract, even though investments backing the policy could well be subject to principal risk.

While the existence of nonforfeiture laws has much merit generally, the presence of cash surrender values can add significant cost to the product. Having to provide cash surrender benefits normally affects both the required liquidity and maturity targets of an insurer's corresponding investment strategy. A company either has to invest in shorter term securities or else subject itself to greater interest rate risk from policyholder disintermediation. The reduction or elimination of cash surrender benefits, while possibly leaving intact reduced paid-up or extended term, could reduce the long-term cost significantly and open up the door for new product designs.

So how will an SL/IDBA environment facilitate new product development and the relaxation of investment constraints? SL products, for the most part, will not provide the answer, because SL products essentially already exist (except for their unique policy loan provisions) and would be governed by today's nonforfeiture requirements. The complimentary IDBA products, on the other hand, are another story. The total surrender and loan provisions for an SL/IDBA package will be determined by the corresponding provisions of both the SL and the IDBA contracts.

Various degrees of investment risk can be passed on to the policyholder through different IDBA structures. Some IDBAs may be supported by fixed-income assets and offer specific interest rate guarantees. Some may be equity-oriented without any guarantees, while others may have some equity exposure and principal guarantees. A family of IDBA funds could be marketed with periodic penalty-free transfers allowed between funds, perhaps with surrender penalties imposed only on external surrenders. Some may make surrender penalties contingent upon whether the SL product is being surrendered (as opposed to an IDBA exchange). An extreme product may forbid surrenders entirely, or perhaps allow only loans with 401(k)-type requirements.

All these potential contractual arrangements will allow wide latitude to the IDBA writers in developing products and investment strategies. While no changes in life product nonforfeiture laws are necessary for SLs, some potential IDBA products may require changes in nonforfeiture laws governing them. Such a product environment represents a compromise, of sorts, on cash surrender benefits. The SL issuing company will be required to provide the same minimum level of benefits as it does today, but policyholders could voluntarily give up some of those benefits through their choice of the IDBA vehicle. The SL/IDBA environment will therefore encompass elements of both traditional CVLI and VL products, while allowing much freedom in specific product characteristics and investment strategies.

Front-Loaded Commission Structures and Levels Have Been Difficult to Change

CVLI commissions have always been heavily loaded in the first contract year. Attempts to levelize commissions, to both lower surplus strain and provide greater incentive to the agent for long-term policy persistency, have been greatly resisted by agent groups. UL's flexible premium structure has

also created problems because many companies have paid out first-year commissions that were close to WL commission levels, only to have premium persistency drop considerably after the first year or two, which effectively turned the policies into little more than prefunded term insurance.

The continued use of front-loaded commission scales may be hurting life insurance products in their competition for savings dollars. Mutual funds and annuities often have level asset-based sales charges and commissions. These lower front-end compensation schemes also create less incentive for churning. In the early 1980s, many life insurance companies felt compelled to pay almost full first-year commissions on internally replaced business (policyholders switching over to new nonsmoker policies or UL policies) even though no new premium resulted for fear of external replacements that paid full first-year commissions. Such actions helped weakened life insurers' capital positions in the 1980s and artificially boosted sales levels.

The implementation of the SL/IDBA concept may succeed in restructuring agent compensation on WL sales where previous efforts have failed. Breaking the WL sale into two sales will certainly force some compensation restructuring, but the exact degree and nature of the restructuring are debatable. Because the same premium dollars (as WL) will be split between two contracts, one might initially expect that:

- The total compensation for the SL/IDBA will be commensurate with WL compensation.
- SL compensation will be somewhat lower than WL compensation.

Certain factors, however, may tend to keep SL compensation close to WL levels and push the total (SL + IDBA) compensation above that for WL:

- SL may be able to compete quite well with WL even with WL's acquisition costs.
- Better SL persistency (versus WL) is expected because IDBAs will bear much of the replacement risk.
- SL's priority status over the IDBA (that is, the IDBA cannot exist without the SL contract) may allow agents to command higher compensation. Stated another way, the SL sale assures the IDBA sale, so the SL agent should be compensated accordingly.
- Two sales presumably will require more time and effort than one, justifying greater *total* compensation than WL.

On the other hand, the fact that SL will compete with WL for premium dollars, and that IDBAs will face stiff competition on their own crowded playing field, will put downward pressure on compensation within each product line. At the very least, SL compensation alone will not exceed WL

compensation because interest margins will not support it, and the potential for IDBA compensation makes that unnecessary.

Regardless of the levels, some structural change is inevitable. IDBAs, both new designs and existing products, will have to compete for funds and pay compensation that both fits the product and appropriately complements SL compensation. In other words, compensation on IDBAs will be affected by what other similar IDBA products are paying (even in a non-IDBA role), as well as by how the total SL/IDBA compensation compares with WL compensation. It is unlikely that total compensation on an SL and IDBA sale would exceed the total compensation on two present-day sales, one being WL and the other being an IDBA-like product. Also, asset-based compensation for IDBAs will be easier to justify and implement, since front-loading probably will already exist on the SL contract and deposits into the IDBAs should grow over time (as SL cash value increases grow).

A significant advantage of an SL/IDBA environment is that costly wholesale replacement scenarios are less likely. When widespread systematic replacement occurred in the 1980s, brought on by the introduction of non-smoker dividend scales and UL policies, many companies paid full, or close to full, first-year commissions on these new policies, even though they were often funded by an existing policy and no new premium. (In the case of external replacements, the new premium came at the expense of the company that wrote the original policy.) Companies in many cases may have felt they were held hostage by agents who made the case that first-year commissions were available across the street and that replacements were easily justified. The agent's leverage has proven to be powerful and arguably forced more compensation during the 1980s than justified by the volume of new premium.

Replacement activity associated with SLs and IDBAs will, at least in theory, be less driven by agents' compensation, and writing companies will be better protected from potential abuses. For example, a replacement of one IDBA fund with another, which will probably be the most common replacement, need not affect the existing SL policy in any way. If IDBA compensation is strictly asset-based, there will also be less agent motivation for such replacements and complete protection for IDBA writers from the cost of internal replacements.

In the event that an SL policy is replaced by another SL policy (a 1035 exchange), the existing SL company may still benefit from lower unamortized acquisition costs than with WL. But an SL replacement will face the hurdle of imposing new surrender charges on the policyholder (buried in the

cash value schedules) on a product that is not giving the policyholder any additional investment advantages. This impediment may induce insurers to offer a higher early cash value SL product for replacement situations only, possibly coupled with lower agent compensation. In addition, the new SL company probably will not feel pressured to pay commissions on rollovers of existing cash values into the SL, because those funds will already reside in IDBAs and have generated commissions (and possibly continue to generate commissions).

In summary, it appears likely that breaking up the WL product will facilitate the breakup of the traditional WL commission structure and practices, and that competing market forces will determine where SL and IDBA compensation ultimately settles.

The Underlying Components of CVLI Are Inseparable

The insurance-buying public understands that a CVLI policy has underlying investment and mortality components. This understanding was heightened during the 1980s when UL flourished with its unbundled, high-interest component. For the first time policyholders clearly saw how much interest the policy was earning and how much they were being charged for mortality coverage and expenses.

This unbundling, however, is all appearance and no substance. UL is still a package deal—if you buy a company's product, you get the interest, mortality, and expense charges that the product packages together. You cannot buy the individual components alone. VL and VUL offer some choice on the investment component, but the policyholder is still tied to a company's mortality and expense charges. Similarly, once a policy has been bought, a 1035 exchange can be made only on the entire policy and not on the individual components.

The SL/IDBA package takes the next logical step, the physical unbundling of the interest component of CVLI. This true unbundling benefits the consumer in four clearly identifiable ways:

- Increased competition within each component will put downward pressure on the total cost of insurance.
- SL policies will have virtually no asset or interest rate risk associated with them; that is, SL companies will be selling lower risk policies.
- Wide latitude in the choice of IDBAs, each of which will have its own risk-return profile, will enable consumers to pursue greater long-term returns subject to their own risk tolerance.

- Selective replacement of “bad” components will prevail, instead of today’s wasteful practice of total replacement.

Blocks of Whole Life Are Not Easily Sold

There may be several reasons for this. Valuation is made more difficult because of the uncertainty surrounding future dividend scales and policyholder behavior in different interest rate environments. On the asset side, there are probably more illiquid assets such as commercial mortgages, real estate, and certain private placements unattractive to a potential buyer. Another reason may be that annuity blocks, with their simpler asset and liability components, have lent themselves more readily to such transactions. Finally, all acquisitions will be more difficult to transact in the future, given the impending model legislation (and potential federal legislation) that will make it easier for policyholders to opt out of the transfer. While the lack of movement of WL blocks may not have been considered much of a problem to date, it may become more of a problem as many companies attempt to improve their balance sheets through block sales and acquisitions.

Blocks of SL policies will more readily lend themselves to acquisition by another company. Problem assets, which often pose a big obstacle for potential deals, will not be involved. The acquiring company will also avoid the due diligence normally required to assess the selling company’s asset portfolio. The liabilities can also be analyzed with more precision because of a more predictable dividend scale for any given interest rate scenario. In fact, there may even be less uncertainty in evaluating SL blocks than annuity blocks, which are often involved in transactions today and which have a lot of disintermediation risk and uncertain credited rate formulas. Furthermore, SL acquisitions will allow companies to take more mortality risk and increase their base of insured lives, without simultaneously increasing their interest rate risk. In short, the SL product will be more of a commodity than WL.

Once SL blocks have reached a critical mass within the industry, they will become attractive acquisition candidates for companies that wish to lower their overall risk profile. Given this, some companies may originate SL policies with the intent of unloading them. However, any sale of a block of SL policies will be subject to each policyholder’s consent. Consequently, this transfer of mortality and expense risk may be difficult to execute with sufficient policyholder consent unless the acquiring company has a superior rating. On the other hand, policyholders may find transfers of SL blocks less

objectionable than annuity blocks, because no investment risk is being transferred and they may view the event as relatively low risk.

The Life Insurance Industry Has Been under Seemingly Constant Attack from Federal Regulators

Among the revenue-raising measures that passed over the last decade were the tightening of the definition of life insurance, lower reserves for tax purposes, greater taxes on certain distributions from life contracts, and the DAC tax. Other initiatives that have thus far failed include the elimination or restriction of deferred taxes on the inside buildup of both CVLI and deferred annuities. The attacks are likely to continue as federal officials scramble to raise revenue. The net effect is that these taxes can and already have hurt the competitiveness of life insurance products, both in an absolute sense and relative to other investment alternatives.

The security of the tax-deferred inside buildup remains debatable. There are, however, at least three reasons why the blessing of the SL/IDBA concept by Congress could further secure the tax-deferred inside buildup:

- (1) Congress would be giving a vote of confidence to the tax-deferred inside buildup principle by opening it up to other financial institutions. To then turn around and attack it anytime soon would appear illogical and unlikely.
- (2) Any subsequent attempts by Congress to tax the inside buildup would then likely face a united front comprising insurance, bank, and mutual fund institutions, whereas today these institutions are not allies on this issue. The insurance lobby is already powerful today. The introduction of SL/IDBA would, at least in theory, increase the strength of the opposition that Congress would run into if it decided to go after the inside buildup.
- (3) Congress does not need to go after the inside buildup to increase tax revenue. Congress has been very successful over the past decade raiding the back of the fort, while most of the industry's defenses protect the front.

A counterargument to this is that, once Congress has leveled the playing field, it can more easily attack the inside buildup because it would not be extracting tax revenue excessively from any one industry in relation to others. Such a move would hurt life insurers more heavily because their exclusive SL products and traditional WL policies would take the hit as well.

No one knows how a current change will affect Congressional actions well into the future; yet it seems quite likely that any future attacks will at least be deferred for several years.

Confidence in the Life Insurance Industry Is Low

The recent string of life company failures and state takeovers, including some high-profile companies, has tarnished the industry's reputation for financial strength and cast a new light on the meaning of the "guarantees" in their contracts. Such concerns, combined with the failure of illustrated payment schemes and the continued explosion of mutual funds and annuities, will probably continue to depress the growth in new sales of CVLI.

The new National Association of Insurance Commissioners (NAIC) risk-based-capital (RBC) requirements and recently imposed junk bond limitations are important steps in preventing companies from undue risk-taking and should help restore the industry's reputation over time. Unfortunately, it may take more than this to heal the present wounds. The industry needs to be more proactive in reversing the flow of funds away from the industry and in reinforcing the continued importance of permanent life insurance as part of an individual's total financial plan. Embracing SL/IDBA could be such a step. The increased competition will accelerate the current industry shakeout, resulting in healthier companies with cost structures and risk profiles more appropriate for the volume and types of business they generate.

Confidence in life insurance companies is lacking not only with consumers but also with regulators, Congress, and even some of its own agents. State regulators continue to clamp down with new laws, such as RBC and the Investments of Insurers Model Act, to limit undue risk-taking, and Congress continues to peck away at any industry advantages perceived as unfair. Many agents are assisting consumers with the flight to quality, either because they or their clients have been associated with a financially troubled company or because prudence and a sense of responsibility dictate that they deal only with the strongest companies.

SL/IDBA could potentially make contributions on all these fronts. Its separate components allow product design that is more RBC efficient, starting with the low-risk SL product. The greater availability of equity returns may help to counteract the unintended consequence of the present flight to quality, which is higher net cost of insurance to the consumer. SL/IDBA could also go a long way toward minimizing policy illustration problems.

Finally, SL/IDBA could spur a new wave of product development, or perhaps even greater magnitude than the introduction of UL and VUL, which would be quite timely given the public's current appetite for other savings vehicles.

III. TO CHANGE OR NOT TO CHANGE

That is the question facing the key players in the life insurance arena. The following is a brief discussion of the likely reaction of regulators, insurance companies, policyholders, and agents to the proposal and introduction of the SL/IDBA concept.

Will Federal and State Regulators Allow It?

To answer this question, first ask whether the concept is, in theory, defensible. A quick reaction is that this idea is nothing more than "buying term insurance and investing the difference." The truth, however, is that the consumer is buying WL and investing the difference. The purchase of an SL policy represents the same long-term commitment to pay for permanent insurance with level premiums over a long time as traditional CVLI. The segregation of investment funds does not in any way alter that commitment.

The legitimacy of the policy loans may be questioned because they are forced and as such are really just paper assets. I believe the policyholder option to fully repay the loans (thereby opting out of the SL contract) preserves their full integrity as loans and that the states will simply need to permit contracts that contain the appropriate loan provisions. Even though the policyholders' loan options are restricted, there is no reason that these loans could not be treated in all ways like policy loans are today.

Of course, Congress will closely examine the potential impact on tax revenue. If a straight comparison between WL and SL/IDBA is made, where the IDBA and WL investment assumptions are consistent, a case can be made that tax revenue will not be affected. Compare the amount of tax-deferred revenue under a present-day product with that under an SL/IDBA package.

For the sake of simplicity, assume that 10% is the available new money rate, 8% is the fixed policy loan rate, and 0.75% is the spread between earned rate and credited rate for the issuing company. The net credited rate on the traditional product then is 9.25% ($10.00 - 0.75$), all of which is tax-deferred. In the SL product, 7.25% is credited ($8.00 - 0.75$) and 8.0% is charged to

the policyholder, for a net nondeductible loss of 0.75%. When that is combined with the 10% tax-deferred earnings in the IDBA product, the net result is also a 9.25% tax-deferred earnings rate. Therefore, the SL/IDBA combination results in tax deferrals and tax revenues equal to those found in a present-day cash value product from which no policy loans are taken. In addition, IDBA policy loans, withdrawals from IDBAs, and the resulting investment income from IDBA policy loan proceeds could all be taxed exactly as loans and withdrawals from WL policies are today.

If these tax rules were adopted, only an absolute increase in CVLI business would increase tax-deferred income and reduce tax revenue. Of course, any deferral of income that comes at the expense of annuities, IRAs, or other qualified retirement plans will not affect tax revenue. But a term insurance policy combined with mutual fund contributions could be replaced by an SL/IDBA package, which would reduce current and/or future tax revenue by some amount. Would Congress tolerate such a loss of revenue? It is not clear, especially considering that it could just as easily occur under today's tax law if there was an increase in the market share of VL and VUL. Nevertheless, any loss in current revenue would often be just deferral of revenue, possibly of some higher amount, because the amount ultimately taxed will have grown at a faster rate. If necessary, perhaps some tightening of certain miscellaneous provisions, such as taxation of IDBA withdrawals or policy loans, could satisfy Congressional concerns over tax revenue.

State regulators have less reason to balk. The concept is consistent with new RBC requirements, which are intended to help keep companies financially healthy. While SL/IDBA does transfer more risk to the policyholder, it would arguably do so to no greater degree than VL already does. Furthermore, it offers some built-in advantages for dividend disclosure and illustrations. While SL policy forms may be a simple variation of today's WL forms, new IDBA regulations will be necessary to clarify what is and is not permissible (that is, for cash surrenders and illustrations). Aside from a possible hesitation to increase the workload of already strained staffs, state regulators probably would not stand in the way of such a new product form.

Will SL/IDBA Be Suicide, a Big Gamble, or a Necessary Step for the Life Insurance Industry?

This question is highly debatable. One camp will undoubtedly argue that to voluntarily give up exclusive rights to a tax-advantaged product, if not suicidal for the industry, is certainly a death blow to many of its members.

They will argue that banks and mutual funds have their own unique advantages and that the life industry must protect its own. Of course, the fear is that the life insurers' role as money managers will dwindle, because much of their investment funds will no longer be captive.

While such a consequence is certainly possible, those who fear the results of such competition should assess the present consequences of failure to compete with outside institutions. The life insurance industry instead competes with itself and this has fostered problems that hurt its profitability and plague its image. Dubious sales illustrations have allowed marginal companies to gain sizable market shares and have established unreasonable policyholder expectations. Large front-end commissions have prevailed, even with little new or sustainable premium. Excessive expense structures have been allowed to persist even though the growth in premium and volume have not been sufficient to support them; meanwhile, profit margins have weakened and surplus ratios have shrunk throughout the 1980s. Aside from the limited presence of VL and VUL, the life insurance industry has retained most of the CVLI investment control and charges the policyholder for it. One could make a case that the industry has done more to serve its employees and agents than its customers.

But while the industry maintains its monopoly over CVLI, it does not have a monopoly on retirement savings, for which CVLI is only one vehicle. The diminishing role of CVLI in securing retirement savings suggests that this product needs to be improved and that the life insurance industry needs to provide more vehicles that are in the public's favor (for example, mutual funds). If the public is funneling more and more money into mutual funds, then the life industry should offer more of these.

The greater competition that an SL/IDBA environment would stimulate would quickly diminish the roles of many insurers, particularly among the smaller ones. But this is already occurring, with the tightening of rating agencies' criteria, RBC requirements, and agents' and customers' flight to quality. Perhaps the new environment would accelerate forces already under way. At the same time, a great opportunity would exist for companies to market their investment capabilities and develop new products that could revitalize the public's interest in CVLI. Those companies that are successful may be much better off in the future than they would have been with the status quo. Therefore, a redistribution of wealth would be expected within the industry, with greater speed and perhaps to greater extent than is already occurring. Such redistribution of wealth, while painful for some, is inevitable to some extent and probably necessary for the vitality of the industry.

In summary, the life insurance industry should take a close look at its navigational equipment and determine whether its ship is on course, off course, or lost at sea and perhaps taking on water.

Will Agents Sell It? and Will the Public Buy It?

The public certainly accepted UL quickly, and it has earned its place alongside traditional WL. UL brought to policyholders the indisputable advantages of premium flexibility and the open display of its policy components. All this happened even though agents, and companies underwriting the products, were somewhat less than thrilled. For the agents, UL commissions have not quite stacked up to traditional commissions, either in first or renewal years. For the companies, UL's uncertain premium and agents' traditional commission structure presented pricing problems. Still, in light of the product's unique advantages to policyholders, resisting UL would have required a great deal of courage and conviction, especially because its sale became so widespread. Most companies that offer WL today also offer UL or, if not, some form of interest-sensitive WL with an "unbundled" structure.

Does SL/IDBA also offer the public clear advantages over the present universe of products? If greater freedom of choice and greater control over how a portion of long-term savings are invested mean anything, then the answer should be a resounding "yes." SL/IDBA may be the key that unlocks the full potential of policyholder investment control that VL has brought in a limited form. VL and VUL have been shackled with too few funds, too narrow a distribution channel, and too much administrative and filing time and expense to have the impact that we might have expected. With the tremendous growth in mutual funds over the past decade, it is quite surprising that variable life sales have remained relatively flat at about 5% of all ordinary life purchases. Does it make any sense that most CVLI policies are less than 5% backed by common stocks, while the corresponding figure for private pension plans is roughly 50%?⁵ Is the life insurance industry missing the beat by focusing on short-term equity rather than long-term value?

Of course, only an open market can determine the real demand for a currently unavailable product. But does there have to be a minimum threshold of market demand to justify the products' availability in the first place? The regulatory framework required to launch such a product is already in place, so the real risk, if any, is with companies that make product development, marketing, and administrative investments in this new product

⁵Ibid.

arena. Therefore, the question of whether agents will sell it and the public will buy it is best left for the market to answer.

There is probably little that the industry's agents can do to successfully stop the products' introduction or advancement, assuming some measurable demand surfaces. I think that this will be the case, in spite of the agents' powerful lobby, simply because such a position is indefensible. What would their argument be? That too much investment freedom hurts the policyholder? Or that they will have to work harder just to earn the same compensation? Those are hardly the foundations of a strong case, especially when many new selling opportunities will become available to agents in such an environment.

While they may not be able to stop it, agents could do a great deal to incorporate the new product form into their sales repertoire. Agents should be able to refocus their sales pitches to emphasize the generic advantages of CVLI and then select from a greater array of vehicles to suit a particular client's needs and desires, with less reliance on a single page of numbers that may be largely dependent on one particular company's assumptions. Compensation will undoubtedly settle wherever the market takes it, that is, at whatever levels insurers, agents, and customers can peacefully coexist. But because the SL and IDBA products can each be sold by different agents and because each product is somewhat unique compared to existing products, traditional commission structures are more likely to be replaced by new ones.

IV. SUMMARY AND CONCLUDING THOUGHTS

Numerous potential ramifications of SL/IDBA have been touched upon throughout this paper. The key points, both pro and con, are restated below.

Pros

1. Traditional WL sales are down; SL/IDBA should rekindle sales of CVLI through diverse new product offerings and wider distribution of VL types of products.
2. Profitability is down, and risky investments persist. SL products may boost profitability through less risky policy loans, lower acquisition costs, better premium persistency, and better policy persistency due to less policyholder incentive to replace them.
3. SL/IDBA will facilitate more investment of policyholder funds in common stocks, equity funds, or other investments more suited to or preferred by a particular policyholder.

4. SL/IDBA allows policyholders to diversify their equity among two or more companies, reducing the risk that they won't have access to their funds.
5. SL products are not exposed to run or liquidity risk.
6. SL products will have more predictable dividend scales, which should lead to more credible illustration assumptions.
7. SL/IDBA will provide a mechanism for relaxing CVLI nonforfeiture requirements, but only at the option of the policyholder.
8. Compensation restructuring is likely, possibly resulting in less compensation per sale, more asset-based compensation, and less agent incentive to replace IDBAs.
9. Separating the mortality and investment components will promote more competition within the two areas, allow selective packaging of the components by both company and policyholder, and allow selective unpackaging (replacement) of unwanted components.
10. The SL product will facilitate assumption reinsurance transactions and provide a tool for RBC repositioning.
11. SL/IDBA may help secure an untaxed future for the inside buildup of CVLI by letting banks and mutual fund companies participate in its benefits, thereby increasing the base of its defense.
12. The insurance industry may regain the confidence of its many publics by endorsing a new product line that benefits them more directly than itself.
13. Most of the pieces (that is, the products and related laws) necessary for launching the SL/IDBA product concept are already in place.

Cons

1. The product concept is more complicated than traditional CVLI or UL, because the responsibility of investment falls on the policyholders' shoulders. Therefore, it is not appropriate for everyone.
2. Administration will be complex; recordkeeping, billing, and reporting requirements must be split and shared between the SL and IDBA writers.
3. Too much investment freedom for the policyholder may result in imprudent investments and reduced surrender and death benefits for many policyholders.
4. Even though the SL product may be more immune to replacement, IDBA policyholders may be targets of agents who focus on replacement activity or push more speculative investment funds.

5. The product will require a significant, though singular, change in the tax code and therefore must be viewed by Congress as having generic advantages and being, at worst, revenue-neutral.
6. The insurance industry may be more vulnerable to having the inside buildup taxed sometime in the future if this buildup no longer exclusively lies within the insurance domain.
7. Insurance companies will no longer be assured the investment component of a WL contract, and many companies will lose money under management to outside institutions. Such companies will likely have to downsize their operations to remain profitable.
8. Agents may resist the product because it threatens to reduce their compensation or refuse to sell it because of perceived compensation inequities relative to other products.

The potential impact of SL/IDBA can be summarized in the following way: Pure competition among insurance companies and insurance products will increase, benefiting the consumer. However, such increased competition may, for various reasons, be unwelcomed by the providers of CVLI insurance, namely, insurance companies and their agents. This reaction raises a fundamental question: Should any new product that offers to the public some clear and unique inherent advantages over existing products be withheld because current insurance providers fear the long-term ramifications of the new product? I believe the answer is "no," because insurance providers exist to serve the insurance public, not the other way around.

The history of UL provides a useful case in point. There is no question that life was easier for insurance companies and agents before UL. The transition has been difficult in the areas of pricing, administration, compensation, and regulation. But with the benefit of hindsight, we can now ask, "Are these or any other problems that UL has brought with it so severe that its path should have been blocked?" Perhaps those who would answer affirmatively are also those who would oppose the SL/IDBA concept.

Many of the claims or opinions I have presented in this paper about potential SL/IDBA profit margins, persistency, sales volume, and compensation can be substantiated only up to a point. All the research in the world will not conclusively answer any of these questions; only an open market can provide real answers. But how much harm will that open market bring? No company will be forced to provide it, no agent forced to sell it, and no consumer forced to buy it. But if many end up doing so, then it would indicate that there is indeed something in it for all of them.

The twenty-first century is rapidly approaching, and the world all around us is changing quickly and dramatically. Computer power and ingenuity have spawned many new, arcane financial products for which there has been great demand. The technological revolution has made complex electronic equipment commonplace, even in the household. Even simple television-watching threatens to enter another dimension. In light of our rapidly changing environment, the life insurance industry should insure that its flagship product, CVLI, is fit to compete in the years ahead. If not, the product and all those embracing it may be left behind. The process of overhauling it may not be simple or pleasant, but it may be necessary for long-term survival.

By way of analogy, consider a nation whose electronic stores sell combination TV/VCR units and stand-alone TVs and VCRs, but no jacks or any way of connecting them together. Given the relative complexity of VCRs and TVs, the addition of jacks and cables would appear to be a simple change that could unleash a whole new market. In fact, this enhanced scenario in the U.S. today has proven that combination TV/VCR units simply do not appeal to the public nearly as much as separate component systems that are easy to integrate. In fact, it is hard to imagine a market in which separate component systems would not be available.

Yet that is precisely where the life insurance industry stands today with its CVLI product. Could today's prepackaged CVLI be in the same relative position as the combination TV/VCR units in our hypothetical scenario, in sharp contrast to its ultimate, inferior position in the era of integrated components? In this age of booming information technology, is there not an opportunity here to create a better CVLI product?

DISCUSSION OF PRECEDING PAPER

GERARD G. SMEDINGHOFF:

Within the confines of the ivory towers of the insurance industry, Steven Reddy's concept of "Cash Value Life Insurance for the Twenty-First Century" sounds like the magic bullet that will allow the industry to make a great leap forward in the financial services arena. The SL/IDBA concept is most certainly clever, sophisticated, and even elegant. But to quote the guru of design engineers, Donald Norman, "If you think something is clever and sophisticated, beware—it's probably self-indulgence" [3]. Not self-indulgence on the author's part, but on behalf of the life insurance industry in general, which is still trying to push a product, CVLI, that should have gone the way of the eight-track tape player.

To his credit, Mr. Reddy conceived and wrote his paper from the proper starting point, that is, *tabula rosa*, by asking himself how he would design a new life insurance product without any of the current legal and industry constraints. But his new product design falls far short of what customers want because he accepts, almost by default, the CVLI paradigm that has dominated the industry for most of this century. This makes about as much sense as trying to strengthen the French military after World War II by restoring the Maginot Line.

The life insurance industry's future does not lie in (yet another) line extension of its outdated flagship product of whole life insurance. The next major innovation to transform the industry will not be a "new-and-improved whole life" or "whole life lite," but a dramatic paradigm shift along the lines of what Thomas Kuhn cataloged in *The Structure of Scientific Revolutions* [2]. And, if history is any guide, it most likely will not come from within the industry (just as IBM, with its army of R&D engineers, did not invent the personal computer), but from a deconstructionist mind in the spirit of Jacques Derrida or a corporate raider such as Michael Milken.

Mr. Reddy provides an excellent and detailed analysis of the gradual decline and the current state of the life insurance industry. But the conclusion he draws deserves further examination. Is the fact that the industry is in decline and on the verge of a dramatic consolidation (such as what occurred in the auto industry in the 1920s and in banking today) necessarily bad? Is the purpose of the life insurance industry to create value from the services it provides to its policyholders or to single-mindedly increase the total volume of CVLI sales?

As with so many other industries in the U.S. economy (such as the railroads), the recent decline in the life insurance industry—however unsettling it may be to those employed within it—represents a windfall to its customers. Just as customers benefited when the rise of the airlines was coupled with the decline of the railroads, customers are also now benefiting as the decline of the life insurance industry is coupled with the rise of the discount brokerage and mutual fund industries.

People do not need CVLI any more than they need buggy whips or record players. What they do need is the value they derive from these products and services. Rather than asking, “How can the life insurance industry increase the sales of CVLI products?” one should ask, “What services do life insurers provide that are of value to their customers and how can this value be increased?” Why did people buy CVLI during the 1950s and 1960s? What *value* did they derive from the purchase of these policies?

- There was little competition and innovation in the financial services industry in general and the life insurance industry in particular.
- Few investment options were available to the middle class, such as mutual funds, money market funds, discount brokers, and IRAs.
- Inflation was not a factor.
- People expected to work at the same job, stay married to the same person, and live in the same house for the rest of their lives.
- Many people held a cultural bias against wives working outside the home, and purchasing large amounts of life insurance was a means to protect against that possibility.
- Few companies had stable pension plans in place and the cash value in their life insurance policy was the only means of retirement savings for many people.

Now consider how many of these conditions hold in today’s economy. Given the vast array of financial products and services available to consumers, why would any rational person purchase CVLI? The only possible incentive is the tax deferral of interest on the policy’s accumulating cash value. And even this is an overrated feature because the tax will have to be paid eventually. Bundling a fixed long-term investment program with basic life insurance protection makes as much economic sense as the auto dealership that gives away a free TV with the purchase of a new car. Lots of people need new cars and lots of people need new TVs, but very few need both of them simultaneously. If it makes sense to couple long-term savings with insurance, why don’t we have cash value auto insurance and cash value homeowner’s insurance?

In fact, why would anyone pay more than the current value received from a product during the period of one's lower-income-earning years for the privilege of paying less than the value received during one's high-income-earning years? People buy cars, houses, and college educations on exactly the opposite premise. They reason: "I can't afford this right now, but if I borrow the money, I can gain the full use of it immediately while paying for it over time."

Why would any young person say, "I don't need to pay for all this life insurance right now. But if I divert funds from some things I could really use now, and pay more than necessary for this policy in advance, I won't have to pay as much when I'm older, my income is much higher and I can afford it much more easily."

Life insurance companies offer two basic services to the public: (1) protection against the loss of one's future earnings via the basic life insurance policy and (2) a guaranteed return on invested funds via an annuity's or life insurance policy's cash value accumulation. The cost of the insurance portion of the policy premium is essentially the same, regardless of whether one buys term or CVLI. The only difference is in internal policyholder accounting.

The investment service offered by life insurers via CVLI requires further examination. Essentially there are four categories on the personal investment scale, starting with the highest risk-reward balance and proceeding to the lowest:

- Invest in oneself or one's own business.
- Use the advantages of size and proven market acceptance to reduce the risk by investing in a larger business that has proven itself in the marketplace by buying shares of its stock.
- Further reduce investment risk via diversification—for example, buying shares in a mutual fund, which spreads the investment risk over many different companies.
- The lowest risk-reward trade-off is the domain of life insurance companies. It involves forgoing most of the rewards of the expanding economy in exchange for a guaranteed return on funds invested. This is the service life insurance companies provide to the investing public, but only via the bundled and convoluted product of CVLI.

Is there any reason that, for an insurance company to provide this valuable service in the domain of the fourth category of personal investing, it must be bundled with a life insurance policy? Banks already offer this service as a stand-alone product. Once the Glass-Steagall Act is finally laid to rest,

why can't life insurance companies do the same? This is where insurance companies should ultimately concentrate their product development efforts.

This is another point at which Mr. Reddy's proposal departs from the value principle. When designing changes to the obsolete legislation regulating the life insurance industry, he implicitly asks the question, "How can Congress best rewrite the laws so the life insurance industry can sell more CVLI at higher profit margins and return to its glory days of the past?" [No one wants Congress to regulate the telecommunications industry on that basis.] Instead he should be asking questions such as, What is the ultimate purpose of insurance regulation? Why isn't the current regulation serving that purpose? And if all the current legislation were immediately discarded, how should the life insurance industry be regulated?

No matter how one wants to redefine the life insurance industry, there are two facts that cannot be ignored when envisioning possible future scenarios: (1) information costs—the cost of comparing product offerings from different companies—will ultimately be driven to near zero and (2) transaction costs—the basic cost of exchanging money for products and services—will ultimately be driven to near zero. To predict the future of the life insurance agent, one need only look at its close relative, the travel agent, who is already on the endangered species list.

Why call a travel agent to find the best flight from city A to city B when you're carrying a copy of the *Official Airline Guide* in your travel bag? And why book a flight through a travel agent when you can buy your tickets online and bypass the agent's commission? By now many people are aware that Mother's Day no longer holds the record for peak phone usage. This honor belongs to random weekdays during the summer months when airline fare wars break out and computers, programmed to arbitrage airline tickets, dominate the phone lines [1]. The evolution—or more accurately, the decay—of commissions of travel agents has closely mirrored that of life insurance agents. And there's no reason to believe that the course of their fates will diverge in the future.

Ignoring, for the moment, the past, present and potential future of the life insurance industry, the SL/IDBA concept immediately triggers an alarm from a generic design perspective. Again, to his credit, Mr. Reddy draws an appropriate and timely analogy of TVs and VCRs. But from a marketing and customer perspective, two sentences in particular signal that the SL/IDBA product is too complicated for most consumers and needs to be redesigned:

- The author admits that “The SL product is appropriate only for those who understand the contractual differences, the ongoing policyholder responsibilities, the investment risks and all the potential tax effects.” Not only does this restrict the potential market for this product to a minuscule percentage of the population, but one wonders how many actuaries can be qualified as potential responsible prospects. How many VCRs would have been sold if all potential buyers had to prove that they were capable of setting the clock and pre-recording programs in advance?
- In an effort to unload as much responsibility from the insurer onto the buyer, Mr. Reddy advises that, “At a minimum, a signed statement acknowledging the policyholder’s duties and the general consequences of failure to invest the funds or poor investment performance will probably be necessary.” Wouldn’t any investor who was that knowledgeable and sophisticated have many more attractive investment alternatives than a newfangled CVLI product? And how much CVLI would have been sold in the past if all customers had to sign a statement saying they completely understood the dividend illustrations and the risk that their “vanishing premiums” might end up as “vanishing promises?”

The potential market for any new product or service can quickly be judged by a simple test developed by Jack Welch, the CEO of General Electric, who says of any idea, “If you can’t explain it to a stranger at a cocktail party, forget it!” One suspects that most people would find the eight steps of the SL/IDBA sale listed under “The Product Mechanics” to be more intimidating than resetting the clock on their VCR to daylight savings time and impossible to explain at a cocktail party without running the risk of destroying a long-term relationship.

Finally, one last case study emphasizes the hard lesson that the life insurance industry is about to learn—unfortunately, the hard way. Throughout the 1980s, IBM marketed the personal computer with the goal of keeping it separate from and protecting its dominance of the mainframe computer market. Back in the mid-1980s, while IBM was posting record profits, Bill Gates is rumored to have said that IBM would cease to exist in seven years.

While IBM hasn’t gone out of business, in 1992 its CEO was fired, its stock lost more than half its value, and it now employs about half as many people as it did ten years ago. Should the life insurance industry cling to the archaic concept of CVLI, it will one day wake up to find that start-up competitors have grabbed its customers and have created a new market that

shuts them out and turns the most valuable assets on their balance sheets into waste that will have to be dumped into a landfill.

REFERENCES

1. DYSON, ESTHER. "Fare Games," *Forbes*, 25 May 1992, 258.
2. KUHN, THOMAS S. *The Structure of Scientific Revolution*. 2nd ed. Chicago, Ill.: University of Chicago Press, 1970.
3. NORMAN, DONALD. *The Design of Everyday Things*. New York, N.Y.: Doubleday, 1990, p. ix.

(AUTHOR'S REVIEW OF DISCUSSION)

STEPHEN D. REDDY:

I thank Mr. Smedinghoff for taking the time and effort to critique this paper. In his discussion he makes several interesting observations. However, I have to take issue with several statements he makes and objections he raises, which I do in the following paragraphs, generally in the order that they appear in his discussion.

Mr. Smedinghoff gave me credit for writing the paper "tabula rosa ... without any of the current legal and industry constraints." I don't deserve that credit, because I did quite the opposite. I tried to envision a new generation of products that could easily spring to life within the existing insurance and tax legislative framework. Rather than examining all the issues tangent to CVLI, such as the justification of tax-deferred treatment or the desirability of minimum nonforfeiture values, I attempted to pursue a pragmatic improvement to the generic CVLI product *given* its surrounding environment. I discussed those tangential issues only to the extent necessary to explore the product idea itself and to assess the likelihood of surviving the environment to which it would be exposed. Take for example, the tax-deferred treatment of the cash value buildup. My mission was not to justify its continued existence, but rather to put forth reasoning that tax-deferred treatment is as justifiable and probable for the new product form as it is for current forms.

Mr. Smedinghoff states that the "new product design" falls far short of what customers want and that the next major innovation to transform the industry will be a "dramatic paradigm shift." I'm not sure what Mr. Smedinghoff has in mind in either case, but I would argue that SL/IDBA gives

consumers more of what they want, that is, much greater investment freedom within the CVLI package, and that it does represent a dramatic paradigm shift. It would certainly be as dramatic a change as variable life and universal life were, if not more so. I also doubt that many would characterize SL/IDBA as another “line extension” of CVLI, and I would expect some challenges from lawmakers that the separate SL and IDBA products cannot be considered as CVLI for tax purposes.

Mr. Smedinghoff then states that “the conclusion he draws deserves further examination.” I did not draw any conclusion. I simply suggested a product change that has the potential to remedy many specific problems with CVLI today.

Mr. Smedinghoff has apparently inferred that my primary objective was to propose a product that would “single-mindedly increase the total volume of CVLI sales.” Increasing sales was only one of 13 benefits that I suggested could result from the introduction of SL/IDBA. While Mr. Smedinghoff may not think that increased sales alone is a worthy objective, I would still like to know what he, and others, think about the other potential benefits I have discussed.

Then Mr. Smedinghoff poses a fundamental question. “Why would any rational person purchase CVLI?” He responds with: “The only possible incentive is the tax deferral of interest on the policy’s accumulating cash value. And even this is an overrated feature since the tax will have to be paid eventually.” This response to his own question perhaps sums up his dim view of what CVLI has to offer and furthers the idea that CVLI is not worth saving.

In my view, Mr. Smedinghoff is grossly underestimating or misunderstanding, or both, the value that CVLI brings to consumers. First, the statement that the only possible incentive is the tax deferral is completely false simply because there are several other incentives, some of which I mention below. Unfortunately, Mr. Smedinghoff compounds his error with his next statement, that the tax deferral is overrated because the tax must eventually be paid. Most people would agree that tax deferral is a significant advantage worth seeking. In fact, the whole 401(k) and IRA markets are built around that tax advantage, even though the tax must eventually be paid. However, CVLI offers a further advantage that those other vehicles do not, namely, that the tax *doesn’t* ever have to be paid if the policy is held to death. That’s right! Life income proceeds are federal income tax free at death! The fact that death benefit proceeds are subject to estate taxes is irrelevant—so are

all other assets held at death, including any 401(k) and IRA funds that would have been previously taxed upon distribution.

Also, consider the fact that upon surrender of the policy the taxable gain is calculated using the entire CVLI premium, including the term portion, as the basis of the policy. Contrast this with a “buy term and invest the difference” strategy. Try deducting your term insurance premiums from the gains in your side fund and see how far you get with the IRS! With CVLI, the tax benefit at surrender could be like getting a third of the (term) insurance premiums back!

Another significant advantage of CVLI is the ability to tap the policy’s equity, via policy loans, without negative tax consequences. With loans, a policyholder can effectively get at the inside buildup, including the tax-deferred excess interest, without any tax consequences. Furthermore the loan advances once again become tax free if the policy is held to death. Loan capacity in 401(k), IRA, or other investment vehicles is much more limited, if permitted at all, and not as tax advantaged.

Mr. Smedinghoff then argues that young people would be foolish to over-pay for CVLI when at the same time they stretch out their payments for cars, houses, and college education. Actually the sellers of those three items all require full and immediate payment, even though the items’ value is realized over time, whereas life insurers at least offer the flexibility of spreading payments out over the life of the policy. Borrowing is simply a means for people to solve their cash-flow problems, and it is certainly as applicable to purchases of CVLI as other tangible items. In fact, the built-in policy loan provisions of a CVLI contract make the borrowing process a lot simpler than buying a house or a car.

Mr. Smedinghoff makes the assertion that insurance companies should concentrate their product development efforts on offering investment products on a stand-alone basis, like banks. This paper essentially proposes that, but within the context of an unbundled CVLI product in which IDBA products could take on many different forms. For all the reasons mentioned above, the IDBA products sold in this context would represent more value than those sold on a stand-alone basis.

Mr. Smedinghoff stated that I “should be asking such questions as: What is the ultimate purpose of insurance regulation? Why isn’t the current regulation serving that purpose? ... How should the life insurance industry be regulated?” Quite frankly, I have no interest in addressing those questions. Someone else who does have an interest, perhaps Mr. Smedinghoff, can tackle those issues.

I believe Mr. Smedinghoff's comments about information costs and transactions costs being driven to near zero are right on the money. However, while this may present problems for the life insurance agent, it should work to the advantage of the SL/IDBA products because the commission and administrative costs of each should come down over time, including the cost of administering the integration of the two products.

Mr. Smedinghoff states that the product may be too complicated for most prospective buyers and that requiring a signed statement acknowledging policyholder duties is evidence of that. I disagree. There is no question that some will not be able to grasp the essentials of the concept. However, for most, the concept of SL/IDBA should be as easy to grasp as the integration of TVs and VCRs, even if certain details, such as setting the clock, still prove troublesome. Other financial instruments such as mutual funds, variable life products and annuities, and IRAs all have complexities and features that can and do get misunderstood. My suggestion to require a signed statement was not an attempt to shift responsibility from insurer to the buyer, but rather a simple attempt to eliminate some sales that should never take place.

Then Mr. Smedinghoff argues that those who are knowledgeable and sophisticated enough would have many more investment alternatives than a "newfangled CVLI product." To say this is to miss the whole point of the paper, which was to make many more attractive investments available within the purchase of a life insurance product!

I agree with Mr. Smedinghoff's assertion that a new idea must be simple enough to explain at a cocktail party. Fortunately, it passes that test, because I already have (one could sum it up as simply "buying whole life and investing the difference"), but the reader must realize that a cocktail party and the SOA *Transactions* are two different forums and thus require different levels of detail. My original draft did not include the section on the "The Product Mechanics," but the Papers Committee required that I dot the 'i's and cross the 't's in describing the concept, which increased the paper's length by more than 50%. Hopefully, the length of the paper does not discourage many readers from giving the paper a look and the concept some consideration.

Mr. Smedinghoff concludes with a dire prediction of what will happen if the life insurance industry clings to the "archaic concept of CVLI." I wouldn't go quite so far. However, my paper addresses a myriad of problems with the present form of CVLI, which are perhaps strong evidence that such present form is somewhat outdated or in need of an overhaul. I believe the

SL/IDBA concept goes a long way in remedying some of the present problems and offering a more suitable CVLI product for the present times.

I thank Mr. Smedinghoff for his time and thoughts. While I share some of his sentiments about the condition of the life industry, I think he incorrectly dismisses CVLI as either beyond repair or not worth fixing. I would have preferred to have seen more comments on the likely impact of SL/IDBA should it be implemented.

That will have to be left for the actuarial community at large. While critiquing the paper is not that important, critiquing the product concept is, because there are too many problems and too much change around us to rest with the status quo. I just hope that the actuarial community will be proactive in its judgment and not wait for momentum to gather before it gets involved.